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ARTICLES

INSIDER TRADING: BUILDING CHINESE WALLS IN INDIA

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This paper examines the "Chinese Walls" defence to insider trading, under the SEBI (Prohibition of Insider Trading) Regulations, 2015. The paper examines the history behind Chinese Walls, as a means of preventing conflicts of interest in financial markets, and its more recent application to insider trading regulation. It breaks down the written form of the defence in the SEBI regulations, focusing on how it is to be established. To this end, the paper navigates foreign case law and regulations, given the dearth of regulatory and jurisprudential guidance in India in this matter. Based on this review, the paper outlines recommendations for organisations that wish to establish or evaluate their Chinese Walls. This lends itself to multiple commercial structures, such as private equity investments, lending arrangements, and to managing risks for financial intermediaries.

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I. INTRODUCTION

Companies and business organisations usually comprise several different departments, nevertheless, they are regarded as an independent entity by law. This includes intermediaries such as securities firms which, as a commercial reality, need to undertake comprehensive business through multiple departments so as to improve their market competitiveness. This causes conflicts of interest, and in case of listed companies and associated organisations, gives rise to concerns of insider trading.[1] Indian securities regulations prohibit the offence of insider trading, which is committed when a person who "possesses" unpublished price-sensitive information ("UPSI") relating to securities of a public listed company traded in securities of such company. The trigger for the prohibition is the "possession", which need not rise to 'use' of the information.[2] The policy objective for this measure is to ensure that securities trading occurs on a "level playing field". In other words, it seeks to prevent an insider from possessing an unfair advantage over public investors arising out of the mere possession of UPSI, known in the context of insider trading as 'information asymmetry'.

It follows that possession of UPSI while trading is presumed to amount to insider trading.[3] Notwithstanding, the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015 ("Insider Trading Regulations") provide certain defences to the presumptive charge of insider trading. These defences are crafted to establish that parity of information existed between the parties to a trade. For instance, it is a valid defence that the trade was *inter se* promoters who possessed the same UPSI.[4] The use of "Chinese Walls" is another defence that is available to non-individual insiders, whose constituent members may possess UPSI. It represents a self-enforced informational barrier consisting of systematic, as opposed to ad hoc, procedural and structural arrangements designed to stem the flow of information in such organisations.[5] Chinese Walls can be used by such organi-

[1] *See* Huang Hui, "Chinese Wall System in Large Finance and Market Institutions" (China Daily Blog, 19 July 2013) <http://blog.chinadaily.com.cn/blog-1158878-11377.html>

[2] Under the "possession" standard, there is no requirement for regulators and courts to identify that trades in question were motivated by UPSI. *See generally* Schoen K., "Insider Trading: The Possession Versus Use Debate", (1999) 148 U Pa L Rev 239.

[3] Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015, S. 4(1); Gazette of India, Pt. III S. 4 (15 January 2015) [hereinafter "2015 Regulations"].

[4] To claim this defence, the transaction must be undertaken off-market and the promoters must prove, (a) that they each made a conscious and informed trading decision; and (b) that they did not breach Regulation 3 of the Insider Trading Regulations, by communicating UPSI to each other (i.e., to ensure that both possessed the same UPSI); *Ibid*., S. 4(1)(i) r/w S. 3.

[5] Harry McVea, *Financial Conglomerates and the Chinese Wall: Regulating Conflicts of Interest* (1993) 123 [hereinafter "McVea"]. For other representative works on Chinese

sations to demonstrate that its members who possessed UPSI were different from the ones that made the trading decision on behalf of the organisations, this 'walls in' the UPSI, and demonstrates that the trade was not motivated by UPSI. These mechanisms are important tools to prevent the flow of confidential information, and consequently, prevent conflicts of interest and protect the organisation from committing insider trading.[6]

In this light, the article examines the scope of this defence by focusing on how it is to be established. Part II traces the origins of the defence and its usage as a tool to prevent conflicts of interest and insider trading. Part III breaks down the written form of the defence in the Insider Trading Regulations to offer clarity of the current position in India. Against this threshold and standard, part IV examines the components necessary for a trader to prove to establish this defence based on foreign case law and regulations. Moreover, the analysis in Part IV seeks to guide persons who wish to establish, or evaluate their, Chinese Walls. It demonstrates how Chinese Walls can be established by adopting certain strategies, such as physical separation of different departments, restricted access to IT servers, security restrictions, adopting formal codes of ethics, monitoring procedures, and disciplinary sanctions. Part V contains concluding remarks and summarises the key recommendations of the article for practitioners and academics alike.

II. Origin of the Chinese Walls Defence

In spite of the nascence of this defence under Indian securities law, the Chinese Wall defence traces its origins to a regulatory action taken against Merrill Lynch in the 1960's.[7] In an administrative action against Merrill

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Walls, *see* Ralph C. Ferrara, *et al.*, *Ferrara on Insider Trading and the Wall*, Chs. 9-10 (2nd edn., 2001); Martin Lipton and Robert Mazur, "The Chinese Wall Solution to the Conflict Problems of Securities Firms", (1975) 50 NYUL Rev 459; Norman S. Poser, "Chinese Wall or Emperor's New Clothes? Regulating Conflicts of Interest of Securities Firms in the US and the UK", (1988) 9 Mich YB Int'l Legal Stud 91.

6 Roman Tomasic, "Chinese Walls, Legal Principle and Commercial Reality in Multi-Service Professional Firms" (1991) 14 UNSW L J 46, 47 [hereinafter "Roman Tomasic"]: Conflicts of duty and interest problems can often be traced back to the law of agency and to the fiduciary duties of professional advisers. In a partnership context, these problems are accentuated as the knowledge of one partner is deemed to be known to all other partners and that, even where information relates to another client of the firm, a partner is required to make available to the other client all material information that is known to the partner, and which might assist that other client.

7 *Merrill Lynch, Pierce, Fenner & Smith Inc.*, *In re*, 43 SEC 933 (1968) [hereinafter "Merrill Lynch"]; Stanislav Dolgopolov, "Insider Trading, Chinese Walls, and Brokerage Commissions: The Origins of Modern Regulation of Information Flows in Securities Markets" (2008) 4(2) J of L Econ & Pol'y 311 [hereinafter "Dolgopolov"].

Lynch, the Securities and Exchange Commission ("SEC") considered the fact that Merrill Lynch had undertaken to adopt, implement, and ensure compliance with revised procedures to provide more effective protection against the disclosure of confidential information.[8] In this case, the underwriting division of Merrill Lynch came into knowledge of material confidential information about Douglas Aircraft Co, Inc. The firm's brokers selectively disclosed this information to institutional investors, who then used this information to trade in Douglas securities through accounts with Merrill Lynch. This case was settled with Merrill Lynch agreeing to implement a policy restricting internal movement of material information available with its underwriting division regarding listed securities, except to senior-executives on a "need-to-know" basis. In effect, this statement of policy was the first formal Chinese Wall in the securities industry.[9] Pursuant to this, other financial institutions employed Chinese Walls on a voluntary basis as a practical method of avoiding insider trading issues. Eventually, this was codified into the already ratified American Securities Exchange Act, 1934.[10]

In 1974, the Chinese Walls defence was applied in a unique context in *Slade* v. *Shearson, Hammill & Co. Inc.*[11] The trading division of the defendant, Shearson, Hammill & Co. ("Shearson") recommended its clients to buy stock of a listed company at the same time when its investment banking division was aware of negative information about the listed company. The stock price of the company fell, and the customers of Shearson's trading division suffered losses. The customers sued Shearson for recommending the stock, despite Shearson possessing the negative information through its investment banking division. This was alleged to constitute a breach of the Shearsons' fiduciary duty to its customers. Shearson took the position that a Chinese Wall prevented the flow of information to the trading division, which was rejected by the trial court. The Court noted that an investment banker had a duty not to reveal inside information. Simultaneously, the Court observed that because Shearson voluntarily entered into a fiduciary relationship with its investment banking customers, it could not recognize its duty to its investment bank clients while ignoring its duty to the stock investing retail clients, and it had to bear whatever commercial disadvantage each obligation entailed. Judge Carter opined,

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8 *Ibid*.

9 Lynch (n 7); the decision is often considered as the impetus for the creation of Chinese Walls within financial intermediaries; Dolgopolov, (n 7) at 187. *See also*, McVea, (n 5), at 124 ["The idea of (informational) segregation was first mooted in the Merrill Lynch Statement of Policy"].

10 Securities Exchange Act of 1934; added pursuant to the (US) Insider Trading and Securities Fraud Enforcement Act of 1988, S. 15(f).

11 See, 517 F 2d 398 : (1973-1974) Fed Sec L Rep (CCH) [94],[329] (SDNY 1974).

> *"To require organizations like defendant's to refrain from effecting transactions in securities of companies about which they have learned adverse inside information may be to render it exceedingly difficult for any such organization to function as an investment banker for a company and at the same time function as a broker dealer in that company's securities. On the other hand, so long as such organizations continue to exercise a dual function, they incur dual (sometimes conflicting) fiduciary obligations which neither they nor this court can properly ignore."*

The defendant filed an appeal before the Second Circuit Court of Appeals. One of the arguments put forth by the appellants was that the Trial Court judgement would mean that an integrated securities firm with both corporate finance and broker-dealer departments "[*m*]*ust use non-public, investment banking information for the benefit of its public customers*". To this extent, the Trial Court's ruling was inconsistent with the current policy of prohibiting the use of such information. While the case was settled, it is worth noting that the SEC provided an *amicus curiae* brief to the Second Circuit, expressly supporting the use of Chinese Walls in securities firms. However, the SEC found that it could not completely prevent conflicts of interest. This could be solved by adopting a "restricted list", where, for instance, if one arm of the firm possessed confidential information relating to a company, that company would be black-listed for trading by the trading arm of the firm.[12] Such securities should be placed on the restricted list at the outset of the relationship, and before any inside information is actually obtained.

In the 1980s, the SEC continued to endorse Chinese Walls and reinforcement procedures as a mechanism for preventing conflicts of interest in multi-service financial institutions in insider trading actions. Some of these matters were settled with the institutions agreeing to review and adopt procedures and policies designed to prevent future violations.[13] In 1988, the United States promulgated the Insider Trading and Securities Fraud Enforcement Act, based on mounting pressure to tighten the law of insider

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12 *See generally* Larry L. Varn, "The Multi-Service Securities Firm and the Chinese Wall: A New Look in the Light of the Federal Securities Code" (1984) 63 Neb L Rev.

13 *See* Securities and Exchange Commission v. Drexel Burnham Lambert, Inc., (1989 Transfer Binder) Fed Sec L Rep (CCH) ¶ 94,474, at 93,026 (SDNY 1989); Securities and Exchange Commission v. Kidder, Peabody & Co., (1987 Transfer Binder) Fed Sec L Rep (CCH) ¶ 93,271 at 96,349 (SDNY 1987), Kidder, Peabody & Co. Inc., In re, Securities Exchange Act Release No. 24-543 (June 4, 1987); Securities and Exchange Commission v. First Boston Corpn., (1986-1987 Transfer Binder) Fed Sec L Rep (CCH) ¶ 92,712, at 93,465 (SDNY 1986).

trading, *inter alia*, due to the highly publicized *Boesky-Levine* case.[14] This Act required registered broker-dealers and investment advisers to establish, maintain, and enforce written policies and procedures "*reasonably designed to prevent the misuse of material non-public information*", i.e., Chinese Walls.

Across the Atlantic, the UK was reluctant to recognize Chinese Walls. In spite of the ability of Chinese Walls to restrict flows of information, [practitioners] considered Chinese Walls unreliable because they could not restrict the underlying conflict of interest themselves.[15] In an early case, a Chinese Wall was recognized with regard to conflicts of interest in the hands of a partner of a law firm who was representing the defendant in a legal proceeding, whose other partner had previously advised the plaintiff in the matter.[16] The Court rejected the plaintiffs request for an injunction on the basis that the Chinese Wall was considered sufficient to make it improbable that the solicitor would breach privilege.[17] In such cases, UK Courts have tested Chinese Walls on the 'probability' of information leakage, whereas US Courts have adopted the standard of 'possibility', which is a lower threshold test that is easier to prove.[18]

In *Prince Jefri Bolkiah* v. *KPMG*,[19] the House of Lords referred to Chinese Walls as the "*existence of established organisational arrangements which preclude the passing of information in the possession of one part of the business to other parts of the business*". These walls are usually characterised by a physical separation, internal policies to prevent leakage, permit and regulate transmission of UPSI only in certain specified instances and monitoring compliance with these requirements. The Court noted that Chinese

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14 Ivan F. Boesky v. Securities Litigation, 36 F 3d 255 (2nd Cir 1994); Securities and Exchange Commission v. Dennis Levine, 881 F 2d 1165 (2nd Cir 1989).

15 Norman S. Poser, "Chinese Wall or Emperor's New Clothes? Regulating Conflicts of Interest of Securities Firms in the US and the UK" (1988) 9 Mich YB Int'l Legal Stud 91, 120 [ref Department of Trade and Industry, Financial Services in the United Kingdom: A New Framework for Investor Protection (1985)].

16 Rakusen v. Ellis, Munday & Clarke, (1992) 2 QB 959 : (1992) 2 WLR 809 : (1911-13) All ER Rep 813, 831.

17 *See also*, *A Firm of Solicitors, In re,* (1991), New LJ, 746-747 [In this case, it was found that a law firm that had advised an insurance company for three years during which it had access to confidential information. This firm advising the party opposite this insurance company in a litigation closely related to the previous matter on which advice was sought. An injunction was granted by the court of first instance. It was confirmed in appeal since the information was highly relevant and there was a possibility that the information may have passed though the Chinese Wall].

18 *See* Tomasic, (n 6), at 47. US Courts have also considered that law firms should be given the opportunity to prove that information did not flow through the Chinese Wall; Analytica Inc. v. NPD Research Inc., 708 F 2d 1263 (7th Cir 1983).

19 (1999) 2 AC 222 : (1999) 2 WLR 215.

Walls are widely used by financial institutions in the City of London and elsewhere, as the favoured technique for managing the conflicts of interest, which arise when a conglomerate carries out financial business. It noted that the Core Conduct of Business Rules published by the United Kingdom Financial Services Authority recognise the effectiveness of Chinese Walls as a means of restricting the movement of information between different departments of the same organisation.

In 2000, the United Kingdom adopted the Financial Services and Markets Act, 2000 (the "FSMA"). With regard to the prohibition on insider trading under the FSMA, the UK Financial Conduct Authority provided guidance in the FCA Handbook. Code §1.3.3E and §1.3.5E of the FCA Handbook set forth guiding factors which the FCA considered to indicate that a person's behaviour is not 'on the basis of' inside information, including Chinese Walls in financial services organisations.[20] Section 118A(5) of the FSMA provides that a behaviour does not amount to market abuse if it conforms with a rule that permits such behaviour, such as Chinese Walls.[21]

Multiple agencies throughout the world, including the SEC[22], the International Monetary Fund[23] ("IMF") and the European Union ("EU") have called for Chinese Walls through legislation.[24] Against the backdrop of calls to prevent conflicts of interest in financial institutions, Chinese Walls are aimed to prevent the misuse of confidential information within an organisation.[25] They seek to separate those areas of the organisation which have routine access to confidential information, considered "*inside areas*"

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20 FCA Handbook (*Ibid*); Ss. 1.3.3-E and 1.3.5-E were deleted from the Code with effect from 3 July 2016.

21 MAR 2016 – safe harbours for "legitimate behaviour", e.g., Chinese walls. However, these safe harbours will not apply if the competent national authority establishes that there was an illegitimate reason for the relevant behaviour, transaction or order to trade. *See* Art. 9, MAR.

22 Corporate Securities Series (2006), "Letter from National Association of Securities Dealers" of June 21, 1991 specifies the need for Chinese Walls and general policies to mitigate insider trading and conflicts of interest, but does not specify the standards of such policies.

23 IMF Country Report (2012), Guidelines on Internal Control for Securities Companies states that companies must establish internal control systems.

24 Art. 9 of EU Regulation 596/2014 ("Market Abuse Regulation").

25 Christopher M. Gorman, "Are Chinese Walls the Best Solution to the Problems of Insider Trading and Conflicts of Interest in Broker-Dealers?" (2004) 9 Fordham J Corp & Fin L 472, 476; For example, the investment banking division of a financial institution should be segregating from its trading department. In this regard, the 1992 Regulations provide that such organisations prepare a restricted/grey list based on criteria such as whether the organisation is handling any assignment for the listed company, etc. [4.0] Restricted/Grey list.

from those which deal with sale, marketing, investment advice, or other departments, considered "*public areas*".

III. "Chinese Walls" under the Insider Trading Regulations

In India, the SEBI prohibited insider trading for the first time in 1992 under the SEBI (Prohibition of Insider Trading) Regulations, 1992. Originally, these regulations did not provide for Chinese Walls, either as a defence to insider trading or as a means to manage UPSI. Regulation 3B was introduced by an amendment in 2002,[26] which brought in the Chinese Wall defence into the 1992 Regulations. To establish this defence, Regulation 3B required an organisation to prove:

(i) that the decision to enter into the transaction or agreement was taken on its behalf by person or persons other than the officer or employee of the organisation that possesses UPSI; and

(ii) that the company has put in place such systems and procedures which demarcate the activities of the company in such a way that the person who enters into transactions in securities on behalf of the company cannot have access to information (including UPSI) which is in possession of other officer or employee of the company; and

(iii) it had in operation at that time, arrangements that could reasonably be expected to ensure that the information was not communicated to the person or persons who made the decision and that no advice with respect to the transactions or agreement was given to that person or any of those persons by that officer or employee; and

(iv) factually, the information was not so communicated and no such advice was so given.

In addition, the SEBI also recognized Chinese Walls as an internal mechanism to prevent leakage of information within organisations. These regulations required all listed entities in 2002 to place and maintain Chinese Walls under a code of conduct known as the "*Minimum Standards for the Code of Conduct to Regulate, Monitor and Report Trading by Insiders*".[27]

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[26] SEBI (Prohibition of Insider Trading) (Second Amendment) Regulations, 2002.

[27] 1992 Regulations, Schedule B, [2.4]. The SEBI Committee on Corporate Governance vide Notification DBOD No. BC. 112/08.138.001/2001-02 (04/06/2002) dated 4 June 2002, provided guidelines to financial institutions requiring nominee directors of such institutions to put up Chinese Walls between departments of the financial institution to whom he

These standards required the adoption of a Chinese Wall policy to separate areas which routinely have access to confidential information ("inside areas") from areas which deal with sale/marketing/investment advice, or other departments providing support services ("public areas"). Employees in the inside area shall not communicate any UPSI to any one in public area, and the organisation is required to physically segregate such employees. In exceptional circumstances, employees from the public areas may be brought "*over the wall*" and given confidential information on a "need-to-know" basis, and under intimation to the compliance officer.

Under the Insider Trading Regulations, the Chinese Walls defence is set forth in the following words:

"*(a) the individuals who were in possession of such unpublished price sensitive information were different from the individuals taking trading decisions and such decision-making individuals were not in possession of such unpublished price sensitive information when they took the decision to trade; and*

(b) appropriate and adequate arrangements *were in place to ensure that these regulations are not violated and no unpublished price sensitive information was communicated by the individuals possessing the information to the individuals taking trading decisions and there is no evidence of such arrangements having been breached*"[28]

The Chinese Walls defence, as articulated above, is multi-tiered and should be established in the following manner:

(i) it must be identified if any of the members of a corporate insider possess UPSI;

(ii) the corporate insider should establish that the individuals that took the trading decision were different from the members who possess UPSI, identified in the first step; and that appropriate and adequate arrangements were in place to ensure compliance with the Insider Trading Regulations and that, no UPSI was communicated by the persons individuals possessing UPSI, to the individuals who took the trading decision; and

(iii) lastly, there should be no evidence of such arrangements having been breached. This is not articulated as a step and it is not clear as to how this requirement is to be implemented. This cannot be treated as

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reports, and other departments which may be dealing in the shares of the company in the stock market.

[28] 2015 Regulations (n 3), Regulation 4(1) proviso, sub-cl. (ii).

something that the insider must prove, as it would require proof of a negative, particularly, when the SEBI heavily relies on circumstantial evidence such as telephone calls, common addresses, etc., to support findings of violations of insider trading regulation.[29]

In view of the above, the defence should be read such that once the first two steps have been established, the SEBI must carry the burden to prove that there is evidence of a breach of the Chinese Walls by such insider. If the insider satisfies the first two conditions, and the SEBI is unable to prove that the Chinese Walls failed, the defence must stand.

IV. What Constitutes "Appropriate & Adequate Arrangements"?

Under the Insider Trading Regulations, the SEBI may specify standards and requirements, from time to time, as it may deem necessary in relation to this defence but it has not done so.[30] In this light, this part analyses the defence, focusing on what constitutes "*appropriate and adequate arrangements*". In this regard, since there is no guidance yet from the SEBI or Indian jurisprudence, it is important to look at other legal regimes and draw principles as appropriate.

A. "Established" v "Ad Hoc" Arrangements

The Insider Trading Regulations do not clarify whether "*appropriate and adequate arrangements*" refer to Chinese Walls that traders have consciously established and become ingrained in the trading infrastructure, or also Chinese Walls created on an ad hoc basis. With respect to ad hoc arrangements, it may well be that there is effective physical separation between the persons who possess UPSI and the persons making the decision to trade.[31] In theory, this should satisfy the requirements of the Chinese Walls defence.

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29 In fact, SEBI recently considered the fact that two persons were friends on Facebook in an Insider Trading investigation; *Palem Srikanth Reddy, In re*, 2016 SCC OnLine SEBI 42; Armaan Patkar, "Insider Trading: When Does Information Become UPSI" (2017) 2(2) journal, page number?Plz Chk).

30 *Ibid.*, Regn. 4(3).

31 If a company invests in a company located in a different continent, and deputes a nominee director to the board of the investee company, there would be a physical Chinese Wall in effect, if the persons who make trading decisions on behalf of the investor company are located on the same continent as the investor company.

Nevertheless, pointing to a written policy has merit and helps prove that Chinese Walls existed in fact. The failure to consciously establish, document, supervise, and enforce Chinese walls based on written policies is likely to give rise to the perception that information flowed without restriction. This may be left open to rebuttal but being a negative fact, it is likely to be subjected to a high burden of proof.

The Chinese Walls defence in the Insider Trading Regulations closely follows Section 1043F of the Australian Corporations Act, 2001.[32] For this purpose, mere possession of information by an officer or employee of a body corporate will not initiate prohibition under §1043A of the Corporations Act, if:

(i) the decision to enter into the transaction or agreement was taken on its behalf by a person or persons other than that officer or employee; and

(ii) it had in operation at that time arrangements that could reasonably be expected[33] to ensure that the information was not communicated to the person or persons who made the decision and that no advice with respect to the transaction or agreement was given to that person or any of those persons by a person in possession of the information; and

(iii) the information was not so communicated and no such advice was so given.

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32 S. 1043-F provides that Chinese Walls are an exception to S. 1043-A (*Prohibited conduct by person in possession of inside information*). Note that in the context of conflicts of interest in law firms, Australian Courts had not clearly adopted a fixed standard as regards Chinese Walls. In some cases, Australian Courts favoured a liberal standard [*e.g.* Fruehauf Finance Corpn. Pty. Ltd. v. Feez Ruthning (A Firm), (1991) 1 Qd R 558] where the Supreme Court of Queensland found that a Chinese Wall had effectively insulated confidential information and that it was not "probable" that there was a conflict of interest and in others have favoured the stricter US standard [*See* Mallesons Stephen Jaques (A Firm) v. KPMG Peat Marwick, (1990) 4 WAR 357], where the West Australian Supreme Court found that Chinese Walls were difficult to implement, and it was not realistic for courts to completely rely on the Chinese Wall; further, even if the Chinese Wall could cut off the explicit information flow, it could not eliminate the implied information transmission, since certain attitude, facial expression, and even the avoidance to answer questions itself could actually transmit information. In general, the attitude of Australian Courts seems to be a cautious approach, paying close attention to specific circumstances of a case. *See generally* Hui (n 1).

33 Similarly, R.10-b5-l of the SEC refers to "reasonable" policies and procedures to be implemented, taking into consideration the nature of the person's business, to ensure that individual making the investment decision (i.e., authorised person) would not violate insider trading law.

In this regard, in *Australian Securities and Investments Commission* v. *Citigroup Global Markets Australia Pty. Ltd.,*[34] the Federal Court of Australia (FCA) held that Citigroup adequately established a Chinese Wall arrangement tested against five components outlined in the United Kingdom Law Commission's Consultation Report No. 124 ("Consultation Report"). This report outlined five components with which a company must comply within order to have adequately "established" Chinese Walls to deal with conflicts of interest and insider trading. This includes an educational programme to emphasise the importance of not improperly or inadvertently divulging confidential information, and strict and carefully defined procedures for dealing with situations where the wall is crossed.

In this case, Citigroup established a Chinese Wall between its investment banking and equities trading divisions. The Australian Securities and Investment Commission (ASIC) investigated Citigroup when its equities division acquired shares of Patrick Corporation Limited (PCL) at the time when its investment banking division was advising Toll Holdings (THL) on a proposed takeover bid for PCL. The shares were purchased on the last trading day before Toll announced its takeover bid. Further, when the investment banking division came to know about the purchase, it took certain steps to prevent its equities division from buying any more shares of PCL. ASIC challenged Citigroup's Chinese Walls and alleged that the knowledge of senior investment possessed by banking personnel was attributable to Citigroup. In this regard, the FCA noted that the effectiveness of a company's compliance programme is a crucial factor to be taken into account when determining allegations of insider trading. As such, the FCA then tested Citigroup's Chinese Walls against the five-component criteria under the Consultation Paper to hold that Citigroup adequately established a Chinese Wall arrangement. The success of Citigroup's defence in *Australian Securities and Investments Commission* v. *Citigroup Global Markets Australia Pty. Ltd.* is owed to the fact that the firm had an established set of arrangements and measures to regulate conflicts of interest, and the arrangements themselves were not limited exclusively to information barriers, but went to the root of Citigroup's code of ethics. It had instilled a culture and a series of checks and balances that prevented conflicts of interest and insider trading.

The Law Commission's consultation paper was also referred to in *Prince Jefri Bolkiah* v. *KPMG*. In this case, the Law Lords held that Chinese Walls require "established institutional arrangements" designed to prevent the flow of information between different departments. These cannot be set up

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[34] Australian Securities and Investments Commission v. Citigroup Global Markets Australia Pty. Ltd., (no. 4), 2007 FCA 963.

on an "*ad-hoc basis*" as and when a matter may arise. In this case, Prince Jefri Bolkiah – brother to the Sultan of Brunei and Chairman of the Brunei Investment Agency (BIA) – retained KPMG to undertake a substantial investigation in connection with a major litigation. Soon after the litigation settled, the government of Brunei began an investigation into the BIA and approached KPMG to assist it in this process. This assignment was adverse to the interests of Prince Jefri and was undertaken by KPMG without his consent. KPMG put in place an information barrier within its forensic accounting department and other such special arrangements were introduced to prevent disclosure of the Prince's confidential information. Any employees of KPMG that had access to confidential information relating to Prince Jefri were not permitted to work on the investigation. BIA work was done in a room with restricted access, and separate servers were used. Prince Jefri sought an injunction to restrain KPMG from acting in the investigation.

In granting Prince Jefri's request for an injunction, Lord Millett, with whom the other Law Lords agreed, held that unless special measures are taken, information moves within organisations. He noted that KPMG failed to show there was no risk of leakage of confidential information. A key factor that swayed the decision was that the information barrier was set up within a single department - forensic accounting. Furthermore, a large number of employees had worked for Prince Jefri and were then brought onto the new investigation.[35] In commenting on Lord Millett's judgment, Hollander and Salzedo view that "*the effect of an information barrier is... to treat different parts of the same firm...as though they were separate entities*."[36] Therefore, an effective Chinese Wall must be established within the organisational structure of the firm, and not set up *ad hoc* and dependent on the acceptance of evidence. Similarly, the EU outlines that that a legal person in possession of insider information must (a) establish; (b) implement; and (c) maintain "adequate and effective internal arrangements and procedures" to prevent a decision-maker from being influenced by insider information.[37]

Similar issues were raised in *Young* v. *Robson Rhodes (A Firm)*.[38] In this case, a Chinese Wall was erected as an ad hoc arrangement, created specifically to protect confidential information following the merger of two accounting firms. The ambiguity of the Insider Trading Regulations in clarifying whether established or ad hoc arrangements are more appropriate is reflective of the broader case-law discussion on this point. While *Prince*

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[35] Each team had rotating membership.

[36] Charles Hollander and Simon Salzado, *Conflicts of Interest* (Sweet & Maxwell 2008) 130.

[37] Art. 9 of EU Regulation 596/2014 ("Market Abuse Regulation").

[38] (1999) 3 All ER 524.

Jefri Bolkiah v. *KPMG* suggested the need for established Chinese Walls and the surrounding discussion points to the true merits of established Chinese Walls, the judgment in *Young* v. *Robson Rhodes (A Firm)* would imply that an ad hoc arrangement could be equally effective. The decision in *Marks & Spencer Plc* v. *Freshfields Bruckhaus Deringer (A Firm)* (2004) brought out the importance of efficacy that an ad hoc Chinese Wall may have in the given circumstances. As such, each instance should be judged on its own set of facts.[39]

Relatedly, as *Prince Jefri Bolkiah* v. *KPMG* held that an effective Chinese Wall is one that is established as part of the organisational structure of the firm, Laddie J. of the Chancery Division of the High Court identified that the crucial question is "*will the barrier work*?" In Laddie J's view, *Prince Jefri Bolkiah* v. *KPMG* established that the courts have the discretion to be satisfied with the effectiveness of the Chinese Wall in preventing leakage. He interpreted that Lord Millett expressed the opinion that Chinese walls that are enmeshed as part of the fabric of the institution are more likely to work than those put in place to meet a specific problem.[40] Laddie J. considered whether a Chinese Wall must form part of the institutional structure of a firm to be effective, but ultimately did not rule on this issue.

B. Type of Arrangements

Having concluded that Chinese Walls must be established institutional arrangements, it is now necessary to consider what constitutes "arrangements". As aforementioned, the Insider Trading Regulations are silent in detailing what kind of arrangements are appropriate and adequate. Foreign regulations are equally brief and it is therefore, necessary to turn to case law for guidance.

A *prima facie* reading of the case law presents that there is no definitive answer of what constitutes appropriate or adequate arrangements. In *Halewood International Ltd.* v. *Addleshaw Booth & Co.*, the Court emphasised the need for a "physical" separation arrangement.[41] However, in *Koch Shipping Inc.* v. *Richards Butler (A Firm)*, the Court deemed a "virtual" separation arrangement as appropriate.[42] In a similar vein to whether ad hoc or established arrangements are appropriate, a court would look to the

[39] (2004) 1 WLR 2331.
[40] Glenn Hall, "Are Chinese Walls Ever Effective?" 1999 ICCLR 278 [hereinafter "Glen Hall"].
[41] 2000 Lloyd's Rep PN 298.
[42] (2002) 2 All ER (Comm) 957.

efficacy of the arrangement – be it "physical" or "virtual" – in preventing insider trading and preventing the disclosure of UPSI.

In turning to *American Securities and Investments Commission* v. *Citigroup Global Markets Australia Pty. Ltd.*, Citigroup's defence succeeded as the firm had an established set of arrangements and measures that effectively regulated conflicts of interest. The arrangements themselves were not limited exclusively to information barriers, but went to the root of Citigroup's code of ethics. It had instilled a culture and a series of checks and balances that prevented conflicts of interest and insider trading. It is therefore, inadvisable to attempt to retrospectively prove that a Chinese Wall policy exists. Instead, a company should take proactive steps to implement a Chinese Walls policy and infrastructure which is enshrined in its company compliance programme. In this regard, the Federal Court of Australia (as the House of Lords did in *Prince Jefri Bolkiah* v. *KPMG*) turned to the Consultation Paper to outline five components of Chinese Walls:[43]

(i) Physical separation of the various departments to isolate them from one another;

(ii) An educational programme to emphasise the importance of not improperly or inadvertently divulging confidential information;

(iii) Strict and carefully defined procedures for dealing with the situation where the wall is crossed;

(iv) Monitoring by compliance officers of the effectiveness of the walls; and

(v) Disciplinary sanctions where there has been an improper breach of the wall.

However, the Consultation Paper provides little guidance as to what would constitute "a physical separation", the nature of "an educational programme", the degree to which a procedure is "strict and carefully defined for dealing with wall crossing", how a compliance officer would monitor "the effectiveness of the walls", and which kinds of "disciplinary sanctions" could be implemented as a result of a breach. Incidentally, the Hong Kong Securities and Finance Commission (SFC) Corporate Finance Advisor Code of Conduct ("the HK Code") considers the same five components under

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[43] *Ibid.*; It should be noted that Lord Millet's findings are supported by the Consultation Report, which contains rules designed to manage conflicts of interest within large multi-functional financial institutions. This may not be ready to simply apply to the Insider Trading Regulations.

the Consultation Paper as necessary to establish functioning and effective Chinese Walls, but moreover elaborates the scope of these components.[44]

C. Recommendations

Effective policies and procedures should be formalized and imprinted into the fabric of the organisation to demonstrate serious efforts to establish Chinese Walls. With this broad recommendation in mind, organisations may consider the following recommendations and guidance, based largely on the HK Code, and substantiated through the author's commentary.

First, the HK Code elaborates that "*Physical Separation*" should occur across all levels. Departments or teams working on conflicting matters should ideally work in separate buildings, and if not, at the very least in different sections of the office building. A company should ensure that visitors are accompanied at all times, that client meetings are only held in client meeting rooms, and where necessary, internal discussions on matters should not be conducted in shared office space. To facilitate the latter point, "Chinese Box" rooms should be set up in which access is limited to specific deal team members. With respect to physically separating information, separate, private and monitored information storage mechanisms and facilities should be put in place, which may also include locking up sensitive information. This may be complemented by "clear desk" policies for paper documents and the use of code names for projects and deals. Concurrently, a company's information technology infrastructure should mitigate conflicts of interest in the way that a literal physical separation would. A company could introduce a printing system in which an employee may only print documents which have been sent from their computers by swiping a personal access card on a control device on the printer. Moreover, the company could set up segregated computer drives for individual deal teams for each transaction with restricted access and password-protected filing systems. Emails and documents containing sensitive or confidential information could be encrypted.[45]

Secondly, though "*Physical Separation*" is a necessary feature, it alone is not sufficient to constitute an effective Chinese Wall. Chinese Walls are effective when they are backed by a formal written code of ethics, which

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44 Corporate Finance Adviser Code of Conduct's 4.3 (Sec & Futures Comm'n, October 2013) <http://www.sfc.hk/web/EN/assets/components/codes/files-current/web/corporate-finance-adviser-code-of-conduct/corporate-finance-adviser-code-of-conduct.pdf>

45 Hong Kong SFC Frequently Asked Questions for S. 4.3 of the Corporate Finance Adviser Code of Conduct (the Code).

each employee should read, understand, and contractually agree to obey.[46] An employee's true understanding and immersion in this regard may only occur when the formal written code of ethics is further delivered as an "*Educational Programme*" that goes to the core of a company's corporate culture. The SEC has weighed in, commenting how any Educational Programme should not be static or fixed. It should be regularly updated to reflect the evolving marketplace and changing corporate "good practice."[47] Given the technical knowledge required to deliver a successful "*Educational Programme*", it is advised that a company appoints a Compliance Officer to provide such a programme. This may ensure that the company's staff are properly trained on the relevant regulatory and legal requirements, and on the procedures and controls that the company has implemented to comply with those requirements.

Thirdly, a company's formal written code of ethics should outline "*Wall Crossing Procedures*". In particular, the circumstances in which and the process by which a Chinese Wall may be crossed by an employee,[48] in cases where inter-departmental co-operation and consultation is absolutely necessary.[49] Here too, a Compliance Officer may be instrumental. The Compliance Officer may set out uniform thresholds and criteria, which an employee must satisfy to have a valid ground to cross the wall. The employee may then serve a notice to the Compliance Officer, who in turn, may sanction disclosure of information "across the wall" at the Officer's sole discretion and full consent and on the need to know basis of the client. Such procedures facilitate a transparent process, create a level playing field for all employees in a company, and moreover limit the scope for "wall-crossing" to occur only when it is of utmost necessity for a client.

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46 Joint Memo on Chinese Wall Policies and Procedures, NASD Notice to Members No. 91-45 (21 June 1991).

47 Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Non-public Information, (1989-1990 Transfer Binder) Fed Sec L Rep (CCH) 84,520, at 80,627 (March 1990) [hereinafter "Broker-Dealer Policies"].

48 *See* S. 9, Insider Trading Regulations r/w Schedule B [Minimum Standards for Code of Conduct to Regulate, Monitor and Report Trading by Insiders Code of Conduct]. The minimum standards to be incorporated in codes under the Insider Trading Regulations include norms for appropriate Chinese Walls procedures, and processes for permitting any designated person to "*cross the wall*". Under the erstwhile SEBI (Prohibition of Insider Trading) Regulations, 1992, the code of conduct for prevention of insider trading provides for segregation of areas of the organisations which routinely have access to confidential information, from other areas. Further, in exceptional circumstances employees from the public areas may be brought "over the wall" and given confidential information on the basis of "need-to-know" criteria, under intimation to the compliance officer; *See* Model Code of Conduct for Prevention of Insider Trading for other Entities, and 1992 Regulations, S. 12 r/w Schedule I, Part B.

49 In such cases, information should be shared on a "need-to-know" basis.

Fourthly, a company should routinely review and evaluate the effectiveness of its Chinese Walls, so as to ensure that they reflect contemporary corporate "good practices" and continue to meet and mitigate the challenges insider trading and conflicts of interest pose. A company's appointed Compliance Officer should pursue "*Monitoring Procedures*" to test the effectiveness of the Chinese Walls in simulated situations. Pursuant to this, the Compliance Officer should submit an evaluation report to the board of the company and outline proposals for change, and subsequently carry out these proposals upon board approval. Moreover, as and when legislation is passed or amended affecting how to implement Chinese Walls, the Compliance Officer should take immediate steps to revise, and align the Chinese Walls of the company with the most up-to-date legislation.

Fifthly, where a company's Compliance Officer should implement "*Wall Crossing Procedures*", the Officer must concurrently enforce a set of "*Disciplinary Sanctions*" for those instances in which there has been an improper breach of the Wall. Primarily, an improper breach should result in the Compliance Officer reporting the breach to the relevant financial regulatory bodies. Thereafter, the trading licence of the breaching party could be revoked, the individual would then be subject to a disciplinary inquiry and hearing, and ultimately may be dismissed on grounds of unethical practices.

Sixthly, the Chinese Wall should be supported by reinforcement measures; no matter how carefully the Chinese Wall might be constructed, it could be breached.[50] "Restricted lists" *Slade* v. *Shearson, Hammill & Co. Inc.*[51] are useful reinforcement measures. This list must be maintained by the compliance department which then supervises securities trading by the firm and its employees and clients to investigate potential illegal trading. Securities of companies that the firm is dealing with should be added to the list as and when the engagement begins.[52] Note that it is important to keep this list confidential, as the presence of a security on the restricted list implies that there is material information relating to the securities. This may do more to reveal than conceal information.

Lastly, efforts taken under each of these policies and procedures must be thoroughly documented. This should include the standards applied for placing securities on the restricted list or removing them, the date, time and the person responsible for such placing or removal, records of inter-departmental

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50 *See* William Steward Arnold Martin v. William Hamilton Gray, 1990 SCC OnLine Can SC 41 : (1991) 1 WWR 705, 730-731.

51 See, 517 F 2d 398 : (1973-1974) Fed Sec L Rep (CCH) [94], [329] (SDNY 1974).

52 Firms may even consider placing securities on the list when pre-engagement discussions are ongoing.

communications and wall-crossings, and details of enquiries and actions taken when the compliance teams identify potential misuses of information. This must also include the date of investigation, security involved, accounts used for trading, a summary of proceedings, and other relevant information.[53]

V. CONCLUSION

Modern financial and market intermediaries have used Chinese Walls to prevent conflicts of interest among their different business departments for years. It also finds meaningful application in jurisdictions, which test insider trading on the touchstone of "possession" of inside information. However, this defence has yet to be used to its full potential in India; corporate insiders sometimes attempt to establish the Chinese Walls defence retrospectively, when they wish to trade. Further, the prevalent approach to internal corporate governance policies is a tick-the-box approach, where only the bare minimum requirements are incorporated. This may not be sufficient when corporate insiders look to establish the Chinese Walls defence. It is advisable to look at arrangements that effectively tackle the risk of UPSI transfer in the given scenario and based on the circumstances and set of facts. In an increasingly technologically integrated and complex global financial market, it is key to ingrain actual and effective Chinese Walls into the very fabric of the company, taking into consideration the recommendations in this paper. Having said that, as long as the Chinese Walls prevent the risk of UPSI transfer, it should not matter whether this results from established or ad hoc arrangements (though, surely the former approach is more sensible and easier to demonstrate).[54]

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53 Schedule I of the SEBI (Prohibition of Insider Trading) Regulations, 1992 provided for a "Model Code of Conduct for Prevention of Insider Trading for Other Entities"; it was not a part of the code of conduct for listed companies. It sought to prevent conflicts of interest when an "*organisation/firm* [*was*] *handling any assignment for the listed company or is preparing appraisal report or is handling credit rating assignment*" and was privy to inside information. It rightly noted that the list itself is confidential information, and required that it shall not be communicated directly, or indirectly to anyone outside the organisation/ firm.

54 Hall (n 38).

Case Note: *Daiichi Sankyo* v. *Malvinder Mohan Singh*

Nakul Dewan[*] *and Abhishikta Mallick*[**]

I. Introduction

Daiichi Sankyo Co. Ltd. v. *Malvinder Mohan Singh*[1] marks two critical points in the development of arbitral jurisprudence in India. The first, that an application seeking to resist enforcement of the arbitral award was declined notwithstanding a pending setting aside proceedings in the court of the arbitral seat; and the second, that an issue related to the manner and measure of calculating damages would be outside the purview of judicial interference. The detailed judgment on the issue was rendered by the High Court of Delhi on 31 January 2018, and the Special Leave Petition against that was dismissed *in limine* by the Supreme Court of India on 16 February 2018.

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[1] Daiichi Sankyo Co. Ltd. v. Malvinder Mohan Singh, 2018 SCC Online Del 6869.

II. THE FACTUAL BACKGROUND OF THE CASE

The case related to a dispute arising out of a Share Purchase and Share Subscription Agreement ("**Agreement**") dated 11 June 2008. Under this Agreement, Daiichi agreed to purchase the Respondents' stake in Ranbaxy Laboratories Limited ("**RLL**") for a value of INR 1980 crores.[2]

Subsequently, in November 2009, Daiichi discovered the existence of an internal document known as a Self-Assessment Report prepared in 2004, which expressly set out fraudulent practices taking place at RLL. This included fabrication of data for regulatory submissions which had triggered a series of investigations by the US Food and Drugs Administration ("**FDA**") and the Department of Justice ("**DOJ**"). Daiichi Sankyo had to pay $500 million to the DOJ and $35-$50 million to the FDA to arrive at a settlement resolving its liability.

In terms of the dispute resolution clause set out in the Agreement, the dispute was adjudicated under the Rules of the International Chamber of Commerce in Singapore. Daiichi alleged that it had suffered direct and indirect losses as a result of entering into the Agreement based on the Respondents' fraudulent representations. It claimed damages under Section 19 of the Indian Contract Act 1872 ("**Contract Act**").

During the pendency of the arbitral proceedings, Daiichi proceeded to sell its stake in RLL to an Indian company called Sun Pharma for a sum of INR 2267 crores, which was INR 287 crores more than the purchase price paid by Daiichi for the stake in RLL.

The Arbitral Tribunal rendered its award (2:1) in favour of Daiichi, and held that the Respondents had misrepresented and concealed facts relating to the investigations against RLL in the United States. The Arbitral Tribunal also found that the Respondents had fraudulently induced Daiichi to enter into the Agreement.

Further, the Arbitral Tribunal also rejected the selling shareholders' assertion that no damages were payable because the grant of consequential damages was beyond its jurisdiction. The Arbitral Tribunal held that Daiichi would not be precluded from claiming damages under Section 19

2 *Ibid.*, 2.

of the Contract Act, either because the Agreement did not have an indemnity clause, or because the subsequent sale of Ranbaxy to Sun Pharma had been done at a value higher than the cost of acquisition. According to the Arbitral Tribunal, an award of damages under Section 19 would ensure that Daiichi was restored to the same position it would have been in had the selling shareholders' representation been true. On that basis, the Tribunal held that Daiichi was entitled to recover damages to the tune of INR 2562 crores.

To achieve that, the Tribunal calculated the quantum of damages based on the present value of Daiichi's stake at the weighted cost of capital. The Tribunal took into account aspects such as reputational issues faced by Daiichi, the opportunity cost of being unable to enter into transactions with different generic companies, and the cost of dealing with the investigations pursued by regulatory authorities.[3]

The Award was sought to be resisted before the High Court of Delhi on the ground that the enforcement of the Award was contrary to the public policy of India, as set out in Section 48(2)(b) of the Arbitration and Conciliation Act, 1996 (the "**Arbitration Act**"). The Respondent asserted that the Tribunal had acted beyond its jurisdiction in awarding consequential damages. It was asserted that the computation of damages was contrary to Section 19 of the Contract Act and resulted in the award of multiple damages, making the Award unenforceable.

III. Restrictive scope of judicial interference

The submissions of the Respondent pertaining to the computation of damages was held to be beyond the scope of review under Section 48 of the Arbitration Act. The Delhi High Court ["**the Court**"] unsurprisingly held that the scope of interference in relation to the enforcement of a foreign award was limited. The Court refrained from reassessing the merits of the case or taking a second look at the foreign award at the stage of enforcement.

Further, in line with the view taken in previous judgments of the Supreme Court of India,[4] the Court confirmed that the expression 'public

[3] *Ibid.*, 49-57.

[4] Shri Lal Mahal Ltd. v. Progetto Grano SpA, (2014) 2 SCC 433; Associate Builders v. DDA, (2015) 3 SCC 49.

policy of India' was to be given a narrow meaning in case of enforcement of foreign arbitral awards. A violation of a statute would not constitute a breach of the fundamental policy of Indian law, i.e., the enforcement of an award could be successfully resisted only if there was a breach of a substantial principle on which Indian law is founded. The Court relied on the recent decision of the High Court of Delhi in *Cruz City 1 Mauritius Holdings* v. *Unitech Ltd.*,[5] to state that a foreign award could not be set aside on the ground that it may be possible to take another view on the factual and legal issues involved in the dispute.

The Court also relied on the decision of the High Court of Delhi in *Xstrata Coal Marketing AG* v. *Dalmia Bharat (Cement) Ltd.*[6] where it was held that "[t]he jurisdiction of the Arbitral Tribunal is not limited to merely accepting or rejecting the measure of damages as claimed by a claimant. The Arbitral Tribunal is equally empowered to assess the quantum of damages on the basis of material and evidence produced." The court took the view that an award of damages would fall foul of the fundamental policy of Indian law only in the limited circumstance that its computation was based on no material at all or on *fanciful surmises*.[7]

In fact, the Court held that since it was within the remit of the Arbitral Tribunal to estimate a reasonable measure of damages, a method which simply sought to put a party back in the position it would have been but for the breach, could not be considered to be perverse or contrary to the public policy of India.[8]

Therefore, the Court reaffirmed the principles of minimal interference in challenges seeking to resist the enforcement of foreign awards, setting the bar high.

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5 Cruz City 1 Mauritius Holdings v. Unitech Ltd.,2017 SCC OnLine Del 7810 : (2017) 239 DLT 649.

6 Xstrata Coal Marketing AG v. Dalmia Bharat (Cement) Ltd., 2016 SCC Online Del 5861.

7 *Ibid.*, 37; Also in McDermott International Inc. v. Burn Standard Co. Ltd., (2006) 11 SCC 181, the Supreme Court held as follows:

"[I]t is an accepted position that different formulas can be applied in different circumstances and the question as to whether damages should be computed by taking recourse to one or the other formula, having regard to the facts and circumstances of a particular case, would eminently fall within the domain of the Arbitrator."

8 See also Glencore International AG v. Dalmia Cement (Bharat) Ltd., 2017 SCC OnLine Del 8932.

IV. Enforcement of arbitral awards where an application for setting aside has been made

Daiichi had commenced execution proceedings before the High Court of Delhi despite the fact that an application seeking to set aside the Award was pending before the Singapore High Court. Interestingly, rather than seeking a stay of execution proceedings, the parties made a concession, which the judgment sets out as follows:

> "21. *Learned senior counsel for the parties have pointed out that apart from resisting the enforcement of the Award in the present court the respondents have also challenged the Award in the proceedings before the Court in Singapore. However,* both the senior counsel stated that the pendency of the proceedings in Singapore would not in any manner prevent this court from adjudicating the present objections filed by the respondents."

(Emphasis supplied)

For this reason, the Court did not discuss the implications of proceeding with the enforcement of an Award during a subsisting challenge. It is pertinent to note that this case is the first reported judgment of an Indian court where enforcement proceedings have not been stayed and the application to resist enforcement of the Award has been disposed of, even during the pendency of setting aside proceedings, in the court of the seat.

It is therefore relevant to analyse the issue of enforcement of an award during the pendency of setting aside proceedings. The language of Section 48 of the Arbitration Act has been adapted from Article V(1)(e) of the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards and sets out as follows:

> "48. Conditions for enforcement of foreign awards
>
> (1) Enforcement of *a foreign award* may be refused, *at the request of the party against whom it is invoked, only if that party furnishes to the court proof that –*
>
> ...

(e) the award has not yet become binding on the parties, or has been set aside *or suspended by a competent authority of the country in which, or under the law of which, that award was made.*"

In terms of Article VI of the New York Convention, where an application has been made to set aside or suspend an award before a competent authority in the country in which it was made, the court of the place where recognition and enforcement is sought ("**Enforcing Court**") may, in its discretion, adjourn the decision on the enforcement of the award. Further, sub paragraph (e) of Article V(1) of the New York Convention, states that recognition and enforcement of an award may be refused if the award has not yet become binding, has been set aside, or has been suspended in the country where the award was made.

In the absence of guidance in the both the Convention and the *travaux to* the Convention, the decision whether to stay the enforcement proceedings is made by domestic courts on a case-by-case basis. Courts have taken into account all relevant factual elements in the backdrop of the Convention's pro-enforcement emphasis. As observed by Lord Mance JSC in *Dallah Real Estate and Tourism Holding Co.* v. *Ministry of Religious Affairs of the Govt. of Pakistan ("Dallah")*,[9] generally it is for each Enforcing Court to determine for itself what weight and significance should be ascribed to the omission, progress, or success of an active challenge in the court of the seat. Courts have also carried out an assessment as to whether foreign court proceedings are being pursued in good faith, and not simply as part of a dilatory strategy.[10]

However, there is no widespread consensus or an articulation of a test to control the exercise of such discretion. While some courts have taken the territorial approach, which renders an award non-existent following a setting aside decision by the court of the seat, other courts have emphasised on the presumption of enforceability of arbitral awards.

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[9] Dallah Real Estate and Tourism Holding Co. v. Ministry of Religious Affairs of the Govt. of Pakistan, (2011) 1 AC 763 : (2010) 3 WLR 1472 : (2010) 1 Lloyd's Law Rep 119 [28].

[10] Dowans Holding SA v. Tanzania Electric Supply Co. Ltd., 2011 EWHC 1957 (Comm).

A. The territorial approach

Under the territorial approach, an annulled award can have no validity in any jurisdiction. Therefore, if there is no award left to enforce, the discretion to an Enforcing Court given by the word 'may' in Article V(1)(e) of the New York Convention creates a legal impossibility.[11] For instance, the Italian Civil Code of Procedure provides that the annulment of an award at the seat of the arbitration creates a mandatory ground for refusing to enforce the award.[12]

In fact, in line with this approach, the courts of Singapore have not allowed for the enforcement of annulled awards. In *PT First Media TBK* v. *Astro Nusantara International BV*,[13] the Singapore Court of Appeal, while acknowledging the discretionary power of the Enforcing Court to enforce an award that has been set aside, took the view that in fact, if an award had been set aside, it would be a nullity and there would be no existing award to enforce. The court stated as follows:

> "77 While the wording of Art V(1)(e) of the New York Convention and Art 36(1)(a)(v) of the Model Law arguably contemplates the possibility that an award which has been set aside may still be enforced, in the sense that the refusal to enforce remains subject to the discretion of the enforcing court, the contemplated erga omnes effect of a successful application to set aside an award would generally lead to the conclusion that there is simply no award to enforce. What else could it mean to set aside an award? If this avenue of recourse would only ever be of efficacy in relation to enforcement proceedings in the seat court, then it seems to have been devised for little, if any, discernible purpose. As such, we do not think that in principle, even the wider notion of "double-control" can encompass the same approach as has been adopted by the French courts. The refusal to enforce awards which have not been set aside at the seat court may therefore constitute one

11 AJ Van Den Berg, "Enforcement of Annulled Awards" (1998) 9(2) ICC International Court of Arbitration Bulletin (November) 15.

12 Andrew Tweeddale, "Cutting the Gordian Knot: Enforcing Awards Where an Application Has Been Made to Set Aside the Award at the Seat of the Arbitration" (2015) 81(2) Arbitration 137, 138.

13 PT First Media TBK v. Astro Nusantara International BV, (2014) 1 SLR 372 : 2013 SGCA 57.

of the outer-limits of "double-control". However, as this specific issue is not directly engaged in the present appeal, we offer no further comment beyond these tentative thoughts."

(Emphasis supplied)

B. The transnational approach

On the other hand, in terms of the transnational approach, an arbitral award is considered to not be attached to any national legal system. Since arbitration is treated as disjunctive, an award does not lose the capacity to be enforced notwithstanding annulment by the court of the arbitral seat.[14]

Courts outside India have upheld the enforcement of arbitral awards during the pendency of setting aside proceedings. In particular, English courts have taken the view that the binding nature of the award must be determined at the Enforcing Court as opposed to the court of the arbitral seat.[15] If the Enforcing Court decides to enforce a foreign arbitral award, there is no change to the binding nature of the award "as a result of some event in the home jurisdiction."[16] In fact, even in cases where the arbitral award has been set aside at the court of the arbitral seat, the enforcement of arbitral award has at times been upheld.

Similarly, in *Yukos Capital SarL* v. *OJSC Oil Co. Rosneft*,[17] the Queen's Bench division of the English High Court addressed, inter alia, the issue of whether the set-aside decisions had the effect that the awards cannot be enforced by the English courts because they no longer exist in a legal sense. The Court upheld the enforcement of an award that had been set aside by the Moscow Arbitrazh Court. The setting aside decision of the Russian court was given no effect on the basis of conventional English conflict of law principles.[18] The English Court opined that it could not be bound by the setting aside decision of a foreign court which offended the basic principles of honesty, natural justice, and domestic concepts of public policy.

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14 This approach has been taken by the French Courts as discussed at para [add] to [add] above.

15 Dowans Holding SA v. Tanzania Electric Supply Co. Ltd., 2011 EWHC 1957 (Comm); Diag Human SE v. Czech Republic, 2014 EWHC 1639 (Comm).

16 Dowans Holding SA v. Tanzania Electric Supply Co. Ltd., 2011 EWHC 1957 (Comm), 26.

17 Yukos Capital SarL v. OJSC Oil Co. Rosneft, 2014 EWHC 2188 (Comm).

18 *Ibid.*, 20.

Particularly, the French Code of Civil Procedure which governs the enforcement of foreign awards, does not even have a ground similar to Article V(I)(e), where a court may, in its discretion, refuse enforcement of an Award on the ground that the award has been set aside in the country of origin.[19] French judges have relied on the more favourable domestic regime for enforcement of arbitral awards provided by French arbitration law on the basis of Art VII(1)[20] of the New York Convention.[21]

C. The intermediate approach

An intermediate view would fall in the middle of the spectrum between an automatic refusal prescribed by the territorial approach, and the complete disregard of an annulment award under the transnational approach. A court may retain the discretion to enforce an arbitral award even if it has been set aside, and articulate tests in relation to the manner of exercise of the discretion.

For instance, the decisions of the English courts have expressly retained the discretion to enforce an award that has been set aside in the

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[19] "Code of Civil Procedure, Book IV, Arbitration" in *ICCA International Handbook on Commercial Arbitration*, Supplement No. 64 (Wolters Kluwer May 2011) 1-16. Art. 1526 of the French Code of Civil Procedure (previously Art. 1502) provides that: "The Court of Appeal may only deny recognition or enforcement of an arbitral award on the grounds listed in Art. 1520"; and Art. 1520 (previously Art. 1506) provides that:

"An award may only be set aside where: (1) the arbitral tribunal wrongly upheld or declined jurisdiction; or (2) the arbitral tribunal was not properly constituted; or (3) the arbitral tribunal ruled without complying with the mandate conferred upon it; or (4) due process was violated; or (5) recognition or enforcement of the award is contrary to international public policy."

[20] Art. VII(1) of the New York Convention sets out as follows:

"The provisions of the present Convention shall not affect the validity of multilateral or bilateral agreements concerning the recognition and enforcement of arbitral awards entered into by the Contracting States nor deprive any interested party of any right he may have to avail himself of an arbitral award in the manner and to the extent allowed by the law or the treaties of the country where such award is sought to be relied upon."

[21] See Soc. Pabalk Ticaret Ltd. Sirketi v. Sot. anon Norsolor, Cour de Cassation (1re ChCiv) 3 October 1984, 2 Journal of International Arbitration (Kluwer Law International 1985, Issue 2) 67-76; Hilmarton Ltd. v. Omnium de Traitement et de Valorisation Cour d'appel de Paris, 19 December 1991 in ICCA Yearbook Commercial Arbitration ["**Yearbook**"] XIX (Kluwer 1994) 655-657; Arab Republic of Egypt v. Chromalloy Aeroservices Inc. Cour d'appel Paris, 14 January 1997 in Yearbook XXII (1997) 691-695; PT Putrabali Adyamulia (Indonesia) v. Rena Holding et al Cour de Cassation [Supreme Court], First Civil Chamber, 29 June 2007 in Yearbook XXXII (2007) 299-302. In that case, the Cour de Cassation confirmed that "[a]n international arbitral award – which is not anchored to any national legal order – is an international judicial decision whose validity must be ascertained with regard to the rules applicable in the country where its recognition and enforcement is sought".

home jurisdiction while setting out that this discretion may be exercised sparingly.[22] In *Dallah*, Riz LJ set out as follows[23]:

> "*89 In sum, I see no reason arising out of the interesting arguments put before the court in this appeal to doubt, even if it was open to do so, this court's views in* Dardana Ltd. v. Yukos Oil Co.[24] *and* Kanoria v. Guinness[25] *that any discretion to enforce despite the establishment of a Convention defence recognised in our 1996 Act is a narrow one. Indeed, it seems to me that in context the expression "may be refused . . . only if" (article V), especially against the background of the French text ("ne serontrefusees"), and the expressions of the English statute "shall not be refused except" and "may be refused if" (sections 103(1) and (2)), are really concerned to express a limitation on the power to refuse enforcement rather than to grant a discretion to enforce despite the existence of a proven defence. What one is left with therefore is a general requirement to enforce, subject to certain limited defences. There is no express provision however as to what is to happen if a defence is proven, but the strong inference is that a proven defence is a defence.* It is possible to see that a defence allowed under Convention or statute may nevertheless no longer be open because of an estoppel *(Professor van den Berg's view, see The New York Arbitration Convention 1958, at p 265),* or that a minor and prejudicially irrelevant error, albeit within the Convention or statutory language, might not succeed as a defence (as in *China Agribusiness Development Corpn.* v. *Balli Trading*[26]. But it is difficult to think that anything as fundamental as the absence of consent or some substantial and material unfairness in the arbitral proceedings could leave it open to a court to ignore the proven defence and instead decide in favour of enforcement."
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> (Emphasis supplied)

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[22] Dowans Holding SA v. Tanzania Electric Supply Co. Ltd., 2011 EWHC 1957 (Comm).

[23] Dallah Estates and Tourism Holding Co. v. Ministry of Religious Affairs, Govt. of Pakistan, 2009 EWCA Civ 755.

[24] (2002) 1 All ER (Comm) 819.

[25] (2006) 2 All ER (Comm) 413.

[26] (1988) 2 Lloyd's Rep 76.

It has been suggested by noted arbitrator Jan Paulsson in his article that enforcement of an arbitral award should be refused only when the judgment setting aside the arbitral award constitutes an international standard annulment. These grounds, Paulsson suggests, fall within the scope of the first four paragraphs of Article V(1) of the New York Convention. Therefore, an Enforcing Court may exercise its discretion to enforce an award when the ground of setting aside is outside the realm of the New York Convention.[27]

V. Will Indian courts enforce an award annulled at the seat?

Indian courts have, so far, not considered the issue of enforcement of awards that have been set aside by the court of the arbitral seat. The fact that the language used in Section 48 is permissive rests the discretion on the Enforcing Court to decide whether to enforce such an award. This begs the question on how Indian courts might exercise its discretion.

Practitioners have, in the past, taken the view that Indian courts are unlikely to enforce an annulled award, and therefore take a territorial approach. In fact, *Cruz City* sets out that "*[p]lainly, it would be highly unsatisfactory if a party is permitted to once again invite the enforcing court to rule on questions that have been agitated before a court of competent jurisdiction where the seat of arbitration is located (the supervisory court).*"

Such an approach is, however, inconsistent with the position in *BALCO*, where the judges have proceeded on the basis that seat is the centre of gravity. In addition, this also goes against the parties' choice of seat, which includes in its ambit the choice of supervisory court. Therefore, the discretion to enforce an annulled award materially alters the bargain between the parties and also introduces a significant unstable variable into the arbitral process.[28]

To consider the transnational approach in the Indian context, it is pertinent to appreciate the legislative intent of the Arbitration & Conciliation

27 Jan Paulsson, "Enforcing Arbitral Awards Notwithstanding Local Standard Annulments" (1998) 6 Asia Pacific Law Review 1-28.

28 Sundaresh Menon, "Standards in Need of Bearers: Encouraging Reform from Within" (Singapore Centenary Conference of the Chartered Institute of Arbitrators, 3 September 2015) 26.

(Amendment) Act 2015 (the "**Amendment Act**"). One of the important changes brought about by the Amendment Act was the removal of the provision for an automatic stay on the execution of an award during the pendency of a setting aside proceeding. The recent decision of the Supreme Court in *BCCI* v. *Kochi Cricket (P) Ltd.*[29] simply reaffirms that as being the mandate of the Amendment Act.

While the judgment is in relation to Part I of the Arbitration Act which deals with India-seated awards, it expressly recognises the intent of the courts in India to empower the decree holder to enforce an award, irrespective of the fact that a proceeding challenging the award is pending before the courts exercising jurisdiction over the seat. The decision goes to the extent of setting out that a judgment debtor has no substantive vested right to resist execution of an award, and therefore an award pending challenge would be executable like a decree of a court. This, as expressed by the Supreme Court, is in consonance with the true intent of the Amendment Act and its pro-arbitration approach which aims at minimal intervention with an award.

While it is arguable that a similar approach may be expected in case of foreign awards pending a challenge at the court of the seat, the emphasis on the choice of foreign seat and, by extension, foreign curial law, might be a clog in the enforceability of such an award. However, it is reasonable to expect that courts shall not grant a blanket automatic stay in cases where the award has been challenged in the court of the seat. Instead, the court should evolve a test on the basis of which the discretion to enforce such an award may be exercised in line with the foreign jurisprudence.

In light of this, it will be interesting to observe the approach taken by Indian courts in the event that the award is set aside by Singapore courts in the instant case.

[29] BCCI v. Kochi Cricket (P) Ltd., (2018) 6 SCC 287.

Individual Culpability: Liability of Directors & Officers Under The Indian Competition Regime

*Piyush Gupta** *& Harshil Mehta***

I. Introduction

As has been the case since time immemorial, directors and officers of companies ('**D&Os**') have had the responsibility (and indeed the duty) to ensure that the best interests of the company, its employees and stakeholders, the community at large, as well as the environment, are adequately safeguarded[1].

This fiduciary duty of the D&Os may, at times, lead to a triaging of interests, whereby some interests – viz. maximising the revenues for the company and its shareholders – may supersede others – viz. acting for the benefit of the community.

The emerging jurisprudence in the space of directors' duties entails an exposure to personal liability for D&Os in default for any violation of the laws, which includes, amongst others, the competition law regime in India.

This article provides an insight into the aspect of individual culpability under the Competition Act, 2002 ('**Act**') and the increasing trend of the

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1 S. 166(2) of the Companies Act.

competition regulator to penalize the office bearers of companies, thereby making the decision-makers at companies, uneasy.

II. Relevant Provisions Under The Act

Section 48(1) of the Act provides that where a person committing contravention of any of the provisions of the Act is a company (including a firm or an association), *every person who, at the time the contravention was committed, was in charge of, and was responsible for the conduct of the business of the company/association, shall be deemed to be guilty of the contravention* and shall be liable to be proceeded against and punished accordingly [emphasis added].

Section 27 of the Act empowers the competition regulator in India – the Competition Commission of India ('**CCI**') to impose penalties for anti-competitive agreements and/or abusive conduct, upon "*each of such person or enterprises which are parties to such agreements or abuse*" [emphasis added].

The term "*person*" in turn, has been accorded a wide definition under Section 2 of the Act to include, amongst others, individuals as well.

Thus, in so far as legislation is concerned, individuals' liability is adequately covered within the ambit of the Act.

III. Emerging Jurisprudence On Personal Liability Of D&O Under The Act

Initially when the regulator was still in its infancy, its position on the issue of liability seemed to have been that separate proceedings were required to proceed against directors and officers, which proceedings would need to be initiated after following the necessary procedure[2].

Then in 2012, in *Varca* case[3], against the Chemists & Druggists Association of Goa (CDAG), it was opined by the CCI that "an association of enterprises cannot be considered as a company and therefore, the office

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2 Kapoor Glass (P) Ltd. v. Schott Glass India (P) Ltd., 2012 SCC OnLine CCI 17; GKB Hi-Tech Lenses (P) Ltd. v. Transitions Optical India (P) Ltd., 2012 SCC OnLine CCI 38.

3 Varca Druggist & Chemist v. Chemists & Duggists Assn., 2012 SCC OnLine CCI 41.

bearers of CDAG would not be covered under section 48 ... so no penalty is leviable on the office bearers".

In an interesting decision on the issue, the CCI while deciding *Santuka* case[4] in 2013, attributed liability on to the office bearers of trade associations. In its decision, the CCI held that "the anti-competitive decision or practice of the association can be attributed to the members who were responsible for running the affairs of the association and actively participated in giving effect to the anti-competitive decision for practice of the association."

This thought process of the CCI continued in its decision in *Prasar Bharti* case[5] wherein it was held that "[I]n case the DG finds the OP company was in violation of the provisions of the Competition Act, it shall also investigate the role of the persons who, at the time of such contravention, were in charge of and responsible for the conduct of the business of the Company, so as to fix responsibility of such person(s) under section 48 of the Act."

Up until 2013, even though the CCI had attributed liability on to office bearers of companies and associations, no penalties had been ascribed to them in any case. This trend buckled in 2014 when in *Bengal Chemist* case[6] (which was investigated by the CCI in its *suo motu* capacity), the CCI not only held the Bengal Chemists and Druggists Association (BDCA) guilty for anti-competitive practices and penalized it, but also held the office bearers of the BDCA guilty under section 48 of the Act. To determine the penalty of the individuals, the CCI took into account, the income certificates of the concerned office bearers and imposed a cumulative penalty of INR 18.38 crores (of which, the penalty on BDCA was a mere INR 13.24 lakh). This decision was a breakthrough for the CCI, given that this was the first instance wherein penalties on individuals were imposed.

Similarly, the CCI found the office bearers of Indian Jute Mills Association to be vicariously liable and were penalized for their anti-competitive conduct in *Indian Jute Mills Assn.* case[7] in latter half of 2014.

The issue of individual culpability and penalty has now been enshrined in the CCI's thought-process and decision-making. Thus, there is now no surprise when office bearers of entities, enterprises and associations, get penalized for their anti-competitive conduct on a more regular basis. For instance,

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4 Santuka Associates (P) Ltd. v. All India Organization of Chemists and Druggists, 2013 SCC OnLine CCI 14.

5 Prasar Bharti (Broadcasting Corpn. of India) v. TAM Media Research (P) Ltd., 2013 SCC OnLine CCI 23.

6 *Bengal Chemist and Druggist Assn.*, *In re*, 2014 SCC OnLine CCI 38.

7 Indian Sugar Mills Assn. v. Indian Jute Mills Assn., 2014 SCC OnLine CCI 141.

in *Macleods Pharma* case[8] the president of the Himachal Pradesh Society of Chemists and Druggists Alliance was penalized. A similar approach was adopted by the CCI in *Alkem Laboratories* case[9], where again, a DGM level individual, along with the Branch Manager and the Authorised Signatory of an association were held to be responsible owing to the "key positions" held by them and were fined in their individual capacities.

By the advent of 2015, the CCI evidently started broadening their focus and started targeting industries other than the pharmaceutical industry, but with the same ideology and methodology. For instance, the transport sector (*Shivam Enterprises* case[10]), the entertainment industry (*Kerala Cine Exhibitors* case[11]) etc.

IV. CONCLUDING WORDS

We have seen an increasing trend, especially in the last couple of years, where the CCI has started seeking individual culpability in cases for which it has penalised organisations. The intent of the CCI by way of this trend is to ensure that the D&Os act carefully and examine the matters before them from all legal angles, while making decisions on behalf of the organisation.

However, the CCI is not dealing with the individual culpability *stricto sensu*, but from the precedents on the subject till date, it appears that the CCI is, at least for the time being, only penalising those individuals whose names appear multiple times and who have been given a fair chance to be heard.

This move has had a mixed response from the corporate sector. While some people feel that individual culpability would help improve compliance of competition guidelines, others feel that such an initiative is hampering the decision-makers in corporate houses from taking risks and being innovative, especially in light of the sanctions against breach of fiduciary duties by directors under the new Companies Act in India.

In our considered opinion, this emerging jurisprudence could make decision-makers at companies uneasy, but it is actually a good thing from an

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8 Rohit Medical Store v. Macleods Pharmaceutical Ltd., 2013 SCC OnLine CCI 29.

9 P.K. Krishnan v. Paul Madavana, 2015 SCC OnLine CCI 187.

10 Shivam Enterprises v. Kiratpur Sahib Truck Operators Coop. Transport Society Ltd., 2015 SCC OnLine CCI 27.

11 Kerala Cine Exhibitors Assn. v. Kerala Film Exhibitors Federation, 2015 SCC OnLine CCI 98.

economic perspective as an organisation is eventually governed by its decision-makers. Proper enforcement and implementation of the competition laws in India will go a long way in attracting foreign investments into India as in any competitive economy/market, a potential investor will value a level playing field and assurances that the government will not accord unfair advantage to domestic players.

In addition to the above, penalizing individuals under the competition regime, will also bring India to the forefront amongst its South-East Asian neighbours, most of whom, have a competition law regime which entails penalizing D&Os under their respective statutes in order to curtail the competition law violations. A brief overview of the respective competition law legislations amongst the ASEAN nations on the case in point, is appended as Annexure A.

I. ANNEXURE A

Liability of individuals under the competition regime in ASEAN Countries

Country	Legislation	Liability of D&O
Thailand	Trade Competition Act, 2017 (w.e.f. October 2017); Trade Competition Act 1999	**Section 54 of 1999 Act –** "In the case where the person who commits an offence punishable under this Act is a juristic person, the managing director, the managing partner or the person responsible for the operation of the business of the juristic person in such matter shall also be liable to the penalty provided by the law for such offence unless it is proved that such act has been committed without his or her knowledge or consent or he or she has already taken reasonable action for preventing the commission of such offence from occurring." **Section 77 of 2017 Act –** "Where an offender is a juristic person, if a commission of an offence of such juristic person is caused by an instruction or an act of a director or a manager or any person who is responsible for the business operation of such juristic person or where such person has the duty to give an instruction or act and did not give the instruction or did not act, which caused such juristic person to commit the offence, such person shall also be liable to the punishment as specified for such offence."
Malaysia	Competition Act, 2010	**Section 63 –** "(1) If a body corporate commits an offence under this Act, any person who at the time of the commission of the offence was a director, chief executive officer, chief operating officer, manager, secretary or other similar officer of the body corporate or was purporting to act in any such capacity or was in any manner or to any extent responsible for the management of any of the affairs of the body corporate or was assisting in such management— *(a)* may be charged severally or jointly in the same proceedings with the body corporate; and *(b)* if the body corporate is found to have committed the offence, shall be deemed to have committed that offence unless, having regard to the nature of his functions in that capacity and to all circumstances, he proves— (i) that the offence was committed without his knowledge, consent or connivance; and (ii) that he had taken all reasonable precautions and exercised due diligence to prevent the commission of the offence.

Country	Legislation	Liability of D&O
		(2) If any person would be liable under this Act to any punishment or penalty for his act, omission, neglect or default, he shall be liable to the same punishment or penalty for every such act, omission, neglect or default of any employee or agent of his, or of the employee of the agent, if the act, omission, neglect or default was committed— *(a)* by that person's employee in the course of his employment; *(b)* by the agent when acting on behalf of that person; or *(c)* by the employee of the agent in the course of his employment by the agent or otherwise on behalf of the agent acting on behalf of that person.
Myanmar	The Competition Act, 2015	**Section 39 –** "Any person who violates the prohibition contained in section 13 shall, on conviction, be punished with imprisonment for a term not exceeding three years or with a fine not exceeding one hundred and fifty lakhs Kyat or with both". **Section 40 –** "Any businessman who violates the prohibitions contained in section 23, section 24 or section 29 shall, on conviction, be punished with imprisonment for a term not exceeding three years or with fine not exceeding Kyat one hundred and fifty lakhs or with both. **Section 41** - "Any person who violates the prohibitions contained in section 15, section 19, section 22, section 26, section 27, section 31 or section 32 shall, on conviction, be punished with imprisonment for a term not exceeding two years or with fine not exceeding Kyat one hundred lakhs or with both." **Section 42** - "Any person who violates the prohibitions contained in section 18, section 20, section 21, section 25 or section 28 shall, on conviction, be punished with imprisonment for a term not exceeding one year or with fine not exceeding Kyat fifty lakhs or with both." **Section 43** - "Any person who fails without any concrete reason to apply to the request of the Investigation Committee to submit any evidence, document or financial evidence or to appear for the examination as witness for investigation under this Law shall be punished, on conviction, with imprisonment for a term not exceeding three months or with fine not exceeding Kyat one hundred thousand. **Section 44** - "Notwithstanding contained in any existing law, the matters related to any provision contained in this law regarding competition shall be carried out by this Law"

Country	Legislation	Liability of D&O
Cambodia	Draft Law on Competition of Cambodia[12]	**Article 10** (**Assisting Unlawful Activities**) **–** "It is unlawful for any owner, director, officer, employee, or paid agent of a person to knowingly assist in activities of a person that are made unlawful by Articles 5, 6, 7 and 8."
Brunei	Brunei Competition Order, 2015	**Section 66** - If a body corporate commits an offence under this Order, any person who at the time of the commission of the offence was a director, manager, secretary or other similar officer of the body corporate or was purporting to act in any such capacity or was in any manner or to any extent responsible for the management of any of the affairs of the body corporate or was assisting in such management {a) may be charged severally or jointly in the same proceedings with the body corporate; and {b) if the body corporate is found to have committed the offence, shall be deemed to have committed that offence unless, having regard to the nature of his functions in that capacity and to all circumstances, he proves - (i) that the offence was committed without his knowledge, consent or connivance; and (ii) that he had taken all reasonable precautions and exercised due diligence to prevent the commission of the offence. 12) If any person would be liable under this Order to any punishment or penalty for his act, omission, neglect or default, he shall be liable to the same punishment or penalty for every such act, omission, neglect or default of any employee or agent of his, or of the employee of the agent, if the act, omission, neglect or default was committed - {a) by that person's employee in the course of his employment; {b) by the agent when acting on behalf of that person; or {c) by the employee of the agent in the course of his employment by the agent or otherwise on behalf of the agent acting on behalf of that person.

[12] Version 5.5 (7 March 2016) – Close to getting approved, "31 November, 2017 http://www.khmertimeskh.com/5088630/ministry-commerce-nears-completion-competition-law/" (The Competition Legislation cited above is close to getting approved in Cambodia).

Country	Legislation	Liability of D&O
Singapore	Competition Act, 2004	**Section 81 – Offences by Body Corporate etc. –** “(1) Where an offence under this Act committed by a body corporate is proved —(a) to have been committed with the consent or connivance of an officer; or (b) to be attributable to any neglect on his part, the officer as well as the body corporate shall be guilty of the offence and shall be liable to be proceeded against and punished accordingly. (2) Where the affairs of a body corporate are managed by its members, subsection (1) shall apply in relation to the acts and defaults of a member in connection with his functions of management as if he were a director of the body corporate. (3) Where an offence under this Act committed by a partnership is proved —(a) to have been committed with the consent or connivance of a partner; or(b) to be attributable to any neglect on his part, the partner as well as the partnership shall be guilty of the offence and shall be liable to be proceeded against and punished accordingly. (4) Where an offence under this Act committed by an unincorporated association (other than a partnership) is proved — (a) to have been committed with the consent or connivance of an officer of the unincorporated association or a member of its governing body; or (b) to be attributable to any neglect on his part, the officer or member as well as the unincorporated association shall be guilty of the offence and shall be liable to be proceeded against and punished accordingly. (5) In this section — “officer” — (a) in relation to a body corporate, means any director, member of the committee of management, chief executive, manager, secretary or other similar officer of the body corporate and includes any person purporting to act in any such capacity; or (b) in relation to an unincorporated association (other than a partnership), means the president, the secretary, or any member of the committee of the unincorporated association, or any person holding a position analogous to that of president, secretary or member of a committee and includes any person purporting to act in any such capacity; “partner” includes a person purporting to act as a partner. (6) The Commission may, with the approval of the Minister, make regulations to provide for the application of any provision of this section, with such modifications as may be appropriate, to any body corporate or unincorporated association formed or recognised under the law of a territory outside Singapore.”

Country	Legislation	Liability of D&O
Philippines	The Philippine Competition Act, 2015	**Section 30 - Criminal Penalties –** "An entity that enters into any anti-competitive agreement as covered by Chapter III, Section 14(a) and 14(b) under this Act shall, for each and every violation, be penalized by imprisonment from two (2) to seven (7) years, and a fine of not less than Fifty Million Pesos (P50,000,000.00) but not more than Two Hundred Fifty Million Pesos (P250,000,000.00). The penalty of imprisonment shall be imposed upon the responsible officers, and directors of the entity. When the entities involved are juridical persons, the penalty of imprisonment shall be imposed on its officers, directors, or employees holding managerial positions, who are knowingly and wilfully responsible for such violation."
Indonesia	Law of the Republic of Indonesia concerning the Ban on Monopolistic Practices and Business Competition, 1999	**Section 47 –** Administrative Sanctions on entrepreneurs.[13] **Section 48 –** Criminal Punishment **Section 49 –** Additional Criminal Punishment
Vietnam	Law on Competition, 2005	**Article 118 – Level of fines for breach of laws on competition –** "A body authorized to impose penalties may impose a fine up to no more than ten (10) per cent of the total turnover of the organization *or individual* in breach in the financial year preceding the year in which the prohibited practice took place …" [emphasis added]

[13] Art. I – Definition of Entrepreneur – "*Entrepreneur is an* individual person *or a company, in the form of legal or non-legal entity established and domiciled or engaged in activities within the legal territory of the Republic of Indonesia, conducting various kinds of business activities in economic sector through contracts, both individually or collectively.*"

Country	Legislation	Liability of D&O
Lao People's Democratic Republic	Law on Competition, 2015	**Article 87 – Measures against violators** – "Individuals, legal entities or organizations violating the Competition Law shall be educated, warned, disciplined, fined, subject to compensate for the damages or punished by relevant laws depending on the gravity of the violation." **Article 90 – Fine Measures** – "Individuals, legal entities or organizations violating this Law, particularly the prohibitions which deemed as non-criminal offence shall be fined." **Article 91 – Civil Measures** – "Individuals, legal entities or organizations violating the prohibitions under this Law which cause damages to other persons shall compensate for the actual caused damages." **Article 92 – Criminal Measures** – "Individuals violating this Law which constituted as the criminal offence shall be punished in accordance with the Penal Law or other laws that provide criminal liability."

The Case for a Specialised Resolution Law For Financial Institutions

Joyjayanti Chatterjee[*]

This paper presents arguments in favour of a specialised insolvency law for certain financial institutions which handle consumer deposits and/or are systemically important. Such a law is commonly referred to as a resolution law, and the paper discusses the evolution of such a law from 1814 to the 2008 global financial crash, and beyond. Several unique features of financial institutions which merit a specialised approach to their winding up have been examined in this paper. This paper also discusses the impact of the 2008 crash on policy-making in this area and its influence on resolution laws in various nations, as well as it role on creating new international standards in this area. This paper goes on to analyse the need for a specialised resolution law in India. Lastly, this paper refers to and discusses some key features

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of the Financial Resolution and Deposit Insurance Bill, which was withdrawn by the Central Government in August 2018, around a year after being introduced in the Indian Parliament.

"Democracy tends to institutionalise moral hazard in sectors that are economically or politically important, such as finance or real estate, allowing them to privatise gains and socialise losses. But this does not mean that policymakers must repeat the same mistakes every time such sectors get into trouble"[1]

I. PRE-2008 FINANCIAL CRISIS & FIRST GENERATION OF RESOLUTION REFORMS

From 1814 to 1914, the United States ('**US**') witnessed 13 banking panics - of these, the panic of 1907 was the worst.[2] The "panic of 1907' or the 'Knickerbocker' crisis was a result of the failure of the Knickerbocker Trust in New York and the Westinghouse Electric Company. The stock exchange plummeted and depositors rushed to withdraw their hard-earned money. The distinctive fact of this crisis was that the then business leaders rose to the occasion and channelled money from the strong institutions to the weaker ones in an effort to keep them afloat.[3] The lesson here was abundantly clear - an overhaul of the US banking system was necessitated to have a centralised banking system, which after six years of protracted investigation, saw the light of the day in 1913 in the form of the Federal Reserve System.[4]

The US economic history of the last three centuries is speckled with financial crises, most of them involving bank failures.[5] Banks or financial institutions fail or default when such entities run out of cash reserve necessary for

1 Raghuram Rajan, "Will Next Time Be Different?" (Project Syndicate, March 2011) <https://www.project-syndicate.org/commentary/will-next-time-be-different?barrier=accesspaylog>.

2 Robert F. Bruner & Sean D. Carr, *The Panic of 1907: Lessons Learned from the Market's Perfect Storm* (2007) <https://poseidon01.ssrn.com/delivery.php?ID=4460050070691261251211080230851130931210540880680020560770310990871231270880660851100300121160610090620521010021170900001040820390390010110460671150001260740680000070551150950950011020080940761250960920830820681031271041200950280230870240760210 01&EXT=pdf>.

3 "Panic of 1907: J.P. Morgan Saves the Day" (United States History) <http://www.u-s-history.com/pages/h952.html>.

4 A.C. Davidson, "American Banks 'In the Jungle' " *The Advertiser* (Adelaide, 16 March 1933) 8.

5 Charles Goodhart, "Financial Crises" in David Chambers and Elroy Dimson (eds.) *Financial Market History: Reflections on the Past for Investors Today* (2016) 187.

meeting outflows, leading to illiquidity. In order to meet such illiquidity, a bank or financial institution may sell its long-term assets at depressed values. This situation is particularly feared by financial experts as *first*, this means that such bank or financial institution may not be able to meet the payment obligation to other banks and financial intermediaries. *Second*, such fire sales of the assets of the primary bank or financial institution prior to failure, and subsequently, such sales by the liquidator, can reduce the current market value of similar assets, since assets are mostly valued on a mark-to-market basis. *Third*, the failure of a bank or financial institution may lead to speculation among the creditors of other players in the market who have a similar asset class or have like-structure.

The major distinguishing factor of a financial firm, as opposed to ordinary firms is that the failure of an ordinary firm, unlike a financial firm, in most cases, does not pose a *"systemic risk"* to the economy. Ordinary firms can be wound up in an insolvency procedure which (though time-bound) takes time to identify and realise assets of the debtor firm, take account of debts owed, and pay creditors in accordance with their priorities. Such delay, in case of banks and the financial institution, can intensify a systemic contagion.[6] Additionally, financial institutions may consider filing for bankruptcy only when it gets obviously distressed and not otherwise, since, the incentive to "*gamble for resurrection*"- to delay bankruptcy as long as possible-will be very strong, particularly because equity holders generally receive nothing and managers often lose their jobs after a bankruptcy filing. While during such times, the creditors to such institution would have already commenced a "run"on the resources of such institution, leading to a loss of confidence. Thus, in order to tackle a failure of a bank or financial institution, a case can be made for a "*specialised resolution"regime*.[7] More importantly, the bankruptcy costs of a bank failure are far higher than those incurred in the

[6] Edward R. Morrison, "Is the Bankruptcy Code an Adequate Mechanism for Resolving the Distress of Systemically Important Institutions?" 82 Temple Law Review 449 (2010). As per the World Bank Report (2017), the average time taken to resolve insolvency is around 2.5 years. Countries such as Singapore and Hong Kong take 0.8 years to resolve insolvency while countries such United States, United Kingdom and Australia take a year to resolve insolvency. However, it may take as high as 4.3 years to resolve insolvency in India as per the said report. These time lines are too high to deal with failure of banks or financial institutions. The World Bank Report is available at <http://www.doingbusiness.org/data/exploretopics/resolving-insolvency>.

[7] Most countries either provide for a special or specific regime for failure of banks or financial institutions, or there are built-in mechanisms to treat such process differently. *See* generally Philip R. Wood, "Bank Insolvencies", *Law and Practice of International Finance: Principles of International Insolvency* (2nd edn., 2009) Ch. 24, 749-755.

failure of a non-financial firm (perhaps 40%, as opposed to 20%, of the pre-bankruptcy firm value).[8]

The aftermath of the Great Depression of 1929 piloted the first generation of reforms in relation to the resolution regime. These reforms were primarily based on the Federal Deposit Insurance Corporation's[9] ('**FDIC**') receivership regime in the US which provided for waiver of the creditor's property rights in order to complete the process swiftly. This regime was premised on the welfare of depositorsas *first*, this would disincentivise depositors running for withdrawal, thereby containing an accelerated liquidity crisis and *second*, FDIC would have the right to monitor the troubled bank while depositors' claims were insured.[10] This regime was aimed at avoiding coordination problems that depositors would face in a situation of a bank run.

The FDIC typically has recourse to three alternatives - *first*, to act as the receiver of the troubled bank wherein it arranges for the liquidation of such entity.[11] The insured depositors are paid from the funds of the insurer and since FDIC does not need quick liquidity, it can sell assets of the distressed entity at a consistent pace to avoid fire sale contagion. *Second*, it could arrange for purchase and assumption of deposits by a transferee bank.[12] Since depositors' claims remain intact, no money is required to be paid from the insurance fund, and non-depositor creditors are paid off from the consideration received. If there are doubts in relation to asset quality, it allows for partial transfers wherein the "good" assets are transferred to a purchaser, and the "bad" assets that remain with the remnant entity are liquidated gradually to avoid any systemic shock. The *third* option is the "bridge bank"option in which case the entire operations of the troubled bank are transferred into a new "bridge bank"if an immediate sale cannot be made.[13] This "bridge bank"is owned and operated by the FDIC itself. The depositors' money is paid, and the claims of the remaining are guaranteed by the FDIC. The business of the "bridge bank"may be sold at a later date and if no purchaser emerges, the bank may be liquidated. The FDIC regime has been widely used since its inception and over 4000 deposit-taking institu-

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8 C. James, "The Losses Realised in Bank Failures" (1991) 46 Journal of Finance 1223, 1228.

9 Federal Deposit Insurance Act (US) 1950, Ss. 11-12.

10 Douglas W. Diamond and Phillip H. Dybvig, "Bank Runs, Deposit Insurance, and Liquidity" (1983) 91(3) The Journal of Political Economy 401. See also, C.W. Calomiris and E.N. White, "The Origins of Federal Deposit Insurance" in C. Goldin and G.D. Libecap (eds.) *The Regulated Economy: A Historical Approach to Political Economy* (1994) 145.

11 Federal Deposit Insurance Act (US) 1950, S. 11(d)(2)(E).

12 Federal Deposit Insurance Act (US) 1950, S. 11(d)(2)(G).

13 Federal Deposit Insurance Act (US) 1950, S. 11(d)(2)(F).

tions have been through its receivership till 2017.[14] This system of resolution regime has been adopted in jurisdictions such as UK and Germany.[15]

However, the first-generation regimes have been criticised for a variety of reasons.[16]*First*, the tools envisaged are unequipped to deal with 'too big to fail' institutions since it will be extremely difficult to find a buyer based on sheer size. *Second*, additional funding may be required to keep such an entity operational under the control of the public authorities or to incentivise a potential buyer. In such a case, the challenge would be to arrange for a high quantum of funding without being a drain on the public exchequer. *Third*, international cooperation of relevant authorities would be required, considering the multinational nature of large banking operations. *Fourth*, the FDIC regime did not envisage entities other than banks namely non-deposit-taking entities which posed a "systemic risk".

II. Post-2008 crisis: Second generation reforms

The case for a second generation of "special resolution regime" was augmented in the background of the financial crisis of 2008 when failure to handle institutions which were 'too big to fail'led to the collapse of the world economy. Lehman Brothers was an investment banking firm and was not covered under the ambit of the FDIC. However, in the aftermath of the financial crisis in 2008, it was realised that non-bank entities such as Lehman Brothers can transmit systemic contagion to deposit-taking banks and hence, to the real economy.[17]

An implicit consensus was reached in relation to "financial stability"being an international public good, i.e., all nations and all private parties benefit from it. However, in the absence of an international financial regulator, coupled with there latively free flow of capital across national borders and with finite resources, the need for a new order of mutual co-ordination

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[14] Federal Deposit Insurance Corporation, Failures and Assistance Transactions, <https://www5.fdic.gov/hsob/HSOBSummaryRpt.asp?BegYear=1934&EndYear=2017&State=2&Header=1>.

[15] John Armour, "Making Bank Resolution Credible" in Niamh Moloney, Eilis Ferran, and Jennifer Payneeds (eds.) *The Oxford Handbook of Financial Regulation* (OUP 2015) 455.

[16] *Ibid*.

[17] Nicolas Dumontaux and Adrian Pop, "Contagion Effects in the Aftermath of Lehman's Collapse: Evidence from the US Financial Services Industry", (Banque de France WP No. 427 of 2013) <http://www.banque-france.fr/uploads/tx_bdfdocumentstravail/DT-427_03.pdf>.

among regulatory authorities was felt.[18] The indispensability of an *ex-ante* legal framework which was quick, in addition to a robust *ex-post* legal framework, was also realised. Post-crisis, the global initiatives to strengthen the financial regulatory system were driven by G20 under the auspices of the Financial Stability Board ('**FSB**') and the Basel Committee on Banking Supervision ('**BCBS**'), to address, among others, the moral hazard problem posed by the 'too big to fail' institutions.

In November 2008, G20 leaders called member nations "to review resolution regimes and bankruptcy laws in light of recent experience to ensure that they permit an orderly wind down of large complex cross-border institutions".[19] At the G20 summit at Pittsburgh in September 2009, they called on the FSB to propose possible measures to address the 'too big to fail; problem. They also committed to act together to "...create more powerful tools to hold large global firms to account for the risks they take" and, specifically, to "…develop resolution tools and frameworks for the effective resolution of financial groups to help mitigate the disruption of financial institution failures and reduce moral hazard in the future."[20] The BCBS also released the Basel III Capital Regulations in December 2010 with an aim to improve the shock absorption capacity of individual banks and contain systemic risk.[21]

In Seoul (November 2010), the G20 endorsed the FSB Report on "*Reducing the moral hazard posed by systemically important financial institutions*" which recommended that "all jurisdictions should undertake the necessary legal reforms to ensure that they have in place a resolution regime which would make feasible the resolution of any financial institution without taxpayer exposure to loss from solvency support while protecting vital economic functions through mechanisms which make it possible for shareholders and unsecured and uninsured creditors to absorb losses in their order of seniority".[22] In Cannes (November 2011), the G20 endorsed the FSB's core recommendations for effective resolution ('Key Attributes of

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18 S. Choi and A. Guzman, "National Laws, International Money: Regulation in Global Capital Market", (1997) 65 Fordham Law Review 1855.

19 G20, Washington Declaration of November 15, 2008 <http://g20.org.tr/wp-content/uploads/2014/12/Washington_Declaration_0.pdf>.

20 G20, Pittsburgh Declaration of September 24-29, 2009, <http://g20.org.tr/wp-content/uploads/2014/12/Pittsburgh_Declaration_0.pdf>.

21 Basel Committee on Banking Supervision, The Basel III Capital Regulations (2010) <https://www.bis.org/publ/bcbs189.pdf>.

22 G20, Seoul Declaration of November 10, 2010 <http://g20.org.tr/wp-content/uploads/2014/12/Seoul_Summit_Document.pdf>.

Effective Resolution Regimes for Financial Institutions')[23] that jurisdictions should implement to achieve the G20 commitments.[24]

The FSB recommended 12 key attributes for an effective resolution regime ('**FSB Key Attributes**'), which have been discussed below:

1. Scope: The scope of application of the law must be clear and must encompass (a) holding companies of a firm;[25] (b) non-regulated operational entities within a financial group or conglomerate that are significant to the business of the group or conglomerate; and (c) branches of foreign firms.

2. Resolution authority: The relevant law should constitute a resolution authority responsible for exercising resolution powers over firms.

3. Resolution powers: A broad range of resolution powers or 'tools' must be provided to a resolution authority in relation to a firm, including but not limited to the power to replace senior management of the failing firm, appoint administrator, power to terminate contracts, override rights of shareholders, transfer or sell assets, establish a bridge institution, bail-in, effect closure or liquidate the firm.

4. Set-off, netting, collateralisation, segregation of client assets: The law in relation to set-off, netting, collateralisation, segregation of client assets should be clearly laid down so that it does not hamper the exercise of resolution powers.

5. Safeguards: Adherence to "no creditors worse off" principle and adequate legal protection for the exercise of resolution powers with required speed must be afforded.

6. Funding of firms in resolution: The relevant law must provide for alternative funding solutions so that the resolution authority is not constrained to rely on public ownership or bail-out funds as a means of resolving firms.

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[23] Financial Stability Board, "FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions" (2011) <http://www.fsb.org/what-we-do/policy-development/effective-resolution-regimes-and-policies/key-attributes-of-effective-resolution-regimes-for-financial-institutions/>.

[24] G20, Cannes Declaration of November 3-4, 2011 <http://g20.org.tr/wp-content/uploads/2014/12/Declaration_eng_Cannes.pdf>.

[25] A financial institution falling with the scope of resolution regime, i.e., which is systemically important has been referred to as the "firm" for the purposes of the discussion on the FSB's key attributes.

7. Legal framework conditions for cross-border cooperation: The resolution authority should have the power to arrive at a cooperative solution with foreign authorities.
8. Crisis Management Groups ('CMGs'): Relevant authorities in the home and host nations must set up a CMG to ensure preparedness and cooperation in relation to the resolution of firms.
9. Institution-specific cross-border cooperation agreements: Institution-specific agreements of cooperation may be entered into between home and host nations to establish CMGs among other purposes.
10. Resolvability assessments: Resolution authorities should regularly undertake, at least for global firms, resolvability assessments that evaluate the feasibility of resolution strategies and their credibility in light of the likely impact of the firm's failure on the financial system and the overall economy.
11. Recovery and resolution planning: Jurisdictions should put in place an ongoing process for recovery and resolution planning, covering at a minimum domestically incorporated firms that could be systemically significant or critical if they fail.
12. Access to information and information sharing: Nations must ensure that there are no legal or regulatory impediments for providing/obtaining/sharing information.

Various jurisdictions have taken active steps to align their existing legal frameworks with the above requirements. In the US, the FDIC regime initially applied only to deposit-taking institutions as they were the only institutions that fell within the ambit of the insurance fund. Lehman Brothers, being a pure investment bank, did not fall within the purview of the FDIC regime. Non-deposit-taking and systemically important entities were brought under the FDIC regime through the Dodd-Frank Act 2010.[26] A new Orderly Liquidation Authority ('**OLA**') was set up which is essentially an extension of the powers exercised by FDIC to non-bank financial institutions which are designated by the Financial Stability Oversight Council ('**FSOC**').

In the UK, the Banking Act 2009 initially applied only to deposit-taking financial institutions. However, the Financial Services Act 2012 ('**FSA**')[27] extended its reach to include large investment firms, central counterparties, and firms in the same group as a failing bank.[28] The FSA was also

[26] Dodd-Frank Wall Street Reform and Consumer Protection Act (US) 2010.
[27] Financial Services Act, 2012 (United Kingdom).
[28] *Ibid.*, Pt. 8.

responsible for the formation of three new bodies, namely, the Financial Policy Committee ('**FPC**'), the Prudential Regulatory Authority ('**PRA**'), and the Financial Conduct Authority ('**FCA**'). Additionally, pursuant to the European Union's ('**EU**') adoption of the Bank Recovery and Resolution Directive ('**BRRD**'), the EU extended the resolution regime to not only credit institutions, but also to investment firms, financial institution subsidiaries, and holding companies.[29]

In the Asian context, the enactment of the Financial Institutions (Resolution) Ordinance[30] in 2016 in Hong Kong and the Monetary Authority of Singapore (Amendment) Bill[31] in 2017 brought their resolution regimes largely in line with the FSB requirements.The FSB Thematic Review in March, 2016 indicated that India complied only with 4 out of 12 Key Attributes. The latest FSB Report (July 2017) shows that countries like France, Germany, Italy, Netherlands, Spain, Switzerland, Hong Kong, UK, and the US have already implemented all the resolution tools.[32]

III. The Need for a Specialised Resolution Law in India

The Indian financial sector is a bank-dominated financial sector, followed by insurance companies, non-banking financial companies, and mutual funds. A brief snapshot of the present composition of the Indian financial sector has been encapsulated below:

Institutions	Regulator	Number	Total Assets (2016-'17) INR billion	Percentage to Gross Domestic Product

[29] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No. 1093/2010 and (EU) No. 648/2012, of the European Parliament and of the Council [2014] OJ L173/190 (BRRD). A brief analysis of the BRRD is available at <http://europa.eu/rapid/press-release_MEMO-14-297_en.htm>.

[30] The Financial Institutions (Resolution) Ordinance, 2016 (Hong Kong).

[31] Monetary Authority of Singapore (Amendment) Bill, 2017 (Singapore).

[32] Financial Stability Board, Sixth Report on the Implementation of Resolution Reforms (July 2017) <http://www.fsb.org/wp-content/uploads/P060717-3.pdf>.

Scheduled Commercial Banks	Reserve Bank of India ('**RBI**')	92	137,469	81.0%
Regional Rural Banks		56	4,105	2.4%
Local Area Banks		03	7.8	0.0%
Cooperative Credit Institutions		95,558	11,660	6.9%
Non-banking Financial Companies		11,523	19,614	11.6%
Other Financial Institutions	Subject to nature of entity	04	5,613	3.3%
Standalone Primary Dealers	Securities &Exchange Board of India ('**SEBI**')	07	311.6	0.2%
Insurance Companies	Insurance Regulatory and Development Authority ('**IRDA**')	55	30,760	18.1%
Provident & Pension Fund	Pension Fund Regulatory & Development Authority ('**PFRDA**')	08	7,966	4.7%
Mutual Funds	SEBI	45	17,546	10.3%
Total		**148**	**235,053**	**138%**

**India - Financial System Stability Assessment, International Monetary Fund, December2017*

A major criticism of specialised resolution law in India is that the Indian financial sector, despite being heavily bank dominated, has not seen a major bank failure, i.e., a failure of a major public-sector bank or private bank. A few private sector banks which were under financial distress were merged with large public-sector banks.[33] Critics who are against establishing a res-

[33] Five such cases have occurred: The Benares State Bank (BSBL) amalgamated with Bank of Baroda on 19 June 2002; Nedungadi Bank amalgamated with Punjab National Bank on 1 February 2003; Global Trust Bank merged with Oriental Bank of Commerce on 14 August 2004; Ganesh Bank of Kurundwad amalgamated with the Federal Bank Limited on 2 September 2006; and United Western Bank amalgamated with Industrial Development Bank of India (IDBI) on 3 October 2006. Only one commercial bank has faced liquidation—the Bank of Karad in 1992. *Source:* Reserve Bank of India, Report of the Working Group on Resolution Regime for Financial Institutions (2014) 87 <https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/RWG020514_FL.pdf>.

olution regime in India argue that given the financial history of India which has not seen a bank failure, like US or UK, there is no need of such regime.[34]

While there have been no visible bank failures in India till now, it is also true that India has witnessed an unhealthy number of 'forced bank mergers'where healthy public-sector banks have been forced to absorb the losses of failed private sector banks. This practice needs to be questioned, if nothing else, on the grounds of corporate governance: such a merger is not necessarily in the interests of the public shareholders of such public-sector banks. More importantly, this practice offers an easy but detrimental alternative to genuinely confronting the problems of resolution.[35] Since 1961 till date, there have been as many as 82 bank amalgamations in the Indian banking system. As per RBI data, majority of the bank mergers in the post-nationalisation era (26 out of 36) were mandatory mergers effected through a Government Scheme mostly involving public sector banks as transferee banks bearing the full cost of a failed transferor bank.[36] Therefore, in spite of RBI's recovery powers and adoption of Prompt Correction Action Mechanism[37], the forced merger was the major resolution tool for banking sector. Although these cases did not involve direct bail-outs by the Government, indirect support was provided through the aegis ofthe public-sector banks, where the major shareholder was Government.

Further, specialised resolution laws do not take away existing powers of mergers and government bail-outs; they enhance the existing tools to provide a wider range of options for resolution authorities to deal with failed financial entities. While it is true that banks are the major component of the Indian financial system, ignoring the other components of the financial system is problematic. Most importantly, just because there has not been a major bank failure in India till now, it does not mean that there is no possibility of such a failure in the near future. While Dr. Raghuram Rajan was

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[34] Prasenjit Bose, "FRDI Bill, 2017: Inducing Financial Instability" (*EPW Engage* 27 December, 2017)<http://www.epw.in/engage/article/frdi-bill-2017-issues-and-concerns>.

[35] Planning Commission, Government of India, Report of the Committee on Financial Sector Reforms (2009) <http://planningcommission.nic.in/reports/genrep/rep_fr/cfsr_all.pdf>.

[36] V. Leeladhar, "Consolidation in the Indian Financial Sector" (International Banking & Finance Conference 2008, Mumbai, 17 April 2008) <https://rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/84392.pdf>.

[37] RBI's "Prompt Corrective Action Framework" aims to rein in lenders whose operational and financial metrics appear weak. This framework lays down three risk thresholds which are based on gross non-performing assets, net non-performing assets, capital adequacy ratio and return on assets. If a bank is put under this framework, restrictions are placed on dividends, branch expansion and, in some cases, lending based on the discretion of the regulator. See RBI's Prompt Corrective Action Framework dated April 13, 2017, <https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=10921>.

(in) famously scoffed at when he predicted the 2008 financial crisis,[38] his ominous words proved to be shockingly prophetic. There is no justification for an emerging global economy like India to be a sitting duck in the face of likely financial shocks.

Critics claim that since there has been no major experience, Indian sectoral regulators may not have adequate capacity to deal with such failure in the future. They also point to fact that the government has always preferred bail-out or fiscal stimulus to pump up liquidity in public sector banks, the latest being on October 24, 2017, of INR 2.1 trillion.[39]

While it is true that there is no existing expertise in the field of resolution, there is no reason why such expertise cannot be build up. Global resolution experts have built up expertise in this field over a period of time and with a variety of experience. Resolution bodies are designed to comprise of subject matter experts from a variety of fields and contain representatives of various finance sector regulators. They also place extensive reliance of sharing of information with foreign counterparts, and global best practices. It would be doing the Indian financial sector a huge disservice if it were to be denied of the advantage of forward thinking laws, simply based on the perceived lack of expertise. As far as the preference for bail-outs is concerned, the repeated use of tax-payers' money to bail-out failed banks, is deeply problematic. Various authorities, such as the Committee on Financial Sector Reforms has clearly articulated that every effort should be made to narrow what is guaranteed by the government to the bare minimum.[40]

Having said that, bail-out is a sovereign right and cannot be precluded by any statute. It is and will continue to remain an option for the Government. In any event, the presence of the option of government bail-out should not be seen as an impediment in adopting other means of resolution tools, which may be better suited for a particular financial firm.

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38 Michael Schuman, "A Global Financial Guru Who Predicted the Crisis of 2008 Says More Turmoil May Be Coming" *TIME* (Mumbai, 11 August 2014) <http://time.com/3099587/india-central-bank-raghuram-rajan-global-finance-world-economy/>.

39 Alekh Archana, "Govt. Announces Rs 2.11 Trillion PSU Bank Recapitalisation Plan" *Livemint* (24 October 2017) <https://www.livemint.com/Industry/xje0dmj5lYHZkSZn-qVRjwJ/Cabinet-approves-Rs21-trillion-PSU-bank-recapitalisation-pl.html>.

40 Planning Commission (n 35).

IV. Current Structure of Resolution-related Laws in India

Currently, India has a gamut of laws which provide for the resolution of financial firms. While the banks are governed under the provisions of the Banking Regulation Act 1949, certain public-sector banks are governed by separate statutes under which they are formed. The Non-banking financial companies are mostly regulated under the RBI framework. SEBI, the securities market regulator, regulates mutual funds and other stock market intermediaries. Also, under sectoral schemes, provident and pension funds are regulated by the PFRDA and insurance companies by the IRDA. The Indian Companies Act 2013 also governs the operation of all these entities in a varied manner. The recent insolvency law regime under the Insolvency & Bankruptcy Code 2016 ('**IBC**') introduced a modern framework regulating the insolvency of companies, partnerships, and individuals. Further, for companies, there is a corporate resolution procedure that aims at the approval of a restructuring agreement within 180-270 days.[41] Thus, multiple laws and multiple authorities may lead to coordination problems, especially in case of group entities of failing financial institutions which may fall under the purview of more than one sectoral regulator.

Furthermore, the lack of adequate resolution tools may result in the failure of a financial institution being poorly managed. Currently, the RBI in case of banks, for instance, only has the power to merge or amalgamate with another bank or order winding up.[42] In such a case as well, it does not have the power to force merger or trigger liquidation of a public sector bank.[43] Other issues such as lack of institutional capacity to manage resolution, lack of provision for resolution of financial firms such as companies managing mutual funds, or for securities firms and other approval requirements for

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[41] International Monetary Fund, "India: Financial System Stability Assessment" (December 2017) 1 <http://www.imf.org/en/Publications/CR/Issues/2017/12/21/India-Financial-System-Stability-Assessment-Press-Release-and-Statement-by-the-Executive-45497>.

[42] Department of Economic Affairs, Ministry of Finance, Report of Committee to Draft Code on Resolution of Financial Firms (28 September 2016) <https://dea.gov.in/sites/default/files/report_rc_sept21_1.pdf>.

[43] Although the RBI cannot force the merger of PSBs, it can propose mergers, including mergers that would amalgamate a private sector bank with a PSB. *See* International Monetary Fund (n 41) 42.

RBI Governor Urijit Patel also resonated similar concerns in his speech at Gujarat National Law University, Gandhinagar dated March 14, 2018. He raised the need to have an ownership neutral banking law regime in India. The Speech is available at <https://rbi.org.in/scripts/BS_SpeechesView.aspx?Id=1054>.

merger or amalgamation in case of non-bank entities[44] are key reasons that necessitate the establishment of a "special resolution regime" in India.[45]

V. COMMITTEE DELIBERATIONS ON A SPECIAL RESOLUTION REGIME

This need for a special resolution regime in India has been echoed by various committees. The discussion on this issue began with the Narasimham Committee Report on Banking Sector Reforms (1998) which recognised that "Deposit insurance and the aversion to bank failures could create a moral hazard that distorts the incentives for banks and create competitive distortions".[46] The RBI Advisory Group (1999) constituted under the Chairmanship of Mr Jagdish R. Capoor, Deputy Governor, RBI also examined the said issue.[47]

The most important guidance on this subject in India was provided by the Financial Sector Legislative Reforms Commission ('**FSLRC**') (2011-2013) under the aegis of Justice B.N. Srikrishna, former judge of the Hon'ble Supreme Court of India which recommended an overhaul of Indian financial sector regulation also envisaged "*establishing a sophisticated resolution corporation*".[48] Drawing on international best practices, FSLRC recommended a unified resolution corporation, that will deal with an array of financial firms that make highly intense promises to consumers, such as banks, insurance companies, defined benefit pension funds, and payment systems, and further take responsibility for the graceful resolution of systemically important financial firms such as banks and insurance companies.[49]

The FSLRC also clarified the very important clear distinction between micro-prudential regulation and resolution. Micro-prudential regulation and supervision is a continuous affair. In the words of the FSLRC, "...occasionally, when a firm approaches failure, the capabilities of the resolution

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44 Banks have been granted exemption under S. 54 of the Competition Act 2002 from prior approval of the Competition Commission of India in all cases of reconstitution, transfer of the whole or any part thereof and amalgamation under Notification dated 30 August 2017 for ten years from such date.

45 Department of Economic Affairs (n 42) 15.

46 Government of India, Report of the Committee on Banking Sector Reforms (April 1998), <https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?ID=97>.

47 Reserve Bank of India, Report of the Working Group on Reforms in Deposit Insurance in India (1999) <http://www.ispepune.org.in/PDF%20ISSUE/2004/web104/0110001.PDF>.

48 Government of India, Report of the Financial Sector Legislative Reforms Commission (March 2013) <https://dea.gov.in/sites/default/files/fslrc_report_vol1_1.pdf>.

49 *Ibid*.

corporation are required, and would proceed in a different manner than micro-prudential regulation. The resolution corporation is analogous to a specialised disaster management agency, which is not involved in everyday matters of governance, but assumes primacy in a special situation. The resolution corporation will have close co-ordination with the micro-prudential regulators. For strong firms, the resolution corporation will lie in the background. As the firm approaches failure, the resolution corporation will assume primacy."[50]

The Working Group on Resolution Regime for Financial Institutions (2014) chaired by Mr. Anand Sinha, Dy Governor, RBI and Dr Arvind Mayaram, Secretary, Ministry of Finance, Government of India recommended a "*single Financial Resolution Authority (FRA)*" also tasked with the "operation and implementation of the financial resolution framework, including the decision to choose the appropriate resolution tool, except the power to take an institution into temporary public ownership (TPO) that will be invoked by the Government of India on the recommendation of the FRA."[51] The report of the Financial Sector Reform Committee, under the chairmanship of Dr. Raghuram Rajan, also stressed that "...in addition to consolidating supervision, the system of prompt corrective action and resolution of weak banks should be strengthened and made more explicit, possibly under a revamped consolidated deposit insurer. It should be recognized that the continued existence of weak banks without resolution spreads weakness to the rest of the system, is a potential source of instability, and increases the regulator's reluctance to permit new entry".

In 2014, the Report of the Working Group on Resolution Regime for Financial Institutions[52] stated that "...due to separate statutes governing various types of financial institutions in India, the Group recognizes the difficulties in bringing all financial institutions within the scope of a single financial resolution framework without a separate legal framework that overrides all other relevant Acts. Considering the special nature of financial institutions, as well as limitations in applying corporate insolvency laws to these institutions, the Group recommends that there should be a separate comprehensive legal framework for resolving financial institutions and FMIs."[53]

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[50] *Ibid.*

[51] Reserve Bank of India, Report of the Working Group on Resolution Regime for Financial Institutions (2014) <http://www.prsindia.org/uploads/media/Financial%20Resolution%20Bill,%202017/Report%20of%20the%20Working%20Group%20on%20Resolution.pdf>.

[52] *Ibid.*

[53] Four task forces were constituted for implementation of the architecture as envisaged by the FSLRC. PIB Press Release (30 September 2014) <http://pib.nic.in/newsite/printrelease.aspx?relid=110163>.

In 2015, while commenting on the role that bankruptcy reforms play in facilitating economic and political stability in India, the Bankruptcy Law Reforms Committee[54] stated that "this political economy is eliminated by the creation of two institutional mechanisms: the bankruptcy Code proposed by this Committee and the Resolution Corporation which covers the losses of potential failure of all financial firms recommended by the FSLRC. The predictability generated by these two institutional arrangements will increase the robustness of the economy when faced with a downturn. In turn, downturns will become shorter and shallower. The ability of the economy to sustain high levels of credit, safely, will be enhanced and the economy can move on faster after a downturn or a crisis."

The Finance Minister in his budget speeches of 2015-16 announced a plan to draft and table a Bill on the resolution of financial firms. Following the announcement, the Ministry of Finance, Government of India, constituted a committee under the Chairmanship of Mr. Ajay Tyagi, Secretary, Department of Economic Affairs to draft a bill for resolution of financial firms. In September 2016, the Committee submitted its report to draft code on Resolution of Financial Firms laying down the scope and advantages of the proposed law on financial resolution.[55] A draft bill was also made available for seeking public comments.

It was after these deliberations and public consultation that the Financial Resolution and Deposit Insurance Bill 2017 ('**FRDI Bill**')[56] was cleared by the Cabinet on June 14 2017, to be laid in the Parliament. The Preamble to the FRDI Bill reads "A bill to provide for the resolution of certain categories of financial service providers in distress; the deposit insurance to consumers of certain categories of financial services; designation of systemically important financial institutions; and establishment of a Resolution Corporation for protection of consumers of specified service providers and of public funds for ensuring the stability and resilience of the financial system and for matters connected therewith or incidental thereto." In this context, the Ministry of Finance announced in 2017 that "the Government has recently enacted the Insolvency and Bankruptcy Code, 2016 ('Code') for the insolvency resolution of non-financial entities. The proposed Bill complements the Code by providing a resolution framework for the financial sector. Once

54 Interim Report of the Bankruptcy Law Reform Commission (February 2015) <http://ibbi.gov.in/BLRCReportVol1_04112015.pdf>.

55 Department of Economic Affairs (n 42).

56 The Financial Resolution and Deposit Insurance Bill 2017, as introduced in the Lok Sabha <http://www.prsindia.org/uploads/media/Financial%20Resolution%20Bill,%202017/Financial%20Resolution%20Bill,%202017.pdf>.

implemented, this Bill together with the Code will provide a comprehensive resolution framework for the economy".

Under section 227 of the IBC, the Central Government has the power to extend the application of the IBC to certain financial service providers.[57] This was designed with the intention that the remaining entities, which are deposit taking and/or systemically important would automatically be covered under the FRDI Bill. In August 2018, in the face of political backlash, the Government announced its intention to withdraw the FRDI Bill.[58] While the specific issue of the withdrawal has been dealt with in some detail in the concluding paragraphs, it is worthwhile to examine the salient features of the Bill at this juncture.

VI. Financial Resolution and Deposit Insurance Bill: Salient Features

A. Background

The 2008 global financial crisis underscored a number of flaws in modern financial systems which rendered them increasingly vulnerable to adverse shocks. One of the more ominous realisations was that the extensive reliance on government bail-outs, especially for institutions which were perceived to be "too big to fail" had led to a pervasive problem of moral hazard. This, in turn had led to the institutions taking speculative and even risky decisions, which had contributed, at least in part, to the crisis. Simply put, it became clear that financial firms are different and that the "one-size-fits-all" formula is redundant in the context of winding-up proceedings. Therefore, one of the most urgent policy questions emerging from the crisis was therefore how to improve upon the tools available to resolve the distress of financial institutions.[59] In response, a number of nations have either strengthened existing frameworks for insolvency proceedings or introduced new measures altogether.

57 The Interim Report of the Bankruptcy Law Reform Commission (February 2015) states that "We also wish to clarify that this Report does not address issues relating to insolvency resolution of banks and other financial institutions. Recent experience and research have shown that financial institutions require a special insolvency regime that is faster than any traditional insolvency procedure, where rights of the creditors and the shareholders can be overridden in the interest of the financial system and the economy."

58 "Govt. Withdraws FRDI Bill in Parliament Following Backlash" *Livemint* (7 August 2018) <https://www.livemint.com/Industry/Ff29jhSKgcOxZkjkipHY5K/Govt-withdraws-FRDI-Bill-from-Lok-Sabha.html>.

59 Armour (n 15).

Financial firms play a unique role in a nation's socio-economic set-up. While some financial firms handle sensitive consumer deposits like bank savings, pensions and life insurance policies, others, like central counterparties[60] and payment systems, lie at the very centre of the economy rendering their continuity critical to the economy. These institutions are also the repository of consumer faith, and the loss of consumer confidence can cause tremendous negative externalities. Large financial firms perform critical functions in settling payments and intermediating liquidity for individuals and markets. The freezing of these functions at large interconnected financial firms would lead to cascading consequences for counterparties, customers, and even whole markets.[61]

Another crucial distinguishing feature of financial firms is that while the interests in insolvency proceedings for non-financial firms are usually limited to maximizing the value for shareholders and creditors, the set of considerations for financial firms is usually much wider. Traditional insolvency procedures are debtor led, and the resolution process does not adequately address the concerns of sensitive consumers like bank deposit and insurance policy holders.[62] Further, they do not envisage *ex-ante* planning and the use of professionals who are experienced in managing the financial operations of complex financial firms.

Traditional insolvency measures can drag on for years, which progressively depletes the viability of the firm in resolution, and often does not leave any likelihood of it being salvaged. The Orderly Liquidation Authority under the Dodd-Frank Act has reduced the time consumed by resolution proceedings drastically in the post 2008 world, even popularising the concept of "weekend resolutions".[63] The critical role of a large financial company's settlement and liquidity intermediation function for customers and markets effects the speed (and hence the process) with which such a company must be resolved.[64] Not only are modern resolution techniques designed to be time efficient, they ensure that the failure of a firm is orderly, without taxpayer exposure to loss, while maintaining continuity of their vital economic functions.[65]

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60 Central counterparty is an entity that interposes itself between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer and thereby ensuring the performance of open contracts.

61 Paul L. Lee, "Bankruptcy Alternatives to Title II of the Dodd-Frank Act" (2015) Pt. 1.

62 *Ibid.*

63 *Ibid.*

64 *Ibid.*

65 FSB (n 23).

Resolution-related provisions of laws are minor parts of larger laws such as the Banking Regulation Act 1949, the Insurance Act 1938, and the Reserve Bank of India 1934. Additionally, the Central Government has certain powers with regard to statutorily incorporated entities such as the State Bank of India ('**SBI**'), the Life Insurance Corporation of India, and the General Insurance Corporation. The provisions applicable to different financial institutions are also dissimilar, leading to the lack of a level playing field. These factors negate a possibility of a unified, specialized approach and give rise to the possibility of regulatory forbearance. Therefore, there is a lack of focus on full-fledged institutional capability to handle failure of financial firms in a quick and efficient manner.

While the primary role of a regulator is to try and revive a failing institution, resolution only aims at ensuring orderly failure. Regulators are likely to delay resolution in hope of reviving the institution, but this conflicts with the need for timely and speedy resolution. Therefore, a certain degree of independence for resolution is required, which the current setup does not provide. Further, for firms which are regulated by more than one entity, disagreements on how and by whom the resolution should be carried out lead to a case of regulatory arbitrage.

B. Specified Service Providers

The Insolvency and Bankruptcy Code 2016, and the FRDI Bill are in conjunction designed to provide a comprehensive resolution mechanism in India. The bifurcation of resolution process between the two laws was based on the thinking of the Government that the specialised resolution regime for financial service providers should concentrate on only such entities which are systemically important for financial stability and where the consumer protection considerations are paramount. The FSPs which do not accept public funds and are not systemically important for financial stability of the country could be resolved under IBC through a less costly process and where the resolution may happen through a process of negotiation with various stakeholders.

Section 227[66] of the IBC serves as an enabling mechanism for the Government, to include a financial service provider under either the IBC or the FRDI Bill, based on the nature of their functions. With this view in mind, the FRDI Bill extends to a number of deposit-taking or systemically important financial service providers, as laid out in Schedule II, referred to as including banking institutions, insurance companies, financial market

[66] Insolvency and Bankruptcy Code, 2016, S. 227.

infrastructures, non-banking financial institutions not covered under the IBC, and Systemically Important Financial Institutions. For the purposes of the FRDI Bill, these are referred to as Specified Service Providers ('**SSP**'s). In consonance with FSB principles, it also provides for covering holding companies and non-regulated operational entities within a financial group or conglomerates, if necessary from the standpoint of resolution.[67] To avoid any intended financial service providers from falling through the gaps, the Bill provides for automatic coverage of all SSPs laid out in the second schedule. As long a financial service provider falls under Schedule II, it is *deemed* to be covered under the FRDI Bill. To ensure that SSPs don't seek an avoid route for the application of the Act, the FRDI Bill provides that SSPs will continue to be covered under the FRDI Bill for the purposes of resolution, even after withdrawal or cancellation of registration under the relevant statute.

C. Systemically Important Financial Institutions

For the first time in India, the Bill recognizes the concept of Systemically Important Financial Institutions ('**SIFI**')[68], which are financial service providers whose failure might pose a risk to not just their consumers or the sector they operate in, but rather to the overall financial stability. This label was first created in the wake of the 2008 financial crisis under the Dodd-Frank Act, to recognise the importance of systemically important financial institutions and to extend more enhanced supervisory oversight to them. Though this term has not been explicitly used in India before, this concept exists in practice. For instance, RBI has designated SBI, HDFC Bank and ICICI Bank as Domestic Systemically Important Banks ('**D-SIBs**'). Such criteria may be based on a number of attributes including size, inter-connectedness, complexity, etc. Given their importance to the economy, the Bill envisages some additional powers in respect of these SIFIs, such as heightened scrutiny, power to ask for additional information, etc. SIFI designation is to be done by the Central Government in consultation with the Appropriate Regulator, and such designation is required to be published in the Official Gazette. Further, SIFI designation has to be preceded by an opportunity of being heard and is appealable to the National Company Law Tribunal ('**NCLT**').

D. Resolution Corporation and Appropriate Regulator

The FRDI Bill, draws upon the recommendations of the Financial Stability Board, as well as various Indian reports which have been elaborated above, to set up a specialized expert body for resolution of distressed financial

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[67] FSB (n 23).

[68] FRDI Bill (n 56), Ch. III.

firms. In this regard, the FSB Key Attributes state that a resolution authority "should have operational independence consistent with its statutory responsibilities, transparent processes, sound governance and adequate resources and be subject to rigorous evaluation and accountability mechanisms to assess the effectiveness of any resolution measures". To address problems of regulatory arbitrage and forbearance and to ensure operational efficiency and independence, the Bill provides for the setting up of a new body, the Resolution Corporation, ('**Corporation**')[69]. The Corporation is comprised of representatives of the various financial sector regulators (RBI, SEBI, IRDA and PFRDA) as well as representatives from the Ministry of Finance, and a sprinkling of independent members. This composition ensures that the Corporation draws on the wisdom and the expertise of the existing regulators, while ensuring independence of operation.

The Bill also designates an "Appropriate Regulator"[70] ('**Appropriate Regulator**') for each category of financial service providers, such as RBI for banks, IRDA for insurance companies, PFRDA for pension funds, SEBI for stock exchanges and so forth. Both the Corporation, and the Appropriate Regulator, have specific functions under the FRDI Bill. As long as an SSP is in good health, the Corporation has little role to play apart from very minimal information collection. The Corporation does not replace any functions of Appropriate Regulators, nor does it assume any prudential regulation functions. The design of the Bill provides for a clear delineation of powers between the Appropriate Regulators and the Corporation. The Corporation assumes the reins of an SSP only once it has crossed the acceptable likelihood of failure.

E. Risk to Viability

The treatment of an SSP under the FDRDI Bill hinges on its "risk to viability" at any given point. All SSPs are rated on a five-point risk to viability which takes into account several features of the entity, including adequacy of capital, asset quality, leverage ratio, liquidity and capability of management.[71] The five stages of risk to viability under the FRDI Bill are:

(i) *low*, where the probability of failure of an SSP is substantially below the acceptable probability of failure;

(ii) *moderate*, where the probability of failure of an SSP is marginally below or equal to acceptable probability of failure;

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69 FRDI Bill, Cl. 4.

70 FRDI Bill, First Schedule.

71 FRDI Bill, Cl. 36.

(iii) *material*, where the probability of failure of an SSP is marginally above acceptable probability of failure;

(iv) *imminent*, where the probability of failure of an SSP is substantially above the acceptable probability of failure;

(v) *critical*, where the probability of failure of an SSP is substantially above the acceptable probability of failure, and the SSP is on the verge of failing to meet its obligations to its consumers:

The detailed objective criteria and details of each stage of risk to viability have been left to regulations, which are to be fleshed out by the Corporation in consultation with the Appropriate Regulator. These regulations may take into account several factors including assets and liabilities, liquidity, leverage ratio, sensitivity to adverse market conditions, etc. To maintain the confidence of the consumers in the financial system, all such classifications, except a classification into "critical risk to viability" (which has to be done through a written order) are kept confidential.[72]

F. Delineation of roles

The Appropriate Regulators and the Corporation work in tandem to ensure orderly resolution of distressed SSPs. In the spirit of independence, there is a separation of the functions of regulation and resolution. The Bill also distinguishes, to the extent possible, the roles and responsibilities of the Appropriate Regulators and the Corporation. Any duplication in their function is both unavoidable, and necessary, for the effective monitoring of distressed financial firms.

On a broad scale of risk to viability envisaged in the Bill, barring a few special entities like central counterparties, the Appropriate Regulator has full powers in the 'low', 'moderate', and 'material' stages. If an entity crosses the acceptable probability of failure and is classified at "material", the Appropriate Regulator may take several steps including preventing the entity from accepting funds, payment or declaration of dividends, and acquiring any interest in any other business.[73] In the stage of 'imminent', when the financial firm is on the verge of failure, the Appropriate Regulators continue their non-conflicting attempts of recovery, and the Corporation gets powers to prepare for actual resolution- for example, preventing the entity from fleeing with assets and consumer deposits money. However, the Appropriate Regulator continues to exercise non-conflicting powers (such as

[72] FRDI Bill, Cl. 36.
[73] FRDI Bill, Cl. 42.

those relating to consumer protection) under the various statutes even after the Corporation has taken over a failed SSP. The 'imminent' stage is envisaged as a temporary stage for resolution preparation and is not expected to continue beyond a few weeks or months at most. Most importantly, existing recovery mechanisms of the Appropriate Regulator will continue to operate (for example, RBI's Prompt Corrective Action framework) because the Corporation at this stage will only prepare for the failure of the concerned entity, while the Appropriate Regulator will continue its recovery efforts. At this stage, the Corporation may appoint an officer to inspect the working of the entity.[74]

A classification at "critical risk to viability" triggers a number of simultaneous actions.[75] Most important, this signals the beginning of resolution by the Corporation. This timing of the initiation of resolution action is important; it is understood that resolution regime should provide for timely and early entry into resolution before a firm is balance-sheet insolvent and before all equity has been fully wiped out.[76] At this stage, the Corporation gets appointed as the Administrator and takes over the management of the affairs of the specified service provider, with the suspension of the powers of its board of directors.

G. Process of Resolution

One of the most overreaching changes which the FRDI Bill seeks to bring inis the expansion of the methods of resolution itself. As has been discussed earlier, the present insolvency regime is restricted in terms of the methods of resolution methods it offers and provides little recourse apart from liquidation and mergers. In the wake of the 2008 crisis, the need for a wider variety of resolution options was realised. The present limited tools of resolution do not leave much scope for the continuity of the firm, and protracted insolvency proceedings naturally lead to the erosion of the valuation of the firm. Problems of moral hazard have demonstrably exacerbated the health of financial firms in the past, with the taxpayers being left to bear the burden. Most importantly, financial firms do fail, and inefficient firms should be allowed to fail in an orderly fashion.

In this regard, the FSB Key Attributes states, "in order to facilitate the coordinated resolution of firms active in multiple countries, jurisdictions should seek convergence of their resolution regimes through the legislative

74 FRDI Bill, Cl. 43.
75 FRDI Bill, Cl. 45.
76 FSB (n 23).

changes needed to incorporate the tools and powers set out in these Key Attributes into their national regimes". Once a resolution action is triggered by classification a "critical risk to viability" classification, the Corporation can use any of the available tools, either individually, or in combination with another tool. The words "or in combination with another" are important, as they give the Corporation hitherto unavailable flexibility in applying different methods of resolution to different parts of the same entity. While the FRDI Bill replicates some of the existing tools of resolution such as merger and acquisition, it provides for a number of modern tools of resolution such as bail-in, bridge service provider and run-off entity for insurance companies.[77] The FRDI Bill provides for the following methods of resolution:

(i) **Transferring the whole or part of the assets and liabilities of the specified service provider to another person, on terms agreed between the Corporation and such person:** This is simply a transfer of the whole or part of assets and liabilities to an external purchaser. This is a good way to keep the firm running, especially when the problematic assets can be segregated. This protects the interests of the existing consumers, because their claims stay protected and merely get transferred to a new entity. While this tool exists in some form in some existing legislations, the design under the FRDI Bill allows technicalities like the transfer and sale to occur swiftly and under expert supervision. Where there are doubts about the quality of some of the assets, it becomes necessary to effect partial transfers, whereby the purchaser takes only 'good' assets, leaving 'toxic' assets behind.[78]

(ii) **Creating a bridge service provider**: This is one of the new methods of resolution provided in the FRDI Bill, one that has also been adopted by a number of modern resolution laws including the Dodd-Frank Act[79], Hong Kong Financial Institutions Resolution Ordinance[80], and the Monetary Authority of Singapore Act[81]. A Bridge Service Provider is essentially a temporary institution which is set up to take over the operations and critical functions of a financial institution, for a period of one year at the most. A bridge is an entity that is established to temporarily take over and maintain certain assets, liabilities, and operations of a failed firm as part of the resolution process.[82] One possible method of creation of a bridge service provider ('**BSP**') under

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77 FRDI Bill, Ch. X.
78 Armour (n 15).
79 Dodd-Frank Act 2010 (n 26).
80 The Financial Institutions (Resolution) Ordinance 2016 (Hong Kong).
81 Monetary Authority of Singapore (Amendment) Bill 2017 (Singapore).
82 FSB (n 23).

the FRDI Bill is the creation of a company under the Companies Act, 2013, with 100% of its shares to be held by the Corporation. Further to the creation of such BSP, all assets, liabilities and powers of the erstwhile SSP stand transferred to the new BSP. The BSP may be granted with such exemptions as may be necessary for it to carry out its functions expeditiously and without hindrance.

(iii) **Bail-in**: Bail-in is one of the most important new generation resolution tools. This method focuses on changing the structure of a troubled institution's financial contracts, as opposed to the ownership of its assets.[83] Bail-in converts certain creditors' interests into capital, instead of relying on tax-funded bail-outs. The tool of bail-in becomes most advantageous when resolution authorities fail to find a willing buyer for a failed financial institution and effecting a full or partial transfer of the firm proves difficult.

Under the FRDI Bill, this tool is circumscribed by a number of safeguards. Bail-in can only be invoked where the contract creating the liability contains a provision that the parties to the contract agree to the liability being eligible for a bail-in. Only specific liabilities, which are identified in advance by the Appropriate Regulator can be subject to bail-in. Therefore, bail-in can only be carried out with prior consent and on pre-identified liabilities. Further, hierarchy of claims has to be maintained and sensitive deposits like bank deposits protected by deposit insurance are explicitly excluded from the application of bail-in. As a check on the Corporation's powers, a resolution tool has to be necessarily enforced by means of a scheme, which in turn has to be published in the Official gazette and also laid before both the Houses of the Parliament.

(iv) **Run-off (for insurance companies):** this is a new tool of resolution specifically for insurance policies wherein the insurance company is closed to new business and the existing liabilities are "run off" over time. The Corporation has the option to sell or transfer the portfolios of an insurance company to another insurance company or a run-off entity. These powers are not currently present in any statute governing insurance companies, and as pointed out by international bodies such as the FSB[84], are critical to ensure orderly run-off of the whole or part of the existing business lines and insurance products, specially to make sure that the current policies run to their expiration dates, without causing any harm to consumers, even when the insurance firm is failing.

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[83] Armour (n 15).

[84] FSB (n 23) Para 3.7.

(v) **Liquidation:** while the tool of liquidation is pre-existing, the FRDI Bill provides for a more streamlined method of liquidation of an SSP. If the Corporation determines that liquidation is the most appropriate tool for the resolution of a specified service provider, the Corporation is required to make an application to the NCLT for an order of liquidation, subsequent to which the Corporation acts as a liquidator for the SSP. The powers of the Corporation as a liquidator include, amongst others, the power to verify claims of all the creditors, take into custody all the assets, property and actionable claims of the specified service provider, sell property, access information, consolidate and verify claims, admit or reject claims, and payments of deposit insurance.

A critical departure from the existing system of liquidation is that insured bank deposit holders are placed at the top of the liquidation waterfall and get first priority in liquidation. Uninsured depositors are kept at par with insurance policy holders, enhancing their position as compared to the present system. Government deposits, unlike the present system feature significantly lower in the waterfall, with workmen monies and wages due to employees being accorded a higher priority. The liquidation process is in line with the liquidation process under the IBC. The FRDI Bill provides a comprehensive framework for voluntary resolution.[85] SSPs classified at the lower stages of risk to viability, i.e., which are in a healthy financial condition are to close their business "voluntarily" as per the provisions of the IBC, subject to the supervision of the Appropriate Regulator. However, in case the SSP crosses the threshold of acceptable health (classified in the category of 'material' risk to viability or higher), it is to be resolved under the FRDI Bill. This is to ensure that a failing financial institution, under the garb of "voluntary liquidation" does not try to close it business and abdicate its responsibilities to its consumers or depositors. In short, once an acceptable degree of risk of failure has been crossed by a financial institution, there cannot be any "voluntary" closure of business.

(v) **Merger or amalgamation of the specified service provider; Acquisition of the specified service provider, in whole or in part:**

These tools already exist in some form of the other in the current legal framework and can be resorted to by the Corporation if appropriate, in a given situation.

[85] FRDI Bill, Ch. XIII.

H. Resolution and Restoration Plans

One of the features of post-2008 regimes, which is also one of the most important FSB Key Attributes is the reliance on restoration plans and resolution plans (colloquially referred to as "living wills') for the resolution process. For instance, the EU's proposed Recovery and Resolution Directive[86] provides for all firms to which it applies to be required to draw up recovery plans and provide their supervisory authorities with such information as is necessary for the preparation of resolution plans.[87] The Bill provides for the submission of restoration plans[88], which are supposed to serve as a guide in the attempted resuscitation of a failing entity, and resolution plans[89] that are geared towards ensuring the orderly winding up of a failed entity. A response to the challenge of complexity in resolving large financial institutions has been for supervisors to engage in dialogue with these institutions *ex-ante* regarding how resolution might successfully be achieved *ex-post*.[90] The idea is that, should a resolution process ever be initiated, the resolution authority has resort to a roadmap of the necessary actions, in advance.

While restoration plans are supposed to lay down the steps that will be taken to *restore* a financial firm to sound health, i.e., at least "moderate risk to liability", resolution plans encapsulate the plan of action for the *resolution* of a failed financial firm. Restoration plans are to be submitted to the Appropriate Regulator and resolution plans to the Corporation, with a copy of every such plan to be sent to the Corporation and the Appropriate Regulator, as the case may be. The FRDI Bill leaves ample scope for the Appropriate Regulator, or the Corporation to prescribe not only the form and manner, but also the contours of the plans. Further, the FRDI Bill confers flexibility to implement a proportional approach, for smaller and less complex entities. The Appropriate Regulator and the Corporation can also review the restoration and the resolution plans respectively and modify any deficient plans in the interest of orderly resolution. The plans also need to be updated at regular intervals.

The requirement to submit these plans is triggered only once a specified service provider is classified in the category of "material" or "imminent" risk to viability. However, because of the criticality of a "SIFI" designation on the financial system, SIFIs are required to submit both a restoration plan and a resolution plan immediately upon designation.

86 BRRD (n 29).
87 BRRD (n 29).
88 FRDI Bill, Cl. 39.
89 FRDI Bill, Cl. 40.
90 Armour (n 15).

I. Financing of Resolution

A major departure in modern resolution regimes lies in the area of financing of resolution actions. While the previous generations of resolution regimes have relied mainly on Government funds, *ergo* on taxpayers' money in funding resolution actions, the modern school of thought discourages relying solely on government bail-outs. In this regard, the FSB Key Attributes states "jurisdictions should have statutory or other policies in place so that authorities are not constrained to rely on public ownership or bail-out funds as a means of resolving firms."[91] The FRDI Bill enshrines this in the preamble where "protection of public funds to the extent possible" is listed as one of the objectives. While government bail-out is a sovereign right and cannot be precluded by any statute, the FRDI Bill provides for alternative, more efficient means of funding. The FRDI Bill provides for a "Corporation Resolution Fund", which is funded through levying a resolution fee on all covered SSPs.[92] This fee is a variable amount, depending on the size, risk profile and other considerations. The Corporation is also authorised to replenish this fund by imposing an *ex post* fee on an SSP under resolution wherever possible.

J. Deposit Insurance

The FRDI Bill, aside from modernizing the resolution framework in India, is also subsuming the functions of the Deposit Insurance and Credit Guarantee Corporation ('**DICGC**'), which was set up under the Deposit Insurance and Credit Guarantee Corporation Act 1961. DICGC was set up as a pay-box, under the sponsorship of RBI to extend insurance to bank deposits up to a specified limit. The Corporation will take over the deposit insurance functions from the erstwhile DICGC (which operated as a subsidiary of the Reserve Bank of India, with the employees of the RBI being deputed to DICGC). This brings the deposit insurance framework in India largely in line with the international practices in this regard and is a step towards streamlining the existing system. The time period for pay-out of deposit insurance has also been reduced[93], bringing it much closer to the global average. The Bill introduces a risk-based premium framework for charging premiums from banks[94], and imposes an obligation on the Corporation to ensure unhindered deposit insurance coverage for banking institutions.

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91 FSB (n 23).
92 FRDI Bill, Cl. 21.
93 FRDI Bill, Ch. IV.
94 FRDI Bill, Cl. 22.

Separation of the deposit insurance functions from the RBI also has distinct advantages. Distancing the DICGC from the central bank helps reduce the feeling on the part of the DICGC that it has access to unlimited resources and helps induce independence of thought on the part of the DICGC, which must make pre-emptive decisions about the closure of a bank without worrying whether this will signal its past failure.[95] As deposit insurance pay-outs and resolution actions are often inextricably connected, conferring the dual functions of deposit insurance and resolution in a single body also helps achieve closer co-ordination.

K. Safeguards in the FRDI Bill

The FRDI Bill includes a number of safeguards[96] in the application of powers. Resolution has to be completed within one year (except in the case of liquidation), with the provision for an extension of one additional year. One of the most important safeguards which has been introduced is the principle of "no creditor worse off than in liquidation" which imposes an obligation on the Corporation to choose a method of resolution which will ensure that in the course of resolution, the creditors will receive a treatment which is, at the very least, at par with what they would have received in liquidation. The FRDI Bill also provides for a robust independent compensation mechanism in case of derogation from this principle.[97] Ensuring the continuity of critical functions, and the protection of client funds and client assets are some of the other prescribed safeguards. The Corporation has flexibility to specify other additional safeguards, through regulations, made in consultation with the Appropriate Regulator.

Protection of consumer interest is also implicit in the powers of the Appropriate Regulator and the Corporation in cases of material and imminent risk to viability, such as preventing an institution from accepting funds[98] and declaration of payment of dividends[99]. Promptly upon the classification of a financial institution at "critical risk to viability", the Resolution Corporation mandatorily makes payment of deposit insurance to depositors.[100] Payment to depositors of their interest and continued employment of employees, are factors which necessarily have to be included in the scheme of resolution.[101] To hold the directorial and managerial personnel account-

[95] Planning Commission (n 35).
[96] FRDI Bill, Cl. 55.
[97] FRDI Bill, Ch. XVI.
[98] FRDI Bill, Cl. 42.
[99] FRDI Bill, Cl. 43.
[100] FRDI Bill, Cl. 45.
[101] FRDI Bill, Cl. 49.

able and to discourage the taking of excessively risky decisions, the FRDI Bill provides for the "clawing-back" of any remuneration received as performance incentive, in case the SSP in question goes into resolution, after giving a reasonable opportunity of being heard.[102]

L. Checks and Balances

One of the major breakthroughs of the present FRDI Bill is the establishment of an expedient mechanism for resolution, in the absence of which, the purposes of the FRDI Bill will be defeated. The resolution authority should have the capacity to exercise the resolution powers with the necessary speed and flexibility, subject to constitutionally protected legal remedies and due process.[103] However, considering the nature of powers available to the Corporation under the FRDI Bill, there are a number of checks on the exercise of its power and an in-built mechanism for upholding the principles of natural justice.

The Central Government is authorised to supersede the Corporation in matters of grave public importance, and it is bound by the Government's policy directions. Given the technical nature of the subject matter, the FRDI Bill relies considerably on delegated legislation. However, the Corporation as well the Appropriate Regulators are required to hold due consultations with all relevant stakeholders before making any regulations and maintain transparency in its working. Given the implications, every risk to viability classification at material or higher, has to be necessarily preceded by an opportunity of being heard and by the issuance of a show cause notice.[104] The FRDI Bill also requires an annual report to be laid before the Parliament.[105]

M. Cross Border Resolution

Keeping the global interconnected nature of the modern economy, the FRDI Bill gives flexibility to the Corporation to recognise or adopt support measures of foreign resolution actions through bilateral agreements.[106] The Corporation is also empowered to enter into memoranda of understanding with foreign governments, and similarly placed international bodies, to the extent permissible. The FRDI Bill gives the Corporation the option to recognise and enforce a foreign resolution actions which may have local

[102] FRDI Bill, Cl. 51.
[103] FSB (n 23).
[104] FRDI Bill, Cl. 46.
[105] FRDI Bill, Cl. 130.
[106] FRDI Bill, Cl. 95.

implications in India.[107] However, the Corporation is also empowered to *refuse* such recognition if such recognition or enforcement would be likely to lead to adverse impact on the financial stability in India, or be opposed to the public policy of India, and if there exists the possibility of an independent resolution action in India. In line with the prudential regulations in place in India, local creditors have the first charge on assets of in certain cases.[108]

VII. Conclusion

In August 2018, the Central Government officially announced its intention of withdrawing the FRDI Bill, with one of the major reasons citedbeing the severe backlash against the "bail-in" clause.[109] A mere perusal of the FRDI Bill reveals how misguided these concerns are. Further, unlike jurisdictions like Cyprus (which incidentally, was extensively referred to in the criticism of the tool) which provide for a much more stringent statutory bail-in, wherein bail-in is mandated by law in certain circumstances, the FRDI Bill provides for contractual bail-in. The tool of bail-in is circumscribed by a number of conditions and safeguards. This has several aspects to it. *Firstly*, it can only be resorted to in consultation with the concerned regulator: for instance, the Reserve Bank of India in the case of banks.[110] *Secondly,* only those liabilities can be bailed-in where the creating instrument has an express provision stating that the parties agree to the possibility of bail-in.[111] *Thirdly*, only those liabilities can be bailed-in which are specified by regulations to be permissible to be subject to bail-in, and the FRDI Bill provides for consultation with all stakeholders for formulating regulations.[112] *Finally*, crucial liabilities like depositors' money, workmen's wages have been explicitly left out of the purview of bail-in.[113] Apart from being circumscribed by a number of conditions, the Bill also provides for a stringent accountability mechanism. The Resolution Corporation is required to send to the central government a report explaining why a bail-in instrument is necessary, and the report has to be placed before both Houses of Parliament.[114] The Bill also mandates that no action of the Resolution Corporation, including activation of the bail-in tool, must leave any creditor, including depositors, in a worse position than

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107 FRDI Bill, Cl. 96.
108 FRDI Bill, Cl. 96.
109 FRDI Bill, Cl. 20.
110 FRDI Bill, Cl. 52(1).
111 FRDI Bill, Cl. 55(2)(b).
112 FRDI Bill, Cl. 52 (7)(f).
113 FRDI Bill, Cl. 52(7).
114 FRDI Bill, Cl. 52(8).

they would have been in the event of liquidation.[115] In case of departure from this principle, the depositors are eligible for compensation. [116]

In July 2018, India's biggest insurer, Life Insurance Corporation ("**LIC**") stepped in to "take control" of two high-profile entities-IDBI Bank[117] and IL&FS[118]. While these two moves have not strictly been termed as such, they are nothing but government bail-outs for distressed financial entities reeling under bad debts and a history of questionable business practices. The necessary resources in both instances will come out of policyholders' funds or rather public money. The fact that these almost coincided in time with the FRDI Bill is not only somewhat ironical, it serves as a perfect example of a pressing need for a specialised resolution mechanism for financial entities.

Adopting an attitude of "*this time is different*" or worse "*next time will be different*"[119] can at best, delay inevitable systemic failures. The domino effect unleashed by the Lehman-brothers crash exposed the many flaws present in the financial system and underscored the criticality of prudent regulatory and fiscal policies. The present generation of policy making is faced with a unique opportunity and responsibility to apply the lessons of the last generation into devising a healthier, more stable financial system, devoid of moral hazard, and cognizant of consumer interests. This year marks one decade since the 2008 global financial crisis and recent upheavals like the Greek tragedy of the national pension system[120] and the dramatic crash of the Turkish Lira[121] show the extent of interconnectedness of global financial systems and their vulnerability to external shocks. The withdrawal of the FRDI Bill deprives the Indian financial sector of a crucial safety net and may very well prove to be a giant leap backwards in the longer run.

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115 FRDI Bill, Cl. 55(1)(b).

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119 Rajan (n 1).

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