CONUNDRUMS OF MODEL INDIA BILATERAL INVESTMENT TREATY VIS-À-VIS DISPUTE RESOLUTION IN INDIA

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ABSTRACT

India is operational with a multifaceted marketing structure, pervading to steel, pharmaceuticals, telecoms, information technology consultancy, tourism are few enlisted. Needless to say, cross-boarded traders and investors often venture on India's expanse and growth considering the Foreign Direct Investments (FDIs) permissible within the policy framework. Related rights and obligations has been structured through Bilateral Investment Treaty (BITs) models across the globe enunciating the protection that may be granted to the Investor for potential investment in the host state. BITs also contain within them the Dispute Resolution Clauses before which is the cooling off period and exhausting of local remedies leaving scope for settlement. A salient aspect of almost all BITs is that they empower individual investors to directly bring claims against a host State before an international arbitration tribunal. This is also known as Investor-State Dispute Settlement (ISDS) or BIT arbitration.[1] Enforcement of Legal Rights when disputes arise has always been quintessential in understanding the robustness of a legal regime. Through these the best practices are founded upon to smoothen the dispute resolution process and fixate the seat of Arbitration.

I. BACKDROP OF 2015 MODEL BIT

The Indian Bilateral Investment Treaty (hereinafter '**BIT**') Model 2015 is a detailed and descriptive edition of 2003 Model with 38 Articles

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[1] The term is not restricted to Investor State but also covers state-state treaty disputes.

which are housed under seven chapters.[2] The inclination in the new BIT Model is towards protecting the Host State by confining the limits of Investor's protection granted under the said BIT by protecting the state's regulatory power to take measures in the public interest.[3]

The ambit of application of the BIT is casted upon the parties' right from the pre-investment stage and encompasses investments existing on the date the BIT came into force. Exclusion to claims that have arisen before BIT and those measures taken by local government, relating to taxes, compulsory licenses granted under intellectual property and any government procurements.

A. Dispute Resolution under Model India BIT 2015

Major concern at the onset was seemingly due to the polarized opinions of the Arbitrators either favouring the investor or the state[4] and thus closes door to any last resort that is served through appellate bodies increasing the risk of a well-reasoned scrutiny. The International Centre for Settlement of Investment Dispute (hereinafter '**ICSID**') provides an appellate mechanism, but India is not a signatory to the ICSID

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[2] Grant Hanessian & Kabir Duggal, *The Final 2015 Indian Model BIT: Is This the Change the World Wishes to See?,* 30(3) ICSID REVIEW - FOREIGN INVESTMENT LAW JOURNAL 729 (2015), (doi:10.1093/icsidreview/siw020) [hereinafter **Hanessian & Duggal, Is this the Change the World wishes to See (2017)**].

[3] Saman Ahsan & Sanjeev Kapoor, *Substantial changes introduced in new Model Bilateral Investment Treaty,* THE INTERNATIONAL LAW OFFICE (Feb. 18, 2016), https://www.internationallawoffice.com/Newsletters/Arbitration-ADR/India/Khaitan-Co/Substantial-changes-introduced-in-new-Model-Bilateral-Investment-Treaty#.

[4] Gus Van Harten, *Pro-Investor or Pro-State Bias in Investment-Treaty Arbitration? Forthcoming Study Gives Cause for Concern*, INVESTMENT TREATY NEWS (13th April 2012), https://www.iisd.org/itn/2012/04/13/pro-investor-or-pro-state-bias-in-investment-treatyarbitration-forthcoming-study-gives-cause-for-concern/.

mechanism, and therefore, no such appellate mechanism will apply to Indian BIT disputes.[5]

Anomalies still lie in exercising this well thought out model, it has only provided for ad-hoc international arbitrations and avoids reference to other fora like ICSID (for States that are parties to ICSID), as well as the ICSID Additional Facility, which could be used to bring a claim against States that are not party to the ICSID. Even though India is not a party to ICSID, reference to these alternate dispute resolution methods might benefit Indian investors abroad seeking to bring a claim against other States. India is required to make arbitration institutional rather than running the same on ad-hoc arbitrators.

II. CASES ENTAILING ANOMALIES IN APPLICATION OF THE ARBITRATION AND CONCILIATION ACT, 1996

Issues are highlighted through cases fetched under the Investor who approached arbitration though the said BIT.

The first stint of BIT arbitration in India brings into the limelight *Port of Kolkata v. Louis Dreyfus Armatures*,[6] a French company investing in Haldia Bulk Terminals Private Limited (hereinafter '**HBT**'), an Indian company. A contract was entered into consisting of an arbitration clause, later a dispute arose between HBT and Port Trust and arbitration process commenced, meanwhile Louis Dreyfus Armatures (hereinafter '**LDA**')

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[5] Law Commission of India, *Report No.260, Analysis of the 2015 Draft Model Indian Bilateral Investment Treaty,* GOVERNMENT OF INDIA (2015), http://lawcommissionofindia.nic.in/reports/Report260.pdf.

[6] Board of Trustees of the Port of Kolkata v. Louis Dreyfus Armatures, 2014 SCC OnLine Cal 17695.

transpired a BIT arbitration under India- France BIT inclusive of State of West Bengal as one of the parties in the opposition. The clash grew sour when an anti-arbitral award was sought as part of injunction order restraining the ongoing BIT arbitration initiated by LDA. The Court ordered that LDA restrain from continuing proceedings against the Port Trust, which was wrongly identified as a party to the investment arbitration.

Next, in line is the humungous case of *India v. Vodafone,*[7] where in 2006, Vodafone International Holdings entered into an agreement with Hutchison Telecommunications International Ltd (hereinafter '**HTIL**') – a Cayman Island company – to buy HTIL's share of 67 per cent interest in an Indian company Hutchison Essar Ltd. (hereinafter '**HEL**') for 11 billion USD. Capital tax gain was slammed at the doors of the Company of USD 2.2 billion. Vodafone contended that the transactions did not involve a capital asset situated in India and hence no capital gains tax was payable. The Indian tax authorities however argued that Vodafone's income is taxable under the Indian Income Tax Act, 1961, which taxes income deemed to accrue or arise in India.[8]

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[7] Vodafone International Holdings B.V., is a company incorporated in Netherlands, which is the holding company of Vodafone India Limited. On 31 August 2018, Vodafone India merged with Idea Cellular and was renamed as Vodafone Idea Limited. See Company Overview of Vodafone Idea Limited, https://www.vodafoneidea.com/whowe-are/overview (last visited Feb. 25, 2020); Vodafone International Holdings B.V. in turn is the subsidiary of Vodafone Group Plc which is the U.K. based corporation. See Company Overview of Vodafone International Holdings B.V., https://www.bloomberg.com/profile/company/2255396Z:LN.

[8] Income-Tax Act, 1961, No. 43, Acts of Parliament, 1961 (India), §§ 9 & 195.

Later the Apex Court decided that Vodafone did not owe any Tax and that led to the amendments that sportingly overruled the decision of the Court. These amendments legalized the tax demand on Vodafone struck down by the Supreme Court. Vodafone instantly challenged the tax amendments under the India- Netherlands BIT, alleging that retrospective effect given to the tax amendment will vitiate the obligation of India under the BIT. Following which arbitration tribunal was constituted in 2016 which is presently deciding on the matter. Soon after this another notice was served under India-UK BIT challenging the imposition of taxes and on receiving this India approached the High Court of Delhi where an order of restrain was passed on the commencement of arbitration process under India-UK BIT. This was seen as an abuse of process by simultaneously approaching to different forum under the BITs. This was followed by an order of the Delhi High Court on 26 October 2017, clarifying that the representatives/counsel for the parties were free to participate in the proceedings for appointment of a presiding arbitrator under the dismissed the plea of the Indian government seeking an anti-arbitration injunction against Vodafone from proceeding under the India-UK BIT arbitration.[9]

Lastly the case of *Union of India v. Khaitan*,[10] which arose out of a Supreme Court Order of cancelling the licenses of telecom companies on account of irregularities in the allocation of 2G. As a result, 21 such licenses to loop company were cancelled where Khaitan, a Mauritian company which held 26.95 percent shares in it aggrieved, issued a notice of arbitration to India for loss occurred to it and thereby claiming the

[9] Union of India v. Vodafone Group PLC United Kingdom, 2018 SCC OnLine Del 8842.
[10] Union of India v. Khaitan Holdings (Mauritius) Ltd., 2019 SCC OnLine Del 6755.

compensation. Immediately India sought an anti-arbitral injunction on the well premised fact that two of its beneficial shareholders were Indian citizens thus resorting to arbitration meant adjudication between Indian and Republic of India. Though Delhi High court declined to pass an anti-arbitral order of injunction. This is simply the case of nationality planning and abusing the process of arbitration by resorting to it and claiming against one's host state who has given them the nationality status.

Issues that arose was one, that of jurisdiction in cases where foreign investors invoke arbitration to exactly which of the domestic law will apply to set the rights and obligations of the parties straight. *Port of Kolkata v. LDA*, presumed that it had jurisdiction over BIT arbitration under the A&C Act, without dealing in detail with the issue of jurisdiction over BIT arbitrations. The consequence of such presumption is that the national courts of India will have jurisdiction over BIT arbitrations in all those instances where the A&C Act allows such judicial intervention. However, the Delhi High Court in *India v. Vodafone* and *India v. Khaitan* treated the issue of jurisdiction differently. In both the cases the Court rejected the view that the Arbitration and Conciliation Act, 1996 (hereinafter '**A&C Act**') is applicable to BIT arbitration and held that the national courts have inherent jurisdiction over BIT arbitrations under the Civil Procedure Code, 1908.[11]

[11] Satish Bhushan & Shreyas Jayasimha, *Indian Courts' First Brush with Investment Treaty Arbitration: Taking Some Lessons from the Calcutta High Court*, KLUWER ARBITRATION BLOG (Mar. 16, 2015), http://arbitrationblog.kluwerarbitration.com/2015/03/16/indian-courts-first-brush-with-investment-treaty-arbitration-taking-some-lessons-from-calcutta-highcourt/.

This procreates two divergent approaches due to no such definitive pronouncement by the Supreme Court of India namely:

- National courts exercising jurisdiction within the framework of the A&C Act; and
- National courts exercising inherent jurisdiction under the general civil procedure code.

Under the first approach it is a felt understood concept that an arbitral award rendered in India is enforceable as per the provisions of Civil Procedure Code which is adduced when arbitration is seated in India then it is governed under Part I of the A&C Act. Whereas for any foreign arbitral award to be recognized it necessitates the satisfaction of Section 44.[12]

Part II of the A&C Act deals with the enforcement of foreign arbitral awards rendered in countries that are party to the NYC. However, it does not contemplate on the grey area of its non-applicability where Part II of the A&C Act deals with the enforcement of foreign arbitral awards rendered in countries that are party to the NYC. The situation arose under the landmark case of *Bhatia International v. Bulk Trading*,[13] where Supreme Court said that all the non-convention countries would be covered under Part I of the Act and so will the enforcement of the award.

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[12] The Arbitration and Conciliation (Amendment) Act, 1996, No. 26, Acts of Parliament, 1996 (India), §44 ("foreign award" means an arbitral award on differences between persons arising out of legal relationships, whether contractual or not, considered as commercial under the law in force in India).

[13] Bhatia International v Bulk Trading SA, (2002) 4 SCC 105, ¶ 23; Sumeet Kachwaha, *Enforcement of Arbitration Awards in India*, 4(1) ASIAN INTERNATIONAL ARBITRATION JOURNAL 64 (2008).

The dust did not settle in Bhatia when *Balco v. Kaiser*,[14] happened the Court overruled what it decided in Bhatia International leaving no room for remedy to the non-convention countries. It is now in the lap of legislature to provide a solution for the anomalous situation.

Under the second approach of assuming the inherent jurisdiction of the High Court also entails within itself the rejection to the presumed applicability of the A&C Act. In it Court found out that even if the BIT involved a foreign investor and is against a host state it can neither be termed International Commercial Arbitration nor domestic Arbitration. Thus, the Court said that the A&C Act, including Sections 5 and 45, do not apply "*proprio vigore*" to BIT arbitration. Section 5 of the A&C Act, which falls within Part I of the A&C Act, [15] determines the extent to which the judiciary can intervene in arbitral proceedings taking place in India. Further an interesting connotation is being given by the Court is that Part II of the Act will apply where legal relationships are commercial in nature. Delhi High Court enunciated that the element of "commerciality" is absent in the BIT arbitration, therefore, no application to Part II of the Act is viable. Founded on a well-reasoned understanding that dispute in BIT do not arise due to commercial fallacy but because of the fact that the treaty obligations that state had guaranteed to the Investor has not been duly undertaken. Hence, disputes arising from Bilateral Investment are different from simple commercial contract.

[14] Balco Aluminium Co v. Kaiser Aluminium Technical Services Inc, (2012) 9 SCC 552, ¶ 175.

[15] The Arbitration and Conciliation (Amendment) Act, 1996, No. 26, Acts of Parliament, 1996 (India), §5 (Extent of judicial intervention- Notwithstanding anything contained in any other law for the time being in force, in matters governed by this Part, no judicial authority shall intervene except where so provided in this Part).

But on ascertaining the sections with the reasons given by the court it is observed that BIT is a public international law instrument and the legal relationships of the parties (foreign investor and the Host state) are commercial and can be made applicable to Part II of the Act and the emphasis drawn on the Section 44 is not on the commerciality of cause of action but of the legal relations over which the right and obligations of the parties are governed. Therefore, the logic gets defeated on application of the Delhi High Court's and leaves us in swamp of absurdity. Another factor which militates against the interpretation of the Delhi High Court is the fact that the UNCITRAL Model Law on International Commercial Arbitration, 1985 (with amendments as adopted in 2006) prescribes the term "relationships of a commercial nature" to include investments.[16]

In fact, when the Commercial Court Act was passed the legislative debate addressed the role of the commercial courts in overcoming "the delay in judicial process," and creating "an FDI friendly environment to attract more foreign investments in economic growth of the country." This point to the legislative intent that the investment disputes or differences arising out of the investments made by foreign investors in the host State must be considered as arising out of a legal relationship which is commercial in nature.[17]

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[16] UNCITRAL Model Law on International Commercial Arbitration 1985, with amendments as adopted in 2006, http://www.uncitral.org/pdf/english/texts/arbitration/ml-arb/07-86998_Ebook.pdf (UN Doc A/40/17).

[17] Lok Sabha, *Further discussion on the motion for consideration of the Commercial Courts, Commercial Division and Commercial Appellate Division of High Courts Bill, 2015*, GOVT. OF INDIA (Mar. 1, 2020), http://loksabhaph.nic.in/Debates/Result16.aspx?dbsl=6004.

Challenges in ascertaining the provisions of A&C Act are many but remain unresolved. One of the greatest defeats of arbitration is the inclination of major cases to ad-hoc arbitration which is riddled with problems of delayed proceedings and poor quality of awards thus leading to excessive court interventions.

III. CONCLUSION

The forum of dispensing justice as adduced has been seen plunging justice to more egregious dimensions, the interpretation and ascertainment has remained quintessential in abhorring abuse of power of the court. Simultaneously the clarity in understanding Part II of the A&C Act in applying the BITs requires precedent worthy deliveries from the Court of Law.

Further the second glaring issue in the row which relates to poor quality of awards is the reliance to ad-hoc arbitration rather than Institutional arbitration. The seamless reason remains unfettered as the institutional arbitration in India remains in a nascent state. Most arbitral institutions provide little besides rudimentary physical infrastructure for arbitration hearings. Many arbitral institutions have outdated rules of procedure, inadequately trained staff, and poorly staffed panels of arbitrators.

ELEPHANTS IN THE ROOM: SUPREME COURT AND JUDICIAL REFORMS - PROMOTING INVESTMENTS IN INDIA

- Navneet Nair and Shubhi Pahwa*

ABSTRACT

India is the fifth largest economy in the world. While India holds the title for the fastest growing trillion-dollar economy in the world, it is also notorious for its turtle paced dispute resolution mechanism. As of May 2020, over 3.24 crore cases are pending across various district and *taluka* courts in India, out of which over 2.45 crore cases (~75.86%) are more than one year old.[1] Over 48 lakh cases are pending across various High Courts of which over 31 lakh cases are more than one year old.[2] Another 60 thousand cases are pending before the Hon'ble Supreme Court of India.[3] It is not long back that an International Chamber of Commerce arbitral tribunal had pulled up India and directed it to pay AUS$ 4.85 million to a corporation for being in violation of its treaty obligations under the India-Australia BIT (Bilateral Investment Treaty).[4] The Tribunal had held that India failed to provide investors with effective means to enforce their rights in light of the fact that India's Supreme Court had been unable to dispose of an appeal filed by an Australian investor for a period of more than five years. While the pendency may be attributed to multiple factors, reforms initiated in the last

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[1] Information as available at National Judicial Data Grid (District and Taluka Courts of India) on 15.05.2020, available at: https://njdg.ecourts.gov.in/njdgnew/index.php

[2] Information as available at National Judicial Data Grid (High Courts) on 15.05.2020, available at: https://njdg.ecourts.gov.in/hcnjdg_public/main.php. It is to be noted that this information does not include High Court of Bombay, Delhi, and Madhya Pradesh.

[3] Information as available on the basis of Statistics issued by the Supreme Court of India, available at: https://main.sci.gov.in/statistics as of 01.03.2020.

[4] White Industries Australia Limited v. Republic of India, Final Award delivered on 30.11.2011. (J. William Rowley, Charles N. Brower, & Christopher Lau), https://www.italaw.com/sites/default/files/case-documents/ita0906.pdf.

decade have been promising as far as India's movement towards establishing a faster and more efficient judicial system is concerned.

I. INTERPLAY OF LAW AND ECONOMY

A smooth and efficient legal system is important for any economy in as much as it is able to catalyse the economic growth through increased investments. For increasing investments, the regulatory, tax and legal environment needs to play an enabling role. Investment involves a certain degree of risk and innovation. It is futile to expect risk and innovation from investors if there exists an uncertain legal regime. Importance of a stable and consistent legal regime has been discussed over generations, with thinkers like Chanakya suggesting that rule of law is rudimentary to avert law of the jungle.[5] In order to increase productivity of businesses, judicial efficiency is essential. There are various studies, in the context of India, which have established a direct relationship between the speed of contract enforcement and liberalization of tariffs. Further studies have also indicated that in countries which have an efficient judicial system, gains in productivity from a reduction in input tariffs are highest.[6] Financial markets improve as and when a judicial system improves. The efficiency of a judicial system is also a significant determinant of higher performance for domestic sales as well as exports.[7]

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[5] KAUṬALYA, THE ARTHASHASTRA (L. N. Rangarajan 2d ed., Penguin Books India 2012).

[6] Reshad Ahsan, *Input Tariffs, Speed of Contract Enforcement, and the Productivity of Firms in India*, 90(1) JOURNAL OF INTERNATIONAL ECONOMICS 181–92 (2013).

[7] Pavel Chakraborty, *Judicial Quality and Regional Firm Performance: The Case of Indian States*, 44 (4) JOURNAL OF COMPARATIVE ECONOMICS 902–18 (2016).

A. Reforms in India

India has witnessed remarkable legal reforms in the last five years, and has been amongst the top ten improvers for the third year in a row in the World Bank's Ease of Doing Business Report, where India's ranking has improved from being ranked at 142nd place to being ranked at the 63rd position, all in a span of five years.[8] Apart from India, only the Arab Republic of Egypt, Burundi, Colombia and Georgia have been in the list of ten top improvers for three consecutive times.[9] Despite the monstrous pendency, Indian judicial system is one of the most refined legal systems in the world. The Hon'ble Supreme Court of India has been at the forefront of bringing about a change in the Indian society with its ingenuity of thought. Even though judicial vacancies are on the rise, and the infrastructural support being provided to judges in lower courts is abysmal, Courts have, of late, been working against all odds to favour investor sentiment and providing a consistent legal regime.

B. Relevant decisions of the Supreme Court

1. SCG Contracts India Pvt. Ltd. v. K.S. Chamankar Infrastructure Pvt. Ltd.

In the last one year, Supreme Court has rendered a number of judgments that foster an investor friendly judicial climate. In *SCG*

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[8] World Bank. 2020, *Doing Business 2020: Comparing Business Regulation in 190 Economies. Washington, DC: World Bank*, © WORLD BANK (2020), https://openknowledge.worldbank.org/handle/10986/32436 License: CC BY 3.0 IGO.
[9] *Id.*

Contracts India Pvt. Ltd. v. K.S. Chamankar Infrastructure Pvt. Ltd.,[10] the Supreme Court, in order to preserve the objective of the Commercial Courts Act, 2015, held that in commercial suits, written statement of the defendant has to be mandatorily filed within 120 days of the service of summons, and therefore, it cannot be taken on record after the expiry of the said 120 days. This will have a positive spill over effect on the time being taken for the completion of judicial proceedings under the Commercial Courts Act. A recent constitution bench judgment in *New India Assurance Company Ltd. v. Hilli Multipurpose Cold Storage Private Limited*, C.A. Nos. 19041-42/2013, has on similar lines decided in respect of consumer disputes that time for filing a reply cannot be extended beyond a period of 45 days as prescribed under the Consumer Protection Act.

2. *Simplex Infrastructure Ltd. v. Union of India*

In *Simplex Infrastructure Ltd. v. Union of India,*[11] the Supreme Court held that an application for setting aside an arbitral award on any of the grounds provided in Section 34(2) of the Arbitration and Conciliation Act, 1996 can only be made within three months which is extendable by a maximum period of thirty days for sufficient cause. The effect of this judgment is that there is now a certainty to when a particular dispute is going to end. No arbitral award can now be challenged after such period of 120 days.

[10] SCG Contracts India Pvt. Ltd. v. K.S. Chamankar Infrastructure, (2019) SCC Online SC 226.
[11] Simplex Infrastructure Ltd. v. Union of India, (2019) 2 SCC 455.

3. Jignesh Shah v. Union of India

In *Jignesh Shah v. Union of India,*[12] the Supreme Court held that an insolvency petition would be time barred if the winding up petition that formed the basis of it is itself time barred even if a civil suit for recovery in relation to the same debt was already pending. Similar to *Simplex Infrastructure* (supra), this judgment also brings about certainty in as much as dead claims can no longer be used for thwarting business vide the insolvency route. Strict timelines would ensure discipline in the number and kind of cases that come before the Court.

There are multiple other such judgments passed by the Supreme Court in the last 1 year which emphasise on the need to stick to timelines and/or ensuring a consistent legal regime for businesses. However, for the purposes of this article, we shall focus on two such recent cases where the Supreme Court can be said to have ventured into territories which are generally considered to be out of bounds for courts. These judgments stand out due to the bold and affirmative stand taken by the Supreme Court against the executive as well as the legislature.

4. Hindustan Construction Company Limited v. Union of India

First of the two cases is the recent case of *Hindustan Construction Company Limited v. Union of India,*[13] (hereinafter '**HCC case**') where the Hon'ble Supreme Court pushed certain judicial boundaries to ensure a

[12] Jignesh Shah v. Union of India, (2019) 10 SCC 750.
[13] Hindustan Construction Company Limited v. Union of India, 2019 SCC OnLine SC 1520 [hereinafter **HCC Case**].

significant victory for arbitration in India. The interesting part about this case starts much before the time when this case was even filed. This is a unique case in as much as a certain Supreme Court Judge literally invited a constitutional challenge against Section 87 of the Arbitration Act in open court. Subsequently, in the said case, the Hon'ble Court through the Hon'ble Judge, struck down Section 87 of the Arbitration and Conciliation Act, 1996 as amended in 2019. Section 87 as inserted vide Section 13 of the Arbitration and Conciliation (Amendment) Act, 2019 reads as:[14]

> 87. Unless the parties otherwise agree, the amendments made to this Act by the Arbitration and Conciliation (Amendment) Act, 2015 shall-
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> (a) not apply to-
>
> (i) arbitral proceedings commenced before the commencement of the Arbitration and Conciliation (Amendment) Act, 2015;
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> (ii) court proceedings arising out of or in relation to such arbitral proceedings irrespective of whether such court proceedings are commenced prior to or after the commencement of the Arbitration and Conciliation (Amendment) Act, 2015;
>
> (b) apply only to arbitral proceedings commenced on or after the commencement of the Arbitration and Conciliation (Amendment) Act, 2015 and to court proceedings arising out of or in relation to such arbitral proceedings.

[14] Arbitration and Conciliation Act, 1996, No. 26, Acts of Parliament, 1996 (India), § 87 (amended in 2019).

On a bare reading of Section 87, it prima facie appears that the objective of its insertion was to nullify the effect of a previous judgment of the Hon'ble Supreme Court in the *BCCI case*.[15] Notably, in the BCCI case, the Court had specifically warned against the enactment of Section 87 that was being planned to be done in accordance with the report of Justice Srikrishna Committee, as the same would be contrary to the object of the 2015 Amendment Act. Section 87 provided that the amendments made in 2015 will not apply to court proceedings arising out of, or in relation to, arbitration proceedings that were initiated prior to the enactment of the 2015 Amendment irrespective of the date of commencement of the court proceedings. It also clarified that the amendments introduced in 2015 would apply only to those arbitral proceedings which commenced on or after the commencement of the 2015 Amendment Act and to court proceedings arising out of or in relation to such arbitration proceedings.

Taking a business friendly approach, in order to maintain a stable and consistent arbitration regime, the Hon'ble Court struck down Section 87 as inserted vide the 2019 amendment. In its judgment, the Court observed that the mischief of the misconstruction of Section 36 was rectified by the amendments introduced 19 years after the original enactment. The Court found the 2019 amendments to be manifestly arbitrary since they attempted to undo the aforesaid rectifications introduced via amendments made in 2015. The Court held the revival of

[15] B.C.C.I. v. Kochi Cricket Pvt. Ltd., (2018) 6 SCC 287.

grant of automatic stay to be in contravention of the object of Arbitration and Conciliation Act, 1996, and the subsequent amendment introduced in 2015.

The Court also noted that certain applications seeking refund of deposits had been filed before it seeking release of the payment already made subsequent to the conditional stay order that had been passed. The Court specifically highlighted the issues that would arise as a result of such turning of the clock backwards, and held:

> After the advent of the Insolvency Code on 01.12.2016, the consequence of applying Section 87 is that due to the automatic-stay doctrine laid down by judgments of this Court - which have only been reversed today by the present judgment - the award-holder may become insolvent by defaulting on its payment to its suppliers, when such payments would be forthcoming from arbitral awards in cases where there is no stay, or even in cases where conditional stays are granted. Also, an arbitral award-holder is deprived of the fruits of its award - which is usually obtained after several years of litigating - as a result of the automatic-stay, whereas it would be faced with immediate payment to its operational creditors, which payments may not be forthcoming due to monies not being released on account of automatic-stays of arbitral awards, exposing such award-holders to the rigors of the Insolvency Code. For all these reasons, the deletion of Section 26 of the 2015 Amendment Act, together with the insertion of Section 87 into the Arbitration Act, 1996 by the 2019 Amendment Act, is struck down as being manifestly arbitrary under Article 14 of the Constitution of India.

In order to understand the underlying issue here, it is important to know about the decisions of the Hon'ble Supreme Court in *NALCO v. Pressteel & Fabrications Pvt. Ltd.,*[16] and *Fiza Developers & Inter-Trade Pvt. Ltd. v. Amci (I) Pvt. Ltd.,*[17] which form a part of the background. Subsequent to these two decisions, the Court had observed that automatic suspension of the execution of the award defeats the objective of the Arbitration Act. The Hon'ble Supreme Court accordingly recommended amendment to the section, subsequent to which, Section 36 was amended in 2015 for preventing automatic stay of arbitral awards. During the hearing of the *BCCI case*, the Court's attention was drawn to press releases concerning the enactment of Section 87 in the Arbitration Act. In its judgment in the *BCCI case*, the Hon'ble Supreme Court interpreted Section 36 amended in 2015 in consonance with the object of the Act. It also advised the Government against the enactment of Section 87 that had been proposed vide Press release dated 07.02.2018. However, the government went ahead with the 2019 Amendment Act which came into force with effect from 30.08.2019 and included Section 87.

The prompt response of the Hon'ble Court boosted investor sentiments as the decision is a progressive step towards building investor confidence and providing a consistent legal regime which gives tremendous hope to India Inc. However, what is interesting to note is that this judgment is effectively a classic case of judicial overreach by the Apex Court. The Supreme Court tried to expand its boundaries at the cost

[16] NALCO v. Pressteel & Fabrications Pvt. Ltd., (2004) 1 SCC 540.
[17] Fiza Developers & Inter-Trade Pvt. Ltd. v. Amci (I) Pvt. Ltd., (2009) 17 SCC 796.

of not maintaining the sanctity of separation of powers. After having opined in open court that the Government is unnecessarily tinkering with the arbitration regime in India by introducing the 2019 amendment, and more or less assuring that they will strike it off if it comes before the Court, critics can fairly argue predisposition on part of the Judge while deciding the said case. While certain questions may arise, the fact that Court asserted its freedom from the executive as well as the legislature is remarkable, especially when the act of the Court promotes a favourable investor regime which has a consistent legal policy over a course of time. It gives an assurance that the parliament will not be able to make changes on mere whims.

5. Dharani Sugars and Chemicals Ltd. v. Union of India

Not so long before the HCC Case, the Apex Court in a similar move had struck down, in entirety, a circular issued by India's top banking regulator, the Reserve Bank of India (hereinafter '**RBI**'), which directed banks to initiate insolvency proceedings against certain non-performing assets (hereinafter '**NPAs**'). The Preamble of the Reserve Bank of India Act, 1934 (hereinafter '**the RBI Act**') shows that RBI has been constituted to operate the currency and credit system of the country to its advantage. In the *RBI Circular case*,[18] turning a blind eye towards the health of banking system as well as intention of the parliament, the Hon'ble Supreme Court made RBI a toothless monster as far as its powers in respect of directing banks to initiate insolvency proceedings is concerned.

[18] Dharani Sugars & Chemicals Ltd. v. Union of India, (2019) 5 SCC 480 [hereinafter **RBI Circular Case**].

Health of a country's banking system is extremely important for its macro economy. Non-performing assets are a critical bottleneck for a developing economy as unresolved non-performing assets clog a good amount of capital which can be used for boosting the economy. When a borrower's account becomes stressed and is classified as a non performing asset, banks have to make provision for their losses which further depletes the banks' capital. Since banks are subject to regulatory action once they lose capital, they tend to evergreen their non-performing assets and thus misallocate further credit to unhealthy and unworthy borrowers. Once a significant part of the banking system is affected with the problem of high stressed assets, impact on the investment climate becomes very adverse, especially on smaller businesses which are primarily dependent on banks for funding.[19]

Due to the absence of an effective and time sensitive mechanism for the resolution of stressed assets for the purpose of protecting the interest of creditors, Indian banks were avoiding recognition of stress in non-performing large assets accounts. The same explains as to why India has one of the largest number of cases in relation to failed restructuring. Banks, instead of resolving the stress feel incentivized to avoid a downgrade and delay the required provisioning for losses. This is why we have a history of a large number of NPA accounts being ever greened, without any resolution. Notably, RBI had created a number of out of court resolution mechanisms through statutory circulars such as those providing

[19] *Id.* (Written Submissions tendered by RBI in the RBI Circular case).

for Joint Lenders Forum (JLF), Strategic Debt Restructuring (SDR) (created together with the Securities and Exchange Board of India), and scheme for Sustainable Structuring of Stressed Assets (S4A) etc. for large stressed accounts, and none of them had turned out to be successful.

Reserve Bank of India issued circular dated 12.02.2018 which aligned RBI's guidelines for resolution of stressed assets at the pre-Insolvency and Bankruptcy Code, 2016 (hereinafter '**IBC**') stage with the IBC in the context of the aforesaid mechanisms failing to resolve the stress. Since, there was no comprehensive statutory law to effectively deal with insolvency proceedings, RBI issued circular dated 12.02.2018 for dealing with stressed accounts, especially for large value credits. The said circular directed banks to initiate corporate insolvency resolution process (hereinafter '**CIRP**') against those companies which: (1) had an aggregate exposure of more than Rs. 2000 crore, and (2) where no resolution plan had been implemented in respect of them within 180 days of default. The purpose of the circular was to widen the powers of banks in resolving stress in their assets by removing limitations and restrictions contained in the extant instructions/circulars that were also introduced for the purpose of resolving stress.

However, disregarding the contentions put forward by the regulator during the arguments, Hon'ble Court held the impugned circular dated 12.02.2018 to be ultra vires Section 35-AA of the Banking Regulation Act, 1950 (hereinafter '**the Banking Regulation Act**') In the judgment, despite holding that RBI has a specific power to direct banks to move under the Insolvency Code against debtors, and such exercise of powers by RBI was not outside the scope of laws governing it (RBI Act and the Banking Regulation Act). The Court also specifically observed that Sections 21 and 35-A of the Banking Regulation Act conferred very wide powers on RBI to give directions when it came to matters specified therein. However, the Hon'ble Court ultimately went on a very interesting route holding that even though prior to the enactment of Section 35-AA, RBI could have issued directions u/ss. 21 and 35-A to a banking company to initiate CIRP, but after enactment of Section 35-AA, RBI can give such directions only under the purview of Section 35-AA.

The Court based its reasoning on the principle that in case a statute confers power to do a particular act in a particular way, then such power has to mandatorily be exercised in the prescribed way and, exercise of such power in any other way is prohibited. The Court went on to hold:

> It is clear that RBI can only direct banking institutions to move under the Insolvency Code if two conditions precedent are specified, namely, (i) that there is a Central Government authorisation to do so; and (ii) that it should be in respect of specific defaults. The Section, therefore, by necessary implication, prohibits this power from being exercised in any manner other than the manner set out in Section 35-AA.
>
> …Stressed assets can be resolved either through the Insolvency Code or otherwise. When resolution through the Code is to be effected, the specific power granted by Section 35-AA can alone be availed by RBI. When resolution dehors the Code is to be effected, the general powers under Sections 35-A and 35-AB are to

> be used. Any other interpretation would make Section 35-AA otiose. In fact, Shri Dwivedi's argument that RBI can issue directions to a banking company in respect of initiating insolvency resolution process under the Insolvency Code under Sections 21, 35-A and 35-AB of the Banking Regulation Act, would obviate the necessity of a Central Government authorisation to do so. Absent the Central Government authorisation under Section 35-AA, it is clear that RBI would have no such power.

The Court, despite acknowledging the wide gamut of powers available in the hands of RBI, decided to take a conservative approach to the issue. While this judgment did provide relief to a lot of promoters, the same came at the expense of the banking system of India. The Court instead of appreciating the context in which the impugned circular was issued, decided to rely on certain hyper technicalities to hold that RBI does not have the requisite power to issue such circular. The Court failed to give any consideration to the fact that at the time of enactment of Section 35-A, express clarification was given by the legislature to the extent that Section 35-A is mere clarificatory in nature, and RBI had the powers to direct banks to initiate insolvency under other provisions.

II. DICHOTOMY IN APPROACH

Of late, Indian Supreme Court has been trying to increase its jurisdiction by unnecessarily taking up policy related issues which are supposed to be outside its domain. Though it is outside the scope of this article, it is important to note that the current attitude of Supreme Court liberally expanding its jurisdiction raises a number of interesting constitutional issues, The nature of approach taken by Supreme Court in the aforesaid two decisions (*HCC case* and *Dharani Sugars case*) are in stark contrast with each another. While the Court decided to take on an activist role in the HCC case, Court stuck to a conservative line of thought while deciding the RBI Circular case. What is common in both the judgments however, is the outcome – both the judgments foster an investor friendly climate.

The HCC case gave a huge relief to investors by ensuring that an arbitral award does not automatically get stuck in the judicial logjam that is suffering from massive backlog. It also assured India Inc. that if the government ever falters with its duty of providing a stable and consistent legal regime, the Courts would step in to make the required course correction.

The dictum in RBI Circular case has significantly reduced the pressure on banks and promoters to comply with the rigid timelines that were set out in the circular that was held to be ultra vires. It also allowed banks and promoters to fall back upon the previous resolution mechanisms which provided for a much more relaxed timeline albeit at the cost of concerned parties adopting a lax attitude towards reaching a resolution.

Interestingly, RBI has come up with a novel approach to circumvent the Supreme Court dictum by forcing the banks to make additional provisions as an alternative to not initiating CIRP proceedings. This has forced the concerned banks to initiate insolvency proceedings as they get relief from the provisioning requirements easily upon initiating

CIRP proceedings. While half of the additional provisions that are made by the bank can be reversed upon initiating CIRP proceedings, the remaining additional provisions can be reversed at the time of admission of CIRP. Initiation of CIRP is much simpler than finalising and implementing a resolution plan under any of the other schemes and/or being able to complete the proceedings in relation to assignment of debt/recovery– the other two ways of reversing the additional provisioning which are significantly more time consuming and difficult than initiating CIRP.

III. CONCLUSION

As noted in the Indian Economic Survey 2018-19,[20] delays in the enforcement of contracts and dispute resolution are the single biggest hurdle to India achieving a higher Gross Domestic Product (GDP) growth. It is notable that the Indian judiciary at all levels has been stepping up to the challenges despite numerous hurdles. From civil courts operating out of tin sheds to increased emphasis on alternate modes of dispute resolution by the Apex Court, every court in India is contributing towards making India's legal regime an investor friendly regime. There exist multiple reports and surveys which indicate that despite the multiple and attractive opportunities for investment available in India, the fear of getting stuck in litigation that moves at the pace of a corpulent snail with a severe case of gout, is the biggest apprehension of foreign investors who seek/look

[20] Ministry of Finance, *Economic Survey 2018-19*, GOVERNMENT OF INDIA, https://www.indiabudget.gov.in/budget2019-20/economicsurvey/doc/echapter.pdf. (Chapter 5, Volume I).

forward to invest in India.[21]

There are multiple solutions which involve participation and support from various stakeholders in India. A number of countries such as USA have successfully tackled similar issues which arise out of legal formalism. Promoting Alternative Dispute Resolution (ADR), and incentivising the adoption of mediation in civil and family disputes for arriving at a settlement outside the Court can be effective in reducing the judicial pendency. Fine tuning the existing system with the help of modern techniques developed over the course of last few decades would help in making justice more accessible to the Indian masses. While mandating ADR through legislation is one solution, jurists have highlighted the pitfalls of increased regulation of alternate modes of dispute resolution.

As stated in the Economic Survey of 2018-19, a major hurdle to India's economic growth and social well-being can be easily stabilised by means of a relatively small investment in the legal system. The much-debated judicial logjam is after all solvable. It is however recommended that in the quest for solving a problem, stakeholders in India must not lose track of the most important aspect of the end goal – delivering justice. Justice must be done not only to those who seek relief, but also to those who are indirectly affected. We need to engineer dispute resolution

[21] Ministry of Finance, *Economic Survey 2018-19*, GOVERNMENT OF INDIA, https://www.indiabudget.gov.in/budget2019-20/economicsurvey/doc/echapter.pdf; Amitabh Kant, *How to speed up judiciary: Let's make India's slow courts world class*, ECONOMIC TIMES (16.05.2017), https://economictimes.indiatimes.com/news/politics-and-nation/how-to-speed-up-judiciary-lets-make-indias-slow-courts-world-class/.

processes that would promote, instead of impeding social welfare and access to justice.

THE MULTILATERAL INVESTMENT COURT: ONE STEP FORWARD, TWO STEPS BACK

- Rishabh Malaviya and Tanya Singh*

ABSTRACT

The recent past has seen the system of investor-state dispute settlement come under heavy fire from all ends of the spectrum. The media and citizens' groups have called into question the legitimacy of private tribunals deciding matters of public importance. States (even those that have historically been avid users of the system) have reacted by calling for a radical change in the system, and in some cases have rejected it in its entirety. The European Union has commenced the implementation of a bilateral investment court in its dealings with states such as Canada and Vietnam, simultaneously also calling for discussions on a multilateral investment court. This paper questions the viability and neutrality of a permanent investment court, especially in a field as ideologically divided as international investment law. It is argued that the implementation of any such proposal is likely to reverse the (significant) progress made by investment arbitration in insulating investment disputes from political considerations. In any case, the investment court may fall prey to the very ills that plague (and are perceived to plague) investment arbitration. Instead, a carefully thought out system of preliminary referrals could be a possible solution to curing the 'crisis of legitimacy' being faced by investor-state dispute settlement.

I. INTRODUCTION

"The illegitimacy of ISDS flows, according to its critics, from the allegation that a select few arbitrators routinely decide disputes in favour

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of multinational enterprises in an ideologically prejudiced manner, articulating doctrines more extensively than agreed upon by governments negotiating the treaties, thereby also curtailing those governments' regulatory functions."[1] This, along with certain other criticisms, has made investor state dispute settlement (investment arbitration) the target of intense public scrutiny and debate. The reaction of countries has varied, with the European Union recently proposing the formation of an investment court in its bilateral treaties. This paper questions the viability of throwing the baby out with the bathwater and transposing such a ham-fisted and half-baked approach to the multilateral context. Instead, a carefully drafted system of referral by tribunals to a higher tribunal is proposed.

This paper is divided into three parts for clarity in expression. The first part assesses the perceived 'crisis of legitimacy' faced by international investment law, and its preferred mode of dispute settlement-investor-state arbitration. The second part of this paper goes on to critique the viability of a shift away from investor-state arbitration to an investment court. The third part of this paper proposes a more nuanced approach to curing any crisis faced by the prevailing system of investor-state arbitration.

[1] M Sornarajah, *An International Investment Court: Panacea or Purgatory*, COLUMBIA FDI PERSPECTIVES: PERSPECTIVES ON TOPICAL FOREIGN DIRECT INVESTMENT ISSUES (COLUMBIA CENTER ON SUSTAINABLE INVESTMENT 2016) 1 (Karl Sauvant ed.) [*hereinafter* Sornarajah on the International Investment Court].

II. THE PERCEIVED CRISIS OF LEGITIMACY

Today, the criticisms of international investment law and investor-state arbitration abound. Some have raised concerns about the decision makers in these cases. They are alleged to be biased in favour of investors, to the detriment of host states. This bias stems from their alleged 'vested interest' in the perpetuation of the system, as they profit from the initiation of arbitral proceedings and desire repeated appointments from parties.[2] Some accuse arbitrators of adopting broad interpretations of treaty language and imposing liability on states to an extent never anticipated by the parties to the treaty.[3] Criticism is also directed towards the phenomenon of 'double-hatting', where arbitrators appear as counsel in some cases and as arbitrator in others.[4] This, it is said, leads to the possibility of bias and conflicts of interest. The system of party appointment in general has also come under fire for possibly leading to bias.[5]

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[2] Gabrielle Kaufmann-Kohler & Michele Potesta, *Can the Mauritius Convention serve as a model for the reform of investor - State arbitration in connection with the introduction of a permanent investment tribunal or an appeal mechanism?* 12 (UNCITRAL, 3 June 2016), http://www.uncitral.org/pdf/english/CIDS_Research_Paper_Mauritius.pdf [hereinafter **Kaufmann-Kohler & Potesta**].

[3] M SORNARAJAH, THE INTERNATIONAL LAW ON FOREIGN INVESTMENT 562 (4th ed. Cambridge University Press 2017) [hereinafter **Sornarajah**].

[4] UNCTAD, *Reform of Investor-State Dispute Settlement: In Search of a Roadmap*, 4 (June 2013), http://unctad.org/en/PublicationsLibrary/webdiaepcb2013d4_en.pdf [hereinafter **UNCTAD Roadmap**].

[5] Sergio Puig, *Blinding International Justice*, 56 VIRGINIA JOURNAL OF INTERNATIONAL LAW 648 (2016). [hereinafter **Puig**].

The system is further condemned because most of the decision makers are drawn from a small homogenous group with largely similar backgrounds.[6] Historically, most International Centre for Settlement of Investment Disputes (hereinafter '**ICSID**') arbitrators have originated from Europe and North America, with around 75% coming from organisation for Economic Co-operation and Development (OECD) countries.[7] Shockingly, 95% of these arbitrators have been male.[8] One study found that out of 263 ICSID tribunals surveyed, a group of 12 arbitrators was involved in 60% of the tribunals.[9]

Moreover, the conduct of arbitral tribunals is often said to lack transparency.[10] Media outlets have come down heavily against these 'secret trade courts' and 'obscure tribunals' deciding issues of public importance.[11] Such ad hoc tribunals are said to lack the legitimacy needed to decide challenges to sovereign state measures that may have been taken

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[6] Christopher R. Drahozal, *Private Ordering and International Commercial Arbitration*, 113 PENN ST. L. REV. 1031 (2009); Puig, *supra* note 5, at 655.
[7] David Gaukrodger & Kathryn Gordon, *Investor-State Dispute Settlement: A Scoping Paper for the Investment Policy Community*, OECD, WORKING PAPERS ON INTERNATIONAL INVESTMENT 44 (2012), http://www.oecd.org/investment/investment-policy/WP-2012_3.pdf.
[8] *Id.* at 45.
[9] *Id.* at 45.
[10] Kaufmann-Kohler & Potesta, *supra* note 2, at 14.
[11] Anthony De Palma, *Nafta's Powerful Little Secret: Obscure Tribunals Settle Disputes, But Go Too Far, Critics Say*, NEW YORK TIMES, March 11, 2001, at 1.

in the public interest.[12] Therefore, investor-state arbitration is said to be in trouble in the 'court of public opinion'.[13]

Concerns are also frequently raised that there is little consistency in the awards rendered by these tribunals.[14] As a result of the ad hoc nature of the tribunals making decisions, and the lack of any doctrine of precedent operating in the field, different tribunals often come to different conclusions about similar treaty language. For example, different tribunals have held different views on issues such as the effect of umbrella clauses, the effect of most-favoured nation clauses, the precise scope of the fair and equitable treatment standard, etc. Such inconsistency is perpetuated because of the lack of any appeal mechanism.[15] This lack of an appeal mechanism means that even manifestly incorrect awards may sometimes be left untouched.[16]

Yet another criticism is that the system, as it stands, worries states to the point where they are reluctant to freely regulate state affairs. This worry is said to be motivated by the possibility of foreign investors

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[12] UNCTAD Roadmap, *supra* note 4, 3; J Christopher Thomas & Harpreet Kaur Dhillon, *The Foundations of Investment Treaty Arbitration: The ICSID Convention, Investment Treaties and the Review of Arbitration Awards*, 32.3 ICSID Review 3 (2017) [hereinafter Thomas & Dhillon].

[13] American Bar Association, *Investment Treaty Working Group Task Force Report on the Investment Court System Proposal*, 123 (2016), https://shop.americanbar.org/PersonifyImages/ProductFiles/262739281/6-Proposed%20EU%20Investment%20Court.pdf [hereinafter ABA Report].

[14] Christoph H. Schreuer, *Preliminary Rulings in Investment Arbitration*, IN APPEALS MECHANISM IN INTERNATIONAL INVESTMENT DISPUTES, 208 (Karl Sauvant ed. Oxford University Press 2008) [hereinafter "Schreuer"].

[15] Kaufmann-Kohler & Potesta, *supra* note 2, at 13.

[16] Kaufmann-Kohler & Potesta, *supra* note 2, at 14.

bringing claims for obscene amounts of money in response to state regulations. This, it is said, leads to a regulatory 'chill'.[17] Further, these claims are sometimes upheld and even smaller, developing states are required to pay large sums of money as compensation to foreign investors.[18] Apart from amounts actually awarded, concerns are raised about the high costs of the proceedings themselves- one study pegged the average cost per party per case to be 8 million USD.[19] Even where the state prevails in the case, the reimbursement of these costs usually remains at the discretion of the tribunal.

In light of these criticisms, some states are becoming increasingly suspicious of investor-state arbitration. The older investment treaties which were often vaguely worded and did not clearly spell out the scope of obligations on host states are being replaced with newer 'balanced' investment treaties, which specifically preserve the regulatory space of host states and include broader defences to liability (including sometimes restricted or conditional access to investment arbitration).[20] Examples of these newer balanced treaties include the ASEAN Comprehensive Investment Agreement and the new Model Indian Bilateral Investment Treaty (BIT).

[17] EU Commission Staff Working Document, *Report On Online public consultation on investment protection and investor-to-state dispute settlement in the Transatlantic Trade and Investment Partnership Agreement*, 14 (SWD 2015 3 Final, Jan. 13, 2015), http://trade.ec.europa.eu/doclib/docs/2015/january/tradoc_153044.pdf.
[18] UNCTAD Roadmap, *supra* note 4, at 4.
[19] UNCTAD Roadmap, *supra* note 4, at 4.
[20] Sornarajah, *supra* note 3, at 562.

Some states like South Africa and Poland have rejected the system and have even begun to terminate some of their existing investment treaties.[21] Venezuela, Bolivia, and Ecuador have rejected the ICSID Convention for a number of years now.[22] India[23] and Indonesia[24] have also begun reviewing their BIT programs. Further, the European Court of Justice has recently held that arbitration clauses in intra-EU BITs are incompatible with EU law.[25] Calls for a more radical change have been made recently by the European Union. The European Union has rejected the traditional model of investor-state arbitration and is pushing for the formation of a permanent investment court with state appointed judges. The EU-Canada Comprehensive Economic and Trade Agreement, the EU-Vietnam Investment Protection Agreement, and the proposed Transatlantic Trade Investment Partnership (being negotiated between the United States and the EU) already contain provisions for the setting up of a bilateral investment court and an appellate mechanism for the settlement of disputes under those treaties. They also mention the possibility of a

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[21] Marcin Orecki, *Let the Show Begin: Poland Has Commenced the Process of BITs' Termination*, KLUWER ARBITRATION BLOG (August 8, 2017), http://arbitrationblog.kluwerarbitration.com/2017/08/08/let-show-begin-poland-commenced-process-bits-termination/.

[22] Jose Carlos Bernal Rivera & Mauricio Azuga, *Life After ICSID: 10th Anniversary of Bolivia's Withdrawal from ICSID*, KLUWER ARBITRATION BLOG (August 12, 2017), http://arbitrationblog.kluwerarbitration.com/2017/08/12/life-icsid-10th-anniversary-bolivias-withdrawal-icsid/.

[23] Sujay Mehdudia, *BIPA Talks Put on Hold*, THE HINDU (22 January 2013), https://www.thehindu.com/business/Economy/bipa-talks-put-on-hold/article4329332.ece.

[24] Ben Bland & Shawn Donnan, *Indonesia to terminate more than 60 bilateral investment treaties*, FINANCIAL TIMES (March 26, 2014), https://www.ft.com/content/3755c1b2-b4e2-11e3-af92-00144feabdc0.

[25] Case C-284/16, Slovak Republic v. Achmea B.V., 2018 E.C.R. 158, ¶ 11.

multilateral investment court sometime in the future and contain a reference to it.[26]

While the criticisms of traditional investment arbitration have existed for a while, it is curious that these calls for a radical overhaul of the system have been made by developed states only in the last few years. For example, few seemed sympathetic to the plight of Argentina in the wake of its economic crisis and the numerous consequent awards that were rendered against it. The Argentinian saga embodied some of the very evils that are criticized today, including different tribunals coming to different decisions on similar facts,[27] some tribunals ignoring Argentina's right to regulate its economy in times of necessity,[28] the lack of any external control on the correctness of these decisions,[29] and a (developing) country being asked to pay large sums of money to foreign investors despite its economic turmoil. Despite this, most (developed) countries seemed perfectly fine with the system as it existed.

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[26] *See, e.g.*, Article 8.29, EU-Canada Comprehensive Economic and Trade Agreement & Art. 3.38, EU-Vietnam Investment Protection Agreement.

[27] *See*, *e.g.*, the divergence between CMS Gas Transmission Company v. Argentina, (ICSID Case No. ARB/01/8, Award, 12 May 2005, 44 I.L.M. 1205) and LG & E Energy Corp, LG&E Capital Corp, and LG&E International Inc v. Argentina, (ICSID Case No. ARB/02/1, Award, 3 October 2006, 46 ILM). This is discussed in greater detail in: Waibel, Michael, *Two Worlds of Necessity in ICSID Arbitration: CMS and LG&E*, 20 LEIDEN JOURNAL OF INTERNATIONAL LAW 637-648 (2007).

[28] *See, e.g.*, CMS Gas Transmission Company v. Argentina, ICSID Case No. ARB/01/8, Award, 12 May 2005, 44 I.L.M. 1205.

[29] In fact, even the annulment proceedings against these award have resulted in different decisions on similar facts: *see, e.g.*, Sempra Energy Int'l v. Argentine Republic, ICSID Case No. ARB/02/16, Decision on the Argentine Republic's Application for Annulment of the Award, (June 29, 2010) and CMS Gas Transmission Co. v. Argentine Republic, ICSID Case No. ARB/01/8, Decision of the Ad Hoc Committee on the Application for Annulment of the Argentine Republic (Sep. 25, 2007).

Perhaps the reason for this silence is that most investor-state arbitration cases have historically involved a Respondent state from regions other than Western Europe and North America. The ICSID Caseload Statistics are indicative in this regard- only 8% of all ICSID cases have been against Western European nations, and only 4% have been against North American States. This is in stark contrast to the 22% cases brought against South American States and 26% cases against East European and Central Asian States.[30] In 2015, however, the number of cases against Western European States rose to 37% of new cases filed.[31] Clearly, any incentive for these developed States to speak out against the system has existed only in the recent past.

A clear example is that of Germany. At least 64 investment treaty arbitrations have been initiated by German investors against foreign countries.[32] Obviously, Germany was an avid user of the system. By contrast, Germany has only ever been the Respondent in three cases- two of which were settled.[33] Therefore, there was little reason for Germany to complain about the system. Things took an about-turn when Germany decided to phase out its use of nuclear power, in light of the Fukushima

[30] ICSID, The ICSID Caseload- Statistics (Issue 2019-2), INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES p. 12 (2019) https://icsid.worldbank.org/en/Pages/resources/ICSID-Caseload-Statistics.aspx.
[31] ICSID, The ICSID Caseload- Statistics (Issue 2019-2), INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES p. 24 (2016) https://icsid.worldbank.org/en/Pages/resources/ICSID-Caseload-Statistics.aspx.
[32] Investment Policy Hub, *Germany- as Home State*, UNCTAD https://investmentpolicy.unctad.org/investment-dispute-settlement/country/78/germany.
[33] Investment Policy Hub, Germany- as Respondent State, UNCTAD, https://investmentpolicy.unctad.org/country-navigator/79/germany.

nuclear disaster.[34] The third case against Germany (which was not settled and is still pending) was initiated by a Swedish investor affected by Germany's decision to phase out nuclear power.[35] The amount claimed by the investor is over 5 billion USD. Suddenly, the system of investment arbitration does not seem to be quite as attractive to Germany. It is at the forefront of the European Union's calls to replace the system of investment arbitration with that of an investment court with publicly appointed judges- a system which would preserve and underscore a state's right to regulate.

Whatever the political motivations for this volte-face of some states, it is undeniable that there is some amount of discontent among states about traditional investment arbitration. The next part of this paper describes the European Union's proposed 'bilateral' investment court, and assesses the viability of a 'multilateral' investment court for the settlement of investment disputes.

III. THE VIABILITY OF AN INVESTMENT COURT

The bilateral investment court system proposed by the European Union and included in some of its treaties is a hybrid of investor state arbitration and judicial settlement of investment disputes.[36] At its core, it

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[34] Alison Ross, *Schwebel criticises EU act of "appeasement"*, GLOBAL ARBITRATION REVIEW (May 24, 2016), https://globalarbitrationreview.com/article/1036358/schwebel-criticises-eu-act-of-appeasement [hereinafter Alison Ross].

[35] Vattenfall AB and others v. Federal Republic of Germany (II), ICSID Case No. ARB/12/12 (Decision on 31 Aug, 2018).

[36] August Reinisch, *Will the EU's Proposal Concerning an Investment Court System for CETA and TTIP Lead to Enforceable Awards?—The Limits of Modifying the ICSID*

consists of a permanent tribunal of first instance, and an appellate tribunal. Appointments to the tribunal of first instance are to be made by a Joint Committee of the Contracting Parties, from people who possess 'qualifications required in their respective countries for appointment to judicial office' or who are 'jurists of recognized competence', and who have recognized expertise in the field.[37] This tribunal is to be populated by an equal number of nationals from each Contracting Party and from third States. For instance, under the EU-Canada CETA, five appointees are to be from Canada, five are to be from member states of the EU, and five are to be from neutral countries.[38]

Actual cases are to be allocated randomly to 'divisions' of three members of the Tribunal by the President of the Tribunal. These divisions shall have one national of either party and shall be presided over by the national of a third party.[39] After a decision is rendered, an appeal may be made to the Appellate Tribunal. The grounds for appeal include the grounds for annulment under the ICSID Convention and also include appeals for errors of law or fact.[40] The Appellate Tribunal may modify, uphold, or reverse the decision on any of these grounds.[41]

Convention and the Nature of Investment Arbitration, (2016) JIEL 761, 766 [hereinafter Reinisch].

[37] The Comprehensive and Economic Trade Agreement (Oct. 30, 2016), Art. 8.27(2) & 8.28(2) [hereinafter CETA]; EU-Vietnam Investment Protection Agreement, (Jun. 30, 2019), Art. 3.38.

[38] CETA, Art. 8.27(2).

[39] CETA, Art. 8.27(6); EU-Vietnam Investment Protection Agreement, Art. 3.38(6).

[40] CETA, Art. 8.28(2).

[41] CETA, Art. 8.28(2).

At first blush, one can see why such a system could be attractive to the critics of traditional investor-state arbitration. The court would consist of publicly appointed judges, thereby giving 'states' a greater say in choosing who decides their disputes (as opposed to allowing investors to also have a say). Appointment by states would also counter perceptions of bias in favour of investors. Additionally, appointment by states and the stringent qualifications for appointment would mean that such a court would possess greater legitimacy, and it would be more palatable for such a court to decide questions of public importance. Permanency would also presumably lead to consistency, with the same court following past precedents on similar facts. Any incorrect decisions could be rectified by way of the appellate mechanism. Lastly, states would have greater freedom to regulate their affairs if they perceive the decision makers to be neutral and lacking the expansionist tendencies that arbitrators are sometimes accused of.

Therefore, *prima facie*, the merits of such a system appear undeniable. Indeed, there are several proponents of this system.[42] In fact, the Court of Justice of the European Union has recently found the dispute settlement system under the EU-Canada CETA to be compatible with European Union law (and has also held that, in principle, a multilateral

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[42] Anthea Roberts, *Would a Multilateral Investment Court be Biased? Shifting to a treaty party framework of analysis*, BLOG OF THE EUROPEAN JOURNAL OF INTERNATIONAL LAW (April 28, 2017), https://www.ejiltalk.org/would-a-multilateral-investment-court-be-biased-shifting-to-a-treaty-party-framework-of-analysis/ [*hereinafter* Roberts].

investment court would be compatible with EU law).[43] Despite this, several questions remain unanswered. For instance, the biggest question is whether any resultant decision of this bilateral investment court would qualify as an arbitral award for the purposes of enforcement. The question is not merely academic. An ICSID award qualifies for automatic enforcement within the territories of all Contracting Parties, as per Article 54 of the ICSID Convention. An arbitral award can also qualify for enforcement under the New York Convention, which facilitates enforcement in over 150 countries. There is no similarly uniform system for the enforcement of judgments of a court, which are usually enforced as a matter of comity.[44]

The goal of the EU Treaties was to produce awards that can be enforced under the ICSID Convention and under the New York Convention.[45] These treaties have tried to fit their modified system of dispute resolution within the framework of the ICSID, by allowing investors the option of pursuing their claim under the ICSID Convention, but subject to the court system as envisaged under the EU Treaties. Whether this would work despite the substantial departure from the system envisaged under the ICSID, remains uncertain.[46] Further, it is unclear whether other Contracting Parties to the ICSID Convention (i.e. Parties

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[43] Opinion 1/17 of the Court of Justice of the European Union, http://curia.europa.eu/juris/document/document.jsf?text=&docid=213502&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=4976548.

[44] ABA Report, *supra* note 13, at 105.

[45] ABA Report, *supra* note 13, at 8.

[46] Reinisch, *supra* note 36, at 773.

who are not also party to the bilateral treaty providing for this system) would be obliged to enforce the 'award' as an ICSID award.[47]

It is also unclear whether the decision pursuant to such a unique mode of dispute resolution would constitute an award covered by the New York Convention. The specific requirements for an award to be covered by the New York Convention (which applies only to certain arbitral awards) may not be met, not least because the system itself is referred to an investment 'court' system.[48] Some have been optimistic and pointed to similarly modelled systems such as the Iran-US Claims Tribunal, whose awards have been enforced under the New York Convention.[49] Others have been more cautious in their assessment and have cast doubts over the enforceability of these 'awards' (rendered pursuant to the EU Treaties) under the New York Convention.[50] These voices have cautioned that reliance on the example of the Iran-US Claims Tribunal may not be appropriate, and enforcement under the New York Convention may not be a given, absent additional clarity in the text of the EU Treaties.[51]

Other questions have been raised about the lack of clarity regarding the seat of the proceedings, the details of any challenge procedure, the appropriateness of wide grounds of appeal, among others.

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[47] ABA Report, *supra* note 13, at 111.
[48] ABA Report, *supra* note 13, at 127.
[49] Kaufmann-Kohler & Potesta, *supra* note 2, at 43.
[50] Sophie Nappert, *The 2015 EFILA Inaugural Lecture: Escaping from Freedom? The Dilemma of an Improved ISDS Mechanism*, EUROPEAN FEDERATION FOR INVESTMENT LAW AND ARBITRATION, 3 (26 November, 2015), https://efila.org/wp-content/uploads/2015/11/Annual_lecture_Sophie_Nappert_full_text.pdf.
[51] ABA Report, *supra* note 13, at 106.

Therefore, a multilateral investment court modelled on the EU Court may not be appropriate. However, if one were to assess the 'in principle' viability of a multilateral investment court 'independent' from the court as proposed by the EU, different considerations would apply. It is submitted that most of the doubts about the EU Court could be addressed by appropriate drafting of the multilateral treaty which would give birth to the multilateral court. For instance, instead of containing vague references to the New York Convention and the ICSID Convention, enforcement under this new treaty could be a matter of primary obligations like it is under the ICSID Convention- i.e. Contracting Parties could be required under the treaty itself to enforce the decisions of the Court. This would eliminate concerns about the enforceability of the Court's decisions.

Consequently, any criticism of a multilateral investment court would need to focus on the inherent features of the system itself and the principles behind it, rather than matters that can be addressed by appropriate drafting. For the reasons set out below, it is argued that a permanent investment court is unsuited to a field like international investment law.

The first problem that is anticipated with respect to a multilateral investment court is the emphasis on appointment of the adjudicators by states. It is submitted that a move towards such appointments would invariably lead to the politicization of the dispute resolution system. One of the achievements of the traditional mode of investment arbitration is that it has led to reduced politics in the settlement of investment disputes.

In fact, one of the goals of the ICSID Convention was to settle disputes on the 'legal plane' and insulate the disputes from 'the realms of politics and diplomacy'.[52] This was the reason for the original shift away from diplomatic protection. States have therefore been free to conduct their foreign policy without the hurdles that would otherwise be caused by investment disputes.[53] The interests of weaker states have not necessarily been subordinated in the dispute resolution 'process' due to their weaker political clout.

All this is likely to change if states begin to appoint the members of the multilateral investment court. The bilateral courts proposed by the EU are able to provide for equal representation of the parties (in terms of nationality), due to the fact that only two parties are involved in those treaties. In a multilateral treaty on a global scale, it would be impossible (or at the very least completely impractical and unrealistic) to provide for equal representation of all parties. Consequently, the investment court would consist of judges of only some nationalities, with others not having their nationals as adjudicators. Choosing which nations are going to have their nationals as members of the Court would therefore be a political exercise. It is inevitable that the interests of politically weaker states would be subordinated or ignored.

The dispute resolution process under the WTO is a case in point. The EU's chief 'investment court negotiator' pointed to the WTO as the

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[52] Christoph Schreuer, *Do We Need Investment Arbitration, in* RESHAPING THE INVESTOR-STATE DISPUTE SETTLEMENT SYSTEM 882 (Jean Kalicki & Anna Joubin-Bret ed., Brill Nijhoff 2015).
[53] *Id*.

benchmark for efficient dispute resolution, and as an inspiration for the investment court system.[54] However, examples of state conduct within the context of WTO dispute resolution are hardly inspiring. Serious concerns have been raised about the conduct of the United States of America in blocking the appointment of highly qualified, but independent minded, persons to the dispute settlement bodies of the WTO. These appointments were blocked because the candidates had earlier participated in cases against the USA. Other countries countered by threatening to block other appointments.[55]

The appointment process in other permanent international courts is equally uninspiring. It is exceedingly rare for a permanent member of the UN Security Council to 'not' have one of its nationals as a member of the International Court of Justice.[56] Further, the voting process for judges of the ICJ usually involves intense political lobbying.[57]

Thus, it is very likely that under the investment court system, smaller and politically weaker states would be pressured into supporting

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[54] ABA Report, *supra* note 13, at 126.

[55] Gregory Shaffer et al., *U.S. Threats to the WTO Appellate Body,* SSRN ELECTRONIC JOURNAL (Dec. 13, 2017), https://ssrn.com/abstract=3087524; Shawn Donnan, *Fears for global trade as Trump fires first shots to kneecap WTO*, FINANCIAL TIMES (Nov. 10, 2017), https://www.ft.com/content/5afbd914-a2b2-11e7-8d56-98a09be71849.

[56] For instance, the US and France have always had a national as a member of the ICJ. Until very recently, the UK always had a national as a member of the ICJ: *see* "All Members", https://www.icj-cij.org/en/all-members.

[57] For instance, the UK's withdrawal of Sir Christopher Greenwood's candidature was attributed, in part, to India being a key post-Brexit trading partner: *see, e.g.,* Owen Bowcott, *No British judge on world court for first time in its 71-year history*, THE GUARDIAN (Nov. 20, 2017), https://www.theguardian.com/law/2017/nov/20/no-british-judge-on-world-court-for-first-time-in-its-71-year-history.

the candidates backed by the bigger states. Any non-conformity could also lead to sanctions in other areas (such as the blocking of developmental aid). Clearly, such a system of appointment also leads to the relegation of merit in appointments, and the predominance of political considerations.

Consequent to the first problem of political appointments, is the second problem of ideological imbalances within the Court itself. Even if smaller developing states manage to get a few members of their choice appointed (against the will of larger, developed states), Professor Sornarajah rightly points out that these members are likely to be in the minority.[58] If any decision of the court is to be taken by the majority of a particular bench or division of the court, it is likely that the members from the developing countries will have little or no say in actual decision making. They could simply be outvoted. Professor Sornarajah points to the few instances where ICJ judges from developing countries were appointed to investment arbitration tribunals and were simply outvoted by their counterparts from developed countries.[59] This is especially dangerous in a field as divisive as investment law, where opposing sides are sharply divided on ideological lines.

In fact, it must be pointed out that it was because of this ideological selfishness that states had initially preferred a system of ad hoc arbitration to a system of judicial settlement by the ICJ or another permanent body. Permanent bodies invariably have a broader focus, including the creation of a body of jurisprudence- which is one of the

[58] Sornarajah on the International Investment Court, *supra* note 1, at 1.
[59] Sornarajah on the International Investment Court, *supra* note 1, at 1.

stated goals of the investment court system.[60] However, there are certain categories of disputes where states are interested in preserving their own interests and asserting their own ideologies by choosing their own adjudicators.[61] These include disputes of political and public importance where high stakes are involved and where the applicable legal standards leave room for adjudicator discretion, such as disputes related to foreign investments. Therefore, it is unlikely that states will be content for too long with the investment court system, where a lot of them may not have a say in the shaping of the law.

One ideological conflict that is anticipated is in the field of human rights. The last few years have witnessed greater prominence of human rights in investment law.[62] This is partly the result of a greater emphasis on investor obligations and corporate responsibility. For example, Article 18 of the 2016 Morocco-Nigeria BIT includes specific provisions requiring foreign investors to respect human rights in the host state. Similar provisions have been made in the Model BIT of the Southern African Development Community. Whether these provisions are ever actually enforced remains to be seen. Nevertheless, some tribunals have taken into account human rights considerations. For example, the tribunal in *Urbaser v. Argentina* recognized that human rights obligations could, in principle, be enforced against foreign investors even in the absence of a

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[60] Charles Brower, *The Functions And Limits Of Arbitration And Judicial Settlement Under Private And Public International Law*, 18 DUKE JOURNAL OF INTERNATIONAL AND COMPARATIVE LAW 259, 296 (2008).
[61] *Id.* at 304.
[62] Sornarajah, *supra* note 3, at 561.

clear provision to that effect.[63] In *SAUR International v. Argentina,* the tribunal acknowledged the need for states to regulate in respect of human rights issues.[64] In *Copper Mesa Mining v. Ecuador* the tribunal reduced the amount of damages paid to the Claimant, indirectly considering the human rights violations committed by the Claimant.[65]

It is submitted that this increased focus on human rights in investment law militates against having a permanent investment court. If appointments are indeed controlled by a handful of powerful states (as stated above), and the court is populated with judges representing a particular ideology, the court will operate (or at the very least be perceived to operate) as a vehicle to impose (mostly) Western notions of human rights on all countries. Several Asian states have, in the past, rejected the idea that all human rights are universal. These critics argued that some human rights are merely western constructs, and may not be a perfect fit in some Asian societies.[66] Once again, the idea of a permanent investment court could eventually lead to discontent and acrimony among states.

Another problem is the questionable suitability of the judges that will be appointed to the Court. As stated above, a lot of these appointments may be made for political considerations rather than considerations of merit. Further, even if these judges were to possess the

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[63] Urbaser S.A. and Consorcio de Aguas Bilbao Bizkaia, Bilbao Biskaia Ur Partzuergoa v. The Argentine Republic, ICSID Case No. ARB/07/26.
[64] SAUR International SA v. Republic of Argentina, ICSID Case No. ARB/04/4.
[65] Copper Mesa Mining Corporation v. Republic of Ecuador, PCA No. 2012-2.
[66] However, a discussion on cultural relativism and the 'Asian Values' debate is beyond the scope of this paper: *see* Otto D., *Rethinking the "Universality" of Human Rights Law*, 29 COLUM. HUM. RTS. L. REV. 1, 8 (1998).

highest qualifications in the domestic context, it is not necessary that they will be equally well-versed with public international law, international investment law, and indeed the particular industry involved in the dispute. Therefore, by doing away with party appointed arbitrators, the system may also do away with the expertise that those arbitrators bring to the table.

A related concern is about the possible bias of these judges. As stated above, one of the concerns about the system of investment arbitration was that the arbitrators were perceived to be biased in favour of investors. However, the judges appointed to the investment court may well be equally biased (or perceived to be so) - in favour of states.[67] This is because the judges to the court are proposed to be appointed by states, with little or no participation of investors.

Proponents of the system say that this risk is overstated. It has been said that it would be counterintuitive for states to appoint biased members to the court, because when the appointments are made, states would not know *ex ante* whether they would be the Respondent in proceedings or whether their nationals would be Claimants in the proceedings.[68] Therefore, states would prefer to appoint neutral individuals to the Court, who would uphold the applicable treaty.

However, these arguments appear excessively idealistic. As mentioned earlier, in the context of appointments to the WTO dispute settlement bodies, states routinely prefer judges that will advance the

[67] Alison Ross, *supra* note 34.
[68] ABA Report, *supra* note 13, at 25; Roberts, *supra* note 42.

views held by that state, and go as far as to block the appointment of individuals perceived to hold contrary views. Even in the unrealistic scenario that states abandon political considerations, judges are subject to the same 'cognitive' biases as anyone else.[69] Essentially, it is as difficult for judges to abandon preconceived notions of the law and predispositions towards a party, as it is for arbitrators.[70] In a study of appointments to the ICJ, it was found that judges tend to favour the states that appointed them and states whose wealth level is similar to their own states.[71] The German Association of Judges has reportedly raised similar concerns about the possibility of bias of members of the investment court.[72] Thus, an investment court is not the cure to the problem of adjudicator bias. Adjudicator bias may still prevail, and will be unacceptable to investors and to those states in whose favour the bias is not exercised.

The final problem with an investment court is that its decisions will be binding precedent or will be formalized to the extent that they are *de facto* precedent. Concerns have been raised that the court will propound 'neoliberal' principles (essentially western capitalist ideas) which will then become set in stone and binding in all later cases.[73] The reasoning behind such criticism is valid- why should a handful of judges who are chosen by

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[69] Puig, *supra* note 5, at 648.
[70] Puig, *supra* note 5, at 650.
[71] Eric A. Posner & Miguel F. P. de Figueiredo, *Is the International Court of Justice Biased?*, 34 J. LEGAL STUD. 599, 625 (2005).
[72] Juergen Mark, *German Association of Judges on the TTIP Proposal of the European Commission*, GLOBAL ARBITRATION REVIEW (March 21, 2016), https://globalarbitrationnews.com/german-association-judges-proposal-european-commission-introduction-investment-court-system-settle-investor-state-disputes-transatlantic-trade-investmen/.
[73] Sornarajah on the International Investment Court, *supra* note 1, at 2.

questionable political means and who may be biased or inclined to a particular ideology, decide the principles of international investment law 'binding' on all states? Such a process hardly seems democratic, and is excessively unfair in a field which has seen widespread public acrimony.

It might be argued that several of the foregoing problems could be addressed by allowing for a system of ad hoc judges as under Article 31 of the Statute of the International Court of Justice. In such a system disputing parties who do not have an adjudicator of their nationality on the bench of judges can nominate a judge of their choice to adjudicate that particular dispute. Such a solution cannot work in the present context. First, the whole point of the present debate is about a shift away from ad hoc appointments. Further, concerns about political appointments of biased adjudicators would apply with even greater force if states were to appoint their adjudicators 'after' the dispute were to arise. There would be greater incentive for states to appoint adjudicators who would espouse a particular favourable view point, with little or no consideration given to actual merit. Lastly, even if politically weaker states are given a chance to represent themselves by such ad hoc appointments, such an ad hoc judge will likely be in the minority and is likely to be outvoted by the other members of the tribunal. Thus, the weaker developing countries will still have no say in the shaping of the law.

For all these reasons, a permanent investment court is 'in principle' not suitable for the field in which it would be required to operate.

IV. THE SOLUTION

What then is the solution to international investment law's 'crisis of legitimacy'? The criticisms of investment arbitration are not likely to abate anytime soon. This criticism has been drummed up and sensationalized to such an extent that States will feel the need to appease their public.[74] Moreover, it is undeniable that at least some of the criticism is valid. However, as stated above, the idea of a permanent investment court is a misfit in international investment law. What is needed is a more nuanced approach to curing the ills that plague the system.

In finding the appropriate approach, it must be borne in mind that investment arbitration is not the creation of the devil. As such, it should not be rejected in its entirety. The system works 'reasonably well' on any 'objective analysis'.[75] As stated earlier, some of its criticisms are valid, but some are merely overemphasized fear mongering.

Take for example the criticism raised about the lack of consistency in arbitral awards. While it is true that there is inconsistency, this inconsistency was hardly unanticipated. As early as the 1960's, the drafters of the ICSID Convention had recognized the possibility of contradictory decisions as inherent in an ad hoc system of adjudication in a field with unsettled legal principles.[76] The drafters went ahead with the ad hoc system under the ICSID Convention. Moreover, the earlier investment treaties were so vaguely and broadly worded, that arbitrators

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[74] Alison Ross, *supra* note 34.
[75] Alison Ross, *supra* note 34.
[76] Thomas & Dhillon, *supra* note 12, at 10.

'acting in good faith' could 'legitimately' reach different conclusions about the meaning of its provisions.[77] Therefore, it is unfair to blame arbitrators for the inconsistency of their awards- decisions of the most highly qualified judges would have been equally inconsistent. The solution to such inconsistency instead lies in the careful drafting of future investment treaties.

Careful drafting of investment treaties would also eliminate concerns that states cannot freely regulate their affairs. Such a right to regulate can be expressly carved out, as has indeed been done in newer investment treaties like the ASEAN Comprehensive Investment Agreement.[78] States can also consider introducing a cap on their monetary liability under these newer treaties.

Further, practices such as double-hatting are not as prevalent as they are made out to be.[79] Lack of transparency can be cured by the introduction of transparency provisions in investment arbitration rules and treaties. Indeed, the shift towards transparency has already started in the last decade.[80] The homogeneity among arbitrators in investment disputes also seems like a baseless criticism. This homogeneity is not because of the existence of some 'mafia' or pressure tactic. Parties (including states) remain free to choose their own arbitrators. The reason that they choose

[77] Thomas & Dhillon, *supra* note 12, at 2.
[78] ASEAN Comprehensive Investment Agreement, Article 17, (Oct. 7, 1998).
[79] Lacey Yong, *"Double Hatting" Under New Scrutiny*, GLOBAL ARBITRATION REVIEW (June 4, 2017), https://globalarbitrationreview.com/article/1142550/%E2%80%9Cdouble-hatting%E2%80%9D-under-new-scrutiny.
[80] Kaufmann-Kohler & Potesta, *supra* note 2, at 15.

from among this homogenous pool of arbitrators is simply because these arbitrators have unmatched experience and expertise.

It is the remaining concerns that any modified system must address. These remaining concerns are the perceived lack of legitimacy of privately appointed arbitrators deciding questions of public importance, the perceptions of arbitrator bias in favour of investors, and the lack of any external control on the correctness of the decisions of these arbitrators. It is submitted that a system of preliminary reference to a higher body can address these concerns. Such a system can be effected by way of a multilateral 'opt-in' convention.

This system could provide for an interim procedure by which the party-appointed tribunals could stay their own proceedings and refer important and contentious questions of law to a higher tribunal. Such a proposal is not new and has been made in the past.[81] A similar system operates in the context of European Union law. Courts in EU states can refer questions of law to the European Court of Justice.[82] The desirability of such a system should be addressed anew in light of the growing discontent with the system of investment arbitration as it exists today.

However, any such system must not fall prey to the same evils that plague the proposal of a multilateral court system. Accordingly, the structure and functioning of this higher tribunal, and its relationship with the ad hoc tribunal appointed by the parties must be carefully thought out.

[81] Schreuer, *supra* note 14, at 208.
[82] Treaty on the Functioning of the European Union, Art. 267, (OJ L. 326/47-326/390; 26.10.2012).

Blindly following the European Union's system of referral may not work in the context of international investment arbitration.

It is proposed that this higher tribunal be appointed on an essentially ad hoc basis. All states should be required to nominate a member each to this higher body 'in advance'. In the event of a dispute in which the need of a reference to the higher tribunal arises, a tribunal should be constituted consisting of the nominee of each State involved in the dispute (the home state and the host state). If these two nominees agree on a particular point, the same should be binding on the tribunal making the reference. If the two nominees cannot agree on a particular point, the same should be communicated to the tribunal making the reference and that tribunal should then proceed to make its own decision.

First, such a system addresses the remaining concerns of the naysayers of investment arbitration. Reference to this higher body of state appointed persons not only lends greater legitimacy to the party appointed arbitrators, it also acts as an external check on their decisions. Any obvious defects can simply be prevented by referring the question of law to be decided to this higher body. Such a system will also help counter perceptions of bias, as it will be this permanent body which guides the tribunal on any heavily contested question of law. If the question is so contentious that this higher tribunal cannot settle it, then the tribunal making the reference can legitimately decide it one way or the other.

Second, such a system will not suffer the same defects as a multilateral investment court. It is conceded that appointments to this higher body, if made by states, will likely be political. However, this will not lead to the politicization of dispute resolution, because each state will have an equal say in appointments and its own nominee will participate in any dispute in which the state is involved. Therefore, each state will be equally represented, and no state will be able to exert pressure on any other state. Further, any ideological or other bias of these state appointed persons will play little or no role in the resolution of the dispute. This is because their opinion will be relevant only if the other state's nominee agrees with that opinion. In the event of disagreement, the tribunal making the reference will make its own decision. Essentially, any ideological or other biases will be balanced out. In any case, such a proposal would be acceptable to the proponents of an investment court who believe that appointments, if made in advance (before a dispute arises), would be apolitical and neutral.

Finally, it is conceded that such a system is ambitious to say the least. It will require careful thought and precise drafting in order to be workable, and political consensus of the kind rarely seen in international relations. Reasonable concerns may also be raised about the additional time and cost of dispute resolution under such a system. However, these are concerns that apply with even greater force to proposals for a multilateral investment court. On balance, the proposal outlined above is substantially less ambitious than the proposal for a multilateral investment court.

V. CONCLUSION

International investment law is in a state of flux. States are increasingly unhappy with the system as it stands today and some are ready to abandon the system. The situation is worsened by intense public scrutiny of a few isolated cases and heated criticism directed at those cases. The European Union has called for a shift away from traditional investment arbitration to an investment court. The proposals for a multilateral investment court seem half-baked and are unlikely to provide long-term contentment to states. A well thought out system of preliminary referrals may be a possible solution. Such a proposal is more workable than the proposals for a multilateral investment court.

INDIAN INSOLVENCY REGIME: IMPACT ON EASE OF DOING BUSINESS AND INVESTMENT

- Raghav Pandey and Advaith Govind*

I. INTRODUCTION

India, despite being one of the fastest growing economies in the world has seen its worst slump in the past six years; in terms of investment as well as employment. There is a mounting Non-Performing Asset (NPA) crisis along with the lack of sufficient legislations to curb the same. This has affected the lending habits of the banks and has increased the capital risks in the market as well. In order to address this issue and to consolidate the highly fragmented framework on insolvency laws, the government of India enacted the Insolvency and Bankruptcy Code, 2016 (hereinafter '**IBC**').

IBC was introduced in 2016 to, "consolidate and amend the laws relating to reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner."[1] The IBC

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[1] The Insolvency and Bankruptcy Code, 2016, No. 31, Acts of Parliament, 2016 (India), preamble [hereinafter IBC, 2016].

applies to companies as well as individuals. It strives to expedite the time taken for the Corporate Insolvency Resolution Process (CIRP) by several institutions such as Insolvency Professionals, Insolvency Professional Agencies, Information Utilities, and Insolvency and Bankruptcy Board.

It has diverged from the tangential policies that had been made to conform to the prior statutes like, the Sick Industrial Companies (Special Provisions) Act, 1985; the Recovery of Debts Due to Banks and Financial Institutions Act, 1993; the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002; and the Companies Act, 2013.

Recently, the Doing Business Index has highlighted that India has made resolving insolvency easier by promoting reorganization proceedings in practice', in a 2020 Report on 'Business Reforms in India'.[2]

A. Ease of Doing Business

Ease of Doing Business Index (hereinafter '**EDB Index**') is a ranking system established by the World Bank. The index ranks countries on the ease of doing business and the simplicity in the regulatory framework for setting up a business. The EDB Index, in the recent times,

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[2] *Business Reforms in India*, DOING BUSINESS, https://www.doingbusiness.org/en/reforms/overview/economy/india.

has been recognised as a measure of economic development and liberal policies of the government towards investments.[3]

EDB Index is a measurement tool that is confined only to the measurement of the regulatory framework that subsists within a country and its sole effect on the governance of business in that country. It compares and contrasts the regulations, from country to country, that affect businesses and does not consider any general or traditional pre-requisites such as larger markets, advanced technology or infrastructural capabilities, or economic behaviours.

The EDB Index comprises 10 sub-indices that are used to formulate a nation's ranking:[4]

a) Starting a business – Procedures, time, cost, and minimum capital to open a new business

b) Dealing with construction permits – Procedures, time, and cost to build a warehouse

c) Getting electricity – procedures, time, and cost required for a business to obtain a permanent electricity connection for a newly constructed warehouse

d) Registering property – Procedures, time, and cost to register commercial real estate

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[3] *Ease of Doing Business*, MAKE IN INDIA, http://www.makeinindia.com/eodb.
[4] *Methodology*, DOING BUSINESS, https://www.doingbusiness.org/en/methodology.

e) Getting credit – Strength of legal rights index, depth of credit information index

f) Protecting investors – Indices on the extent of disclosure, extent of director liability, and ease of shareholder suits

g) Paying taxes – Number of taxes paid, hours per year spent preparing tax returns, and total tax payable as share of gross profit

h) Trading across borders – Number of documents, cost, and time necessary to export and import

i) Enforcing contracts – Procedures, time, and cost to enforce a debt contract

j) Resolving insolvency – The time, cost, and recovery rate (%) under bankruptcy proceeding

These sub-indices analyse the regulatory framework in a country and how much it complements the businesses therein. Each tool analyses a different aspect of the legal framework and how it helps make the economy investment-friendly. Out of these, 'Resolving Insolvency', analyses the time, cost, and recovery rate under the bankruptcy proceeding. It looks at the effectiveness of the insolvency process in a given legal regime.

B. Indian Law and the EDB Index

India has improved its ranking in the 2019 World Bank's Ease of Doing Business Index.[5] It has gone up 14 places to be ranked at the 63rd position in the EDB Index. Much has to be attributed to the Insolvency and Bankruptcy Code, 2016 that has changed the overall bankruptcy and insolvency regime in the country. In addition to this, India also went 56 places up the ladder to be ranked 52nd in the 2019 'Resolving Index' in the IDB Index. IBC has helped improve the insolvency resolution practices and behaviours in the country over the past 3 years. IBC has been an area of debate and discussion, since its inception, due to the lack of effectiveness in its predecessor legislations in curbing the NPA (Non-Performing Asset) crisis and in dictating a proper mechanism of insolvency resolution process. The previous regime had no single legislation, and due to the multiplicity of laws, the judicial process took a lot of time and also created overlapping jurisdictions.

One of the key aims of the IBC is to provide an "effective legal framework for timely resolution of insolvency and bankruptcy which would support development of credit markets and encourage entrepreneurship." The legislature thereby intended to improve the Ease of Doing Business, and facilitate more investments leading to higher economic growth and development.[6]

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[5] *Ease of Doing Business Rankings*, DOING BUSINESS, https://www.doingbusiness.org/en/methodology.

[6] REPORT OF THE JOINT COMMITTEE ON THE INSOLVENCY AND BANKRUPTCY CODE, 2015, LOK SABHA, ¶ 3 (2016) [hereinafter REPORT OF THE JOINT COMMITTEE].

Since the advent of the IBC, around 21,000 cases have been referred the National Company Law Tribunal (NCLT), which is the adjudicating authority under the code.[7] Out of these, 8,500 cases were settled prior to admission and 1,500 companies were ordered to be liquidated.[8]

IBC has drastically improved the recovery rate of debts. The Corporate Insolvency Resolution Process (CIRP) as mandated by the IBC, has been incidental in improving the recovery rates as well as reducing the time and cost of the resolution processes. The recovery rate has come up from 26.5% in 2018 to 71.6% in 2019. In addition to this, the average recovery time for a corporate insolvency resolution process has also improved from 4.3 years in 2018 to 1.6 years in 2019.[9]

A report published by the Reserve Bank of India (RBI) on Insolvency and Bankruptcy Code and Bank Recapitalisation, discusses about the recovery of NPA and the role of different factors on the same. The report identified the recovery rates of banks to have improved after the enactment of the IBC.[10]

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[7] IBC, 2016, *supra* note 1, § 5(1).

[8] Dipak Mondal, *How IBC helped improve India's ease of doing business rankings*, BUSINESS TODAY, Oct. 24, 2019, https://www.businesstoday.in/current/economy-politics/how-ibc-helped-improve-india-ease-of-doing-business-rankings/story/386544.html.

[9] *Govt took several steps for ease of doing biz: MCA*, THE ECONOMIC TIMES, Dec. 16, 2019, https://economictimes.indiatimes.com/news/economy/policy/govt-took-several-steps-for-ease-of-doing-biz-mca/articleshow/72737217.cms?from=mdr.

[10] *Insolvency and Bankruptcy Code and Bank Recapitalisation*, RESERVE BANK OF INDIA, Dec. 21, 2017, https://www.rbi.org.in/scripts/PublicationsView.aspx?id=18060#FT3.

C. Relevance of Insolvency Regime

The Joint Parliamentary Committee Report on the Insolvency and Bankruptcy Code hailed the new insolvency law as an effective legal framework for the timely resolution of insolvency and bankruptcy proceedings. The report also noted that the code will facilitate more investments and eventually improve the ease of doing business leading to higher economic growth. [11]

The IBC shifted the existing Debtor-in-Possession (DIP) regime to a Creditor-in-Control (CIC) regime, taking cue from the U.K Insolvency law and conforming to the international best practices. While countries like France and Italy have debtor-friendly insolvency laws conforming more to the DIP standards; UK, Germany, and Sweden predominantly favour a CIC regime, granting a higher pedestal to the rights of the creditors. Meanwhile, USA has a hybrid regime, providing for both liquidation (in Chapter 7) and restructuring of debts (in Chapter 10).[12]

A DIP regime allows a debtor to carry on its business and allows the gradual repayment to its creditors. Under this regime, the debtor continues to run the business along with the possession of the assets (including the ancillary equipment and the vehicles). Emphasis is laid on the debtor's interests and the law necessitates the debtor to formulate a reorganization plan that would detail the payment to its creditors and the timeframe for the same. However, one of the key shortfalls of such laws

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[11] REPORT OF THE JOINT COMMITTEE, *supra* note 6.
[12] *Id.*

are the inabilities bestowed upon the debtor companies to generate sufficient income as there are is a dearth of adequate resources, and also the subsistence of impending supervision by the bankruptcy court.[13]

Meanwhile, a CIC regime places the creditors in control of the affairs of the company under scrutiny. Once the company is admitted into any insolvency resolution process, the power of the company shall fall into the hands of the creditors.

One of the foremost Acts that was evolved to address the issue of bad loans were the Sick Industrial Companies (Special Provisions) Act, 1987 (SICA) which was passed in public interest, with a view to securing the timely detection of sick and potentially sick companies owning industrial undertakings.[14] The Board for Industrial and Financial Reconstruction (BIFR) was enacted under the act to deal with the rehabilitation of sick units. However, the BIFR was largely ineffective and the borrowers took unwarranted advantage of the indefinite moratorium provided under the SICA.

The Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 (SARFAESI Act) was enforced to "regulate securitisation and reconstruction of financial assets

[13] Will Kenton, *Debtor in Possession (DIP)*, INVESTOPEDIA (May 14, 2019), https://www.investopedia.com/terms/d/debtorinpossession.asp.
[14] The Sick Industrial Companies (Special Provisions) Act, 1985, No. 1, Acts of Parliament, 1986 (India), preamble.

and enforcement of security interest and to provide for a Central database of security interests created on property rights."[15]

This Act provided the secured creditor with several rights to take charge and enforce the security interests of the debtor/borrower.[16] The account of the borrower was to be classified as a Non-Performing Asset (NPA) in the event of any default in the repayment of the loan to the secured creditor. Such NPAs could be sold by the secured creditors (Banks and Financial Institutions) to Asset Reconstruction Companies (ARCs) for the revival of the same. However, even the SARFAESI Act failed to withhold the incidence of mounting NPAs.

In the meantime, several mechanisms were instituted by the RBI to curb the rising NPA crisis. The Corporate Debt Restructuring (CDR) mechanism, the Joint Lenders' Forums (JLFs) initiative, and the Strategic Debt Restructuring (SDR) mechanism were amongst the few of those. These initiatives did not address the case of the unsecured creditors, and failed to achieve the desired results.

Moreover, the RBI, vide several master circulars, catered took up the incidence of 'Wilful Defaults' by borrowers against secured creditors such as Banks and FIs. The case of wilful default was initially taken up by the RBI vide a circular dated February 20, 1999, which was issued for the collection and dissemination of Information on cases of wilful default of

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[15] The Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002, No. 54, Acts of Parliament, 2002 (India), preamble [hereinafter SARFAESI Act, 2002].
[16] *Id.* § 13.

Rs.25 lakhs and above. This was done pursuant to the instructions of Central Vigilance Commission for the collection of details of wilful defaults of Rs. 25 lakhs and above.[17] The master circular, though regulatory in nature and dictating a proper method to classify wilful defaulters, has been riddled with unwarranted disputes and adjudications.

The Insolvency and Bankruptcy code, 2016 was enacted and notified in May, 2016. It was sought to be made the exclusive law dealing with insolvency and bankruptcy in the country. Individuals, companies, limited liability partnerships (LLP), and partnership firms fall within the purview of the IBC.

II. IBC AND THE IMPACT ON INVESTMENT

One of the key drivers of the Indian economy is the infrastructure sector. In 2018, India was ranked 44th out of 167 countries in World Bank's Logistics Performance Index (LPI) 2018. While India is en route to becoming a $3 trillion economy, the government is planning to invest ₹102 trillion over five years to develop social and economic infrastructure.[18] Moreover, there is a requirement of investment worth Rs. 50 trillion (US$ 777.73 billion) in infrastructure by 2022 to have sustainable development in the country. A sound insolvency law that

[17] *Wilful Defaulters and action there against*, RESERVE BANK OF INDIA (Jul. 29, 2003), https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=1279&Mode=0.

[18] Shreya Nandi, *FM unveils ₹102 tn infra push to reignite growth*, LIVE MINT (Jan. 01, 2020, https://www.livemint.com/news/india/fm-unveils-102-tn-infra-push-to-reignite-growth-11577814770788.html.

protects the rights of investors would go a long way in instilling much required confidence in them to invest in the Indian Economy.[19]

The Insolvency and Bankruptcy Code, 2016 has been formulated along the lines of the UNCITRAL Legislative Guide and the World Bank Principles on insolvency reforms. This has been reflected in statement of objects of the IBC.

Maximisation of the Value of Assets is one of the primary motives of the legislation. This is in fact one of the objects of the act. The IBC caters to offer incentives to achieve maximisation of value of the assets to the concerned parties ensuring higher distribution to the stakeholders thereby reducing the burden in insolvency. The Legislative Guide on Insolvency Law by UNCITRAL[20] shares a similar view to any insolvency law. It recommends that a balance of risk has to be achieved between the parties involved in an insolvency proceeding.

By virtue of Section 13 and 14 of the IBC, the adjudicating authority i.e. the National Company Law Tribunal (NCLT) shall declare a moratorium prohibiting all other judicial proceedings against the corporate debtor.[21] Meanwhile this qualifies as a constructive means to keep available the assets of the corporate debtor for the CIRP; it may affect the value of the assets when the process becomes a long-drawn out one.

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[19] *Infrastructure Sector in India*, INDIA BRAND EQUITY FOUNDATION (Jan. 2020), https://www.ibef.org/industry/infrastructure-sector-india.aspx.

[20] UNCITRAL, Legislative Guide on Insolvency Law, (2005), with amendments as adopted in 2006, UNO, https://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf.

[21] IBC, 2016, *supra* note 1, §§ 13-14.

However, this has to be achieved by the NCLT in consonance with the other judicial authorities.

Another key aspect of the IBC is the Access to Finance/ Credit. In order to facilitate this, an insolvency law ought to be predictable and transparent. Only then, shall it encourage constructive investments that help the economy as well. According to UNCITRAL's Legislative Guide on Insolvency Law, a law on insolvency should also be transparent and predictable. A predictable law assists the potential lenders and creditors to assess the risks associated in the event of insolvency. [22] A similar view has been iterated by the Supreme Court at length in *Mobilox Innovations v. Kirusa Software*.[23]

The IBC has a well-structured reasoned procedure for CIRP. Section 4 of the code provides a minimum threshold of one lakh rupees for the initiation of a CIPR process.[24] Such a process can be initiated either by the corporate debtor himself or the financial creditor or an operational creditor[25] and an application for the same has to be filed before the adjudicating authority (NCLT) for the initiating the insolvency resolution process. An Interim Resolution Professional (IRP) would be appointed by the creditors and would be made in charge of the affairs of the company. The resolution professional is given a time frame of 180 days, which can be extended by 90 more days to draw out a resolution plan, which has to

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[22] *Supra* note 20.
[23] Mobilox Innovations v. Kirusa Software, (2018) 1 SCC 353.
[24] IBC, 2016, *supra* note 1, § 4.
[25] *Id.* § 6.

be approved by the Committee of Creditors (COC) so constituted. However, the insolvency resolution process shall not exceed a maximum of 330 days.[26]

One of the shortfalls of the former insolvency regime was the failure to Harmonize Liquidation and Reorganisation process.[27] This was obviously detrimental to prospective investment in the country.

Under the SARFAESI Act, 2002, a secured creditor could enforce the security interest and needlessly put a stop to the business of the debtor company.[28] In the long run, this could invariably harm the economy. The problem mounts when the so secured assets remain unproductive failing to secure a buyer or be revived duly. The Legislative Guide by UNCITRAL identifies this and necessitates the need for balancing liquidation and reorganisation. The IBC, cater to fix this lacuna in the erstwhile laws.

The Code allows restructuring of doubtful assets and initiates liquidation only in the event restructuring goes futile. The NCLT, being the adjudicating authority, is bestowed with the power to order liquidation of the corporate debtor.

Section 12-A, recently added by the Insolvency and Bankruptcy Code (Second Amendment) Act, 2018 allows for the withdrawal of an insolvency application admitted under Section 7, 9 or 10, but the same has

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[26] *Id.* § 12.
[27] SUMANT BATRA, CORPORATE INSOLVENCY LAW AND PRACTICE 41 (Abhinandan Malik eds., 1st ed. 2017).
[28] SARFAESI Act, 2002, *supra* note 15.

to done with the approval of at least ninety per cent voting shares of the COC.[29]

The IBC facilitates the balancing of the Interests of all stakeholders**.** This is enunciated in the objects of the act. Stakeholders who are equally placed are treated equally by the new act. The code does not differentiate between the rights of foreign creditors and Indian creditors.

Section 53 of the IBC dictates the waterfall mechanism for the distribution of the proceeds from the sale of asset of the corporate debtor in a certain order of priority. As per Section 53 of the IBC, the order of priority is as follows:[30]

a) The insolvency resolution process cost and the liquidation costs paid in full.

b) The following debts which shall rank equally between and among the following:

i. workmen's dues for the period of twenty-four months preceding the liquidation commencement date; and

ii. debts owed to a secured creditor in the event such secured creditor has relinquished security in the manner set out in section 52;

[29] IBC, 2016, *supra* note 1, § 12 A.
[30] *Id.* § 53.

c) wages and any unpaid dues owed to employees other than workmen for the period of twelve months preceding the liquidation commencement date;

d) financial debts owed to unsecured creditors;

e) the following dues shall rank equally between and among the following:

i. any amount due to the Central Government and the State Government including the amount to be received on account of the Consolidated Fund of India and the Consolidated Fund of a State, if any, in respect of the whole or any part of the period of two years preceding the liquidation commencement date;

ii. debts owed to a secured creditor for any amount unpaid following the enforcement of security interest;

f) any remaining debts and dues;

g) preference shareholders, if any and

h) Equity shareholders or the partners as the case may be.

As far as Section 53 of IBC is concerned, the costs associated with the insolvency process and liquidation fall the highest in priority of repayment, followed by the payment due to the workmen for the past 24 months preceding the liquidation, along with the debts owed to the secured creditors, who are the financial creditors of the corporate debtor.

The National Company Law Appellate Tribunal (NCLAT) in *State Bank of India v. Moser Baer Karamchari Union,*[31] ruled on the scope and extent as to which 'workmen dues' have been covered under Section 53 of IBC.

According to Section 36 of the IBC, the liquidator is mandated to create a liquidation estate[32] wherein the "liquidator shall hold the liquidation as a fiduciary for the benefit of all the creditors".[33] However, sub clause (a)(iii) of clause (4) of Section 36 categorically states that no social security benefits in the form of provident, gratuity or pensions fund forms a part of the liquidation estate.

The NCLAT reasserted the same in the *Moser Baer case*. The Appellate authority entailed in a harmonious approach in interpreting 'workmen's dues' under Section 53 of the Code along with Section 36 of the Code and Section 326 of the Companies Act, 2013 (hereinafter referred to as the '2013 Act'). The NCLAT explained that the purpose of Section 326 of the 2013 Act is to give priority to certain amounts while Section 53 deals with the distribution of proceeds from the sale of liquidation asset.[34]

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[31] State Bank of India v. Moser Baer Karamchari Union, 2019 SCC OnLine NCLAT 447, (India).
[32] IBC, 2016, *supra* note 1, § 36(1).
[33] *Id.* § 36(2).
[34] Anshul Prakash & Deeksha Malik, *India: Liquidation Waterfall: NCLAT Rules Against Inclusion of Social Security Dues under 'Workmen's Dues'*, MONDAQ, Aug. 30, 2019, http://www.mondaq.com/india/x/841238/Corporate+Commercial+Law/Liquidation+Waterfall+NCLAT+Rules+Against+Inclusion+Of+Social+Security+Dues+Under+Workmens+Dues.

Homebuyers or allottee of real estate project were also brought under the ambit of the IBC by the Insolvency and Bankruptcy Code (Second Amendment) Act, 2018. The Supreme Court in the case of *Pioneer Urban Land and Infrastructure Limited v. Union of India*,[35] dictated the Real Estate (Regulation and Development) Act, 2016 to be read harmoniously with the IBC and held that homebuyers ought to be construed as financial creditors under the code.

The operational creditor falls lower to the workmen and secured creditors in the in hierarchy of the repayment mechanism under this provision. The position of the financial creditors' vis-à-vis the operational creditors in the priority of payment at the time of liquidation has been a bone of contention since the inception of the Code. The Bank Law Reforms Committee Report has iterated that there is a lack of an effective implementation mechanism to enable operational creditors to trigger the resolution process.[36]

Financial Creditor, under IBC, has been defined in Section 5(7) as "any person to whom a financial debt is owed and includes a person to whom such debt has been legally assigned or transferred to"[37] while an operational creditor is "person to whom an operational debt is owed and includes any person to whom such debt has been legally assigned or transferred."[38] The relation of the financial creditors to that of the

[35] Pioneer Urban Land and Infrastructure Limited v. Union of India, 2019 SCC OnLine SC 1005.
[36] The Report of the Bankruptcy Law Reforms Committee, ¶ 4.3.4 (2015).
[37] IBC, 2016, *supra* note 1, § 5(7).
[38] *Id.* § 5(20).

company is purely financial, on the other hand, the operation creditors' liabilities are in the form of future payments in exchange of goods or services already delivered.[39]

The case of *Swiss Ribbons Pvt. Ltd. v. Union of India,*[40] clarified the position of financial and operational creditors in the waterfall mechanism purported under the IBC. One of the key grounds was the unequal or the inferior treatment of the operational creditor vis-à-vis financial creditors in the event of corporate insolvency resolution process. The Supreme Court in this case noted that the "financial creditor are in the business of moneylending; banks and financial institutions are best equipped to assess viability and feasibility of the business of the corporate debtor."[41] The court opined that such a difference is neither discriminatory nor arbitrary.

The Supreme Court in the recent *Essar Steel Judgement*[42] reiterated the role of the committee of creditors (CoC) and held that the operational and financial creditors are distinct and their claims are different. The financial creditor is necessarily a secured creditor and cannot be equated to an operational creditor who is an unsecured one.

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[39] The Report of the Bankruptcy Law Reforms Committee, ¶ 5.2.1 (2015).
[40] Swiss Ribbons Pvt. Ltd. v. Union of India, AIR 2019 SC 739.
[41] *Id*.
[42] Committee of Creditors of Essar Steel India Limited v. Satish Kumar Gupta, 2019 SCC OnLine SC 1478.

The Insolvency and Bankruptcy Code (Amendment) Act, 2019,[43] amended Section 30(2) (b) in order to restore the rights of the financial creditors. The amendment provided that a resolution place should provide either the liquidation value or the debt or the amount that would have been received by the operational creditor if the amount distributed under the resolution plan was done in accordance to Section 53 of the Code.

The ICRA report, that was released on June 19, 2019, has made comparisons of the haircuts for operational creditors vis-à-vis financial creditors in India. The findings were premised on the 92 Corporate Insolvency Resolution Plans (CIRPs) that have yielded a resolution plan before March 31, 2019 under the IBC. The ICRA's estimation is that the haircuts for the operational creditors is not 'materially different' from that of financial creditors. [44]

Payments due to the government are ranked below the claims of the unsecured creditors along with the residuary payment unpaid to the secured creditor after the enforcement of the security interest. Government dues however used to be given a higher priority in the earlier liquidation regime which no longer subsists under the new one. While the preference and the equity shareholders are one of the lowest stakeholders within the priority of repayment is concerned.

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[43] The Insolvency and Bankruptcy Code (Amendment) Act, 2019, No.26 of 2019, Acts of Parliament, 2019 (India).

[44] *ICRA: Haircuts for operational creditors have been in line with that for the financial creditors*, ICRA, June 19, 2019, https://www.icra.in/Media/OpenMedia?Key=b51602bc-0043-4545-9dd9-fd65096e0849.

'Timely and Efficient Resolution' is yet another defining feature of the IBC. The new law is ambitious when it comes to timely resolution of the insolvency process. The recent Insolvency and Bankruptcy Code (Amendment) Act, 2019 has extended the deadline for a CIRP from 270 days to 330 days.[45] This extension of deadline is to be seen as a positive move, imbibing the progressive changes from the two years of its functioning.

The Institutional Infrastructure maintained by the IBC is one of its kinds in India. The IBC boasted of several institutions which put together a dynamic insolvency regime. The World Bank in its report on 'Principles and Guidelines for Effective Insolvency and Creditor Rights Systems' necessitates the importance of an effective insolvency law and creditor rights system.[46]

According to the report, strong institutions and regulations are crucial for the smooth functioning of any insolvency system. The three main aspects of any insolvency law should be:[47]

a) Institutions formulated under the system for the insolvency process

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[45] The Insolvency and Bankruptcy Code (Amendment) Act, 2019, No.26 of 2019, Acts of Parliament, 2019 (India).

[46] World Bank, *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems*, WORLD BANK GROUP (Apr. 2001), http://siteresources.worldbank.org/GILD/PrinciplesAndGuidelines/20162797/Principles%20and%20Guidelines%20for%20Effective%20Insolvency%20and%20Creditor%20Rights%20Systems.pdf.

[47] *Id.*

b) Operational system for processing cases and decisions

c) Requirements for preserving the integrity of the system

Under the IBC, there are four main institutions: the Insolvency and Bankruptcy Board of India (IBBI), the Adjudicating Authority, the Insolvency Professionals (IP) and the Information Utilities.

a) ***Insolvency and Bankruptcy Board of India (IBBI)*****:** IIBI acts as the regulator for insolvency proceedings under the IBC. The IBBI overlooks and manages the functions of information utilities, insolvency professional agencies and insolvency professionals.

b) ***Adjudicating Authority*****:** National Company Law Tribunal (NCLT)[48] and Debt Recovery Tribunal (DRT)[49] are the adjudicating authorities under the code. While the NCLT is for corporate insolvency process, the DRT is for individual insolvency. An appeal from the NCLT shall go to the National Company Appellate Tribunal (NCLAT) and thereafter to the Supreme Court while an appeal from DRT lies on the Debt Recovery Appellate Tribunal (DRAT) and thereafter to the Supreme Court.

c) ***Insolvency Professionals*****:** Section 3(19) of the Code defines an 'insolvency professional' as person enrolled under section 206 of the Act with an insolvency professional agency as a member and

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[48] IBC, 2016, *supra* note 1, § 5(1).
[49] *Id.* § 79(1).

registered under the IBBI.[50] Insolvency professionals run the business of the debtor during the CIRP.

d) ***Information Utilities (IU)*:** IU stores financial information pertaining to the borrowings made, default occurred, type of interests created and so on. They act as a repository of all the financial transactions as far CIRP is concerned and are incidental to the process. National E-Governance Services Limited is the first IU in India.

III. KEY CONCERNS UNDER IBC

The concerns of the borrowers are one of the primary drawbacks in a CIC system of law. There is a certain tendency to favour liquidation under the current IBC regime. By September 2018, while 80% of the cases admitted ended up in liquidation, only 20% were successfully resolved.[51] When it comes to insolvency restructuring under the IBC, 2016, it fails to provide any pre-insolvency restructuring solution to any company who failed to pay its debts. The power wielded to the Committee of Creditor (or the creditors at large) is one of the jurisprudential drawbacks of the Insolvency Bankruptcy Code, 2016. The question as to the genuinity of the interests of the creditors as far as the revival of the company goes is doubtful. Rather, the interests of the creditors would always be the

[50] *Id.* § 2(19).
[51] Pratik Datta, *Value destruction and wealth transfers under Indian Insolvency and Bankruptcy Code, 2016*, OXFORD BUSINESS LAW BLOG, Feb. 08, 2019, https://www.law.ox.ac.uk/business-law-blog/blog/2019/02/value-destruction-and-wealth-transfers-under-indian-insolvency-and.

recovery of their own claims. Since, the IBC follows a 'creditor-in-control'[52] regime; it could lead to a 'value destruction of a profitable business'.

The IBC is yet to make its deterrent effect more conspicuous, and right now it has only a passive influence on companies and its promoters. Moreover, the incidence of several vague provisions being added into the law ended up in a state of quandary for both the adjudicators as well as the practitioners. Section 29A inserted by virtue of the Insolvency and Bankruptcy Code (Amendment) Act, 2018 was identified as a favourable measure introduced into the IBC to rule out the involvement of various actors who may affect the credibility of the insolvency process.[53] However, IBC is silent as to the instance of the non-defaulting promoters taking part in the resolution process. This is still an area of ambiguity and was conspicuous in the case of *RBL Bank Ltd. v. MBL Infrastructure Ltd.*,[54] wherein the non-defaulting promoters were eventually allowed to submit a resolution plan upon the interference by the NCLT.

Another area of concern is the indifference propelled towards the operational creditor vis-à-vis the financial creditor. The IBC ought to prioritise the rights of the operational creditors in order to make the economy more investment-friendly. The operational creditors who have to

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[52] Ashu Kansal, *Whether It Is a Creditor or Investor Regime*, MONDAQ, Nov. 03, 2017, http://www.mondaq.com/india/x/642766/Insolvency+Bankruptcy/WHETHER+IT+IS+A+CREDITOR+OR+INVESTOR+REGIME.

[53] The Insolvency and Bankruptcy Code (Amendment) Act, 2016, No. 26, Acts of Parliament, 2018 (India), Statement and Objects.

[54] RBL Bank Ltd. v. MBL Infrastructure Ltd., 2017 SCC OnLine NCLT 12612.

undergo unwarranted haircuts can delve into more litigation and this can lead to the CIRP being a long-drawn process, thus decreasing the value of the assets in the long run.

An insolvency resolution process in India takes around 4.3 years on an average in contrast to 1.5 years in U.S.A and 1 year in U.K. IBC being credited as a massive improvement from its predecessor laws, it should be analysed and compared in relative terms to the insolvency laws prevailing in other developed countries and not just to the pre-existing laws.[55] The IBC does not have any provision for mediation or conciliation within it. Alternate Dispute Resolution (ADR) is time saving and is often favoured by investors and corporates. An investment-friendly insolvency regime ought to offer ways of alternatively resolving disputes.

The IBC should differentiate "financially distressed" and "economically distressed" companies. The IBC should seek to identify the type of 'distresses' that a company is under. "When the present value of the expected profits of a company is less than the total value of the assets of the company,"[56] it is said to be economically distressed. On the other hand, if a company is just not able to service its debt due to several reasons like high fixed costs, illiquid assets or revenues that are sensitive

[55] *India's Insolvency and Bankruptcy Code: 3 years of Hits and Misses*, NEWSBARONS, https://www.newsbarons.com/real-estate/indias-insolvency-and-bankruptcy-code-3-years-of-hits-and-misses/.

[56] Nikita Kwatra, *The IBC has an incentive problem*, LIVE MINT, Jan. 02, 2019, https://www.livemint.com/Industry/nYs7QsAfNqtgGoQHZw2zBJ/The-IBC-has-an-incentive-problem.html.

to economic downturns, then such company is said to be under financial distress.[57]

While those companies under irreversible economic distress have to be liquidated, a company running through a certain financial distress could be rescued through financial restructuring or selling it to new investors. Thus, the key is to find a conducive remedy for the distressed company.

IV. CONCLUSION

There are a host of investment opportunities for foreign investors within the subcontinent. A law that is conducive towards investor-interests helps the economy grow. Asset Reconstruction Companies (ARC), Non-banking financial companies (NBFC), Alternative investment fund (AIF), foreign portfolio investment (FPI) and External commercial borrowing (EBCs) are some of the various ways in which a foreign company can invest in India. A strict and an effective insolvency law is one that protects an investor's interests. IBC aims to create a strict insolvency regime where the investors are free to function and stand up to protect their interests, if required.

The major issue relating to the definition and scope of operational creditors and financial creditors. Though the judicial approach has been similar treatment of both operational creditors and financial creditors,

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[57] *Enterprise Value of Firms under Insolvency*, MONDAQ, Jul. 08, 2019, http://www.mondaq.com/india/x/822768/Insolvency+Bankruptcy/Enterprise+Value+of+Firms+Under+Insolvency.

there is still is a lot of scope for statutory clarity on these aspects. It is common knowledge that in the operations of any decently sized corporation, hue operational debts are owed.

If the law refuses to give parity to these creditors, with financial creditors, in at least certain aspects, these operational debtors will stand at a huge disadvantage. This situation may trigger a knock on effect and can further result in a bankruptcy of the corporations in the entire supply chain, of which the corporate debtor is a part of.

As enumerated earlier, the IBC regime does not attempt to find out the cause of distress in a corporate debtor. The IBC simply demands a default on a payment as a ground for triggering in the IBC process. This can be problematic if the causes are not distinguished between financial and economic causes. A corporation, for instance, which is in the business of an outdated technology, is bound to go out of business, regardless of the resolution efforts, the law may put into. However, a corporation undergoing stress due to a general distress in the economy, can be salvaged through the law, by the concerned entities coming up with a resolution scheme. Hence, the cause of distress plays a role in determining the tailor made resolution. The IBC in its current doesn't cater to this issue.

While the Insolvency and Bankruptcy Code, 2016 has largely been an ambitious drive, striving towards a world-class insolvency regime, it suffers from several lacunas that have to be effectively dealt with. In short, the law is an experimental one. However, the road ahead looks more promising than ever.

BOMBAY'S TRYST WITH THE CITY ON RHINE

- Shanya Ruhela*

ABSTRACT

Basel Committee on Banking Supervision, an informal committee based in Switzerland, formulates minimum banking standards, which are touted as the best practices in banking worldwide. These standards have been adopted in most nations of the world despite being framed through a process that involves a select group of nations. India became a member of this Committee after the Great Financial Crisis of 2007-08. This paper aims to understand the regulatory regime created by the Committee and concludes by enumerating its relationship with India.

At its peak, the pollution levels in New Delhi, the capital city of India, were recorded up to the maximum measurable level of air pollution.[1] This led to a situation of public emergency[2] as the level of pollution rose to fifty times the level deemed safe by the World Health Organisation. The reasons for the surge in pollution levels in the capital city include ten million active vehicles on its roads, a boom in the manufacturing and construction industries, power plants using coals and

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[1] On the first two weeks of Nov., 2019, the Air Quality Index or the AQI reached upto 500. Data obtained from National Air Quality Index website (https://app.cpcbccr.com/AQI_India/) managed by the Central Pollution Control Board, Ministry of Environment, Forests and Climate Change.

[2] Press Trust of India, *EPCA declares public health emergency in Delhi-NCR*, THE ECONOMIC TIMES, Nov. 1, 2019; Press Trust of India, *Public health emergency declared in Delhi-NCR*, THE TELEGRAPH INDIA, Nov. 1, 2019.

most importantly, crop stubble burning in the neighbouring states of Punjab and Haryana.[3]

One of the actions proposed to curb the increasing levels of pollution over the years is, setting up of bio-refiners or 2G ethanol.[4] Public Sector Companies like Indian Oil Corporation, Bharat Petroleum Corporation and Hindustan Petroleum Corporation had applied for funding to set up these plants but the companies reportedly have not been able to attain financial closure. According to the senior officials of these companies, the delay or inability to attain financial closure is attributed to a regulation by the Reserve Bank of India (hereinafter '**RBI**') which caps the exposure of single borrower to 20% of their capital base.[5] RBI introduced the regulations to be compliant with its international obligation under transnational banking regime created by the Basel Committee on Banking Supervision (hereinafter '**Committee**'). The standard introduced by the Committee in 2014 lays down a supervisory framework for measuring and controlling large exposures. The Committee developed this standard as a tool to limit maximum loss that a bank could face in the

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[3] Umair Irfan, *The law that's helping fuel Delhi's deadly air pollution*, VOX, Dec. 16, 2019, https://www.vox.com/science-and-health/2019/11/8/20948348/delhi-india-air-pollution-quality-cause.

[4] Donna Lee Jones, *Potential Air Emission Impacts of Cellulosic Ethanol Production at Seven Demonstration Refineries in the United States*, 60 JOURNAL OF THE AIR & WASTE MANAGEMENT ASSOCIATION, 1118–1143 (2010) *(Ethanol plants converts agricultural waste into forms of biofuels and biochemicals, aiding in avoiding combustion of such products in open air).*

[5] Kalpana Pathak & Shayan Ghosh, *North India's stubble burning woes have an RBI link*, LIVE MINT, Nov. 5, 2019, https://www.livemint.com/politics/policy/north-india-s-stubble-burning-problem-has-an-rbi-connection-11572939873441.html.

event of a sudden counterparty failure to a level that does not endanger the bank's solvency.[6]

This paper examines the transnational banking regime created by the Committee and concludes by examining India's involvement in the same.

I. BASEL REGULATORY REGIME

The year 1974 was marred by fragile international economic order and multiple bank failures[7] attributable to that broadcasted a supervisory vacuum, ushering the governors of central banks of the developed nations[8] to seek regular cooperation.[9] Thus, materialised the Committee in Basel, Switzerland, hosted by the Bank for International Settlements (hereinafter '**BIS**'), World's most senior financial regulator.[10] The Committee was established to enhance financial stability by improving the quality of banking supervision worldwide, and to serve as a forum for regular cooperation among its members on banking-supervisosupervisionry

[6] Basel Committee on Banking Supervision's Standards - *Supervisory framework for measuring and controlling large exposures*, BANK OF INTERNATIONAL SETTLEMENTS (April 2014), https://www.bis.org/publ/bcbs283.pdf.

[7] Such as the failure of Bankhaus Herstatt (bank), Franklin National Bank, Israeli – British Bank and Lloyds Lungano. *See* Catherine R. Schenk, *Summer in the city: banking failures of 1974 and the development of international banking supervision*, 129.540 THE ENGLISH HISTORICAL REVIEW, 1129-1156 (2014).

[8] The initial membership of the Committee included nations of G10 (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom and United States) and Luxemburg.

[9] Christopher Kobrak & Michael Troege, *From Basel to bailouts: forty years of international attempts to bolster bank safety*, 22.2 FINANCIAL HISTORY REVIEW (2015) 133-156.

[10] KAZUHIKO YAGO, THE FINANCIAL HISTORY OF THE BANK FOR INTERNATIONAL SETTLEMENTS (Routledge, 2013).

matters.[11] The Committee was instituted to set the foundations of a strong and uniform homogenous international framework to end the turmoil in banking. It was expected that the Committee would ensure smooth international exchange of capital and goods.[12]

The Committee's governance structure consists of a chair, standard setting and research based groups, and Secretariat, which is hosted at BIS. The Group of Central Bank Governors and Head of Supervision exercises oversight over the Committee and endorses its major decisions.[13] The officials sent from the member nations includes those officials who are responsible for banking supervision of their respective nations.

A. Evolution of Standards Set By the Committee

The Latin American debt crisis of 1982 provided a much-needed push to the Committee to work towards a harmonised capital regulation to curb increasing international risks. North – American banks had lent heavily to Latin American nations and hence, were at the brink of facing severe financial consequences. International Monetary Fund (IMF) was called to intervene but the institution depended upon the contributions by the United States for bail-outs. U.S. did not favour unilateral increase in safeguards for American banks as it would not prevent crisis elsewhere

[11] Basel Committee on Banking Supervision's History of the Basel Committee on Banking Supervision, http://www.spaeth.ru/HS20152016/artikel_14.pdf.

[12] Christopher Kobrak & Michael Troege, *From Basel to bailouts: forty years of international attempts to bolster bank safety*, 22(2) FINANCIAL HISTORY REVIEW (2015) 133-156.

[13] Major decisions for the Committee include promulgation of standards, emergency responses and expansion of membership among others.

and would be enforced to the detriment of the competitiveness of American banks. In spite of the on-going crisis, the Committee dismissed the idea of international capital standard requirement. U.S, determined to establish global minimum standards, found an ally in the Bank of England. The two nations reached an agreement regarding increased standards and invited other nations to join. This strong-armed the Committee, which then sprang into action and proposed the draft of first set of substantive standards in December 1987. This proposal was based on the US–UK agreement. The participation in discussions leading up to the final set of standards of minimum capital adequacy (hereinafter '**Basel Accords**' or '**Accords**') were carried out by the domestic representatives of the G10 nations and Luxembourg. The negotiations of the Accords were dominated by the United States. The process remained largely in the hands of participating public authorities with the Committee acting as a mediator of power imbalances between participating states.[14] No other interest group or public policy institute participated in these negotiations. The hegemony of the United States, abstractness of the issue, and a lack of transparency were the driving forces behind the first set of substantial standards being published by the Committee.[15]

The Accords introduced an international standard to compute bank's regulatory capital and, for the very first time in the paradigm of international financial regulation (hereinafter '**IFR**'), attempted to set

[14] Christian Chavagneux, *Prudential Control: Private Rule in the Regulation of Global Finance*, 60 REVUE D'ÉCONOMIE FINANCIÈRE 5, 47-58 (2000).
[15] RICHARD ALBERTUS JOHANNES STEENVOORDE, REGULATORY TRANSFORMATIONS IN INTERNATIONAL ECONOMIC RELATIONS, (1ed., Wolf Legal Publishers, 1 July 2008).

minimum standards for banks at an international level. The purpose of Basel Accords was to reduce the risks faced by an internationally active bank. It aimed at attaining the twain objectives of strengthening soundness and stability of the international banking system, and the reduction of the competitive inequality among international banks, which arise from differences among national bank-capital regulations. The Accords were formulated to curtail and contain systemic risk,[16] and promote a sound and a stable international banking system.

The Accords set up minimum capital standards for internationally active banks. The minimum ratio of regulatory capital to total risk-weighted assets (RWA) that internationally active banks had to adhere to was 8% and this was to contain a core capital element, which was to be at minimum 4%. The 8% risk weighted average rule implied that applicable banks needed to maintain minimum regulatory capital to the extent of 8% of the risk – weighted assets and asset equivalent off-balance sheet exposures. Regulatory capital included the combination of equity, loan-loss reserves, and subordinate debt among other accepted instruments. The Accords provided for determination of risk weights of bank assets. It was a simple framework where only five categories of weights were used (0% for zero risk, 20% for low risk, 50% for medium risk and 100% for high risk). Examples of risk-weighted assets include loans and securities. Asset equivalent off-balance sheet exposures include loan commitments, standby

[16] Basel Committee on Banking Regulations and Supervisory Practices, *Outcome of the Consultative Process on Proposals for International Convergence of Capital Measurement and Capital Standards*, BANK OF INTERNATIONAL SETTLEMENTS, 1 (July 1988), http://www.bis.org/publ/bcbs04b.pdf.

letters of credit, and obligations on derivative contracts. In this formulation, different types of assets were categorised assets according to the level of perceived risk that each type of asset represents. The total risk-weighted assets were, subsequently, multiplied by 8 per cent to determine the bank's minimum capital requirement.

The Accords covered bank's exposure to credit risks while ignoring the other types of risks. Banks face various risks that has the potential to affect its continued solvency. These include market risk, operational risk, interest rate risk and liquidity risk among others. Market risk refers to risk that originates from loss arising from the fluctuations in market prices. In the case of banks, market risk may arise due to fluctuations in prices. Operational risks arise from the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. It includes legal risk.[17] Operational risk ranges from the physical disruption of a bank's operations by natural or human agents to a massive liability judgment entered against the bank. An increase in the interest rate is immediately problematic for the bank as it increases the cost of capital. This is a risk because the bank's assets, which are loans, have already been contracted under lower interest rates. This risk is termed as interest rate risk. Liquidity risk is an inherent risk arising out of financial intermediation. Other risks that a bank faces may include reputational or political risks. The Accords were amended in 1996 to take

[17] Basel Committee 2004d, at 144.

into account market risk by introducing an additional capital charge to cover market risk in banks' trading books.

The Accords were one of the most successful international regulatory initiative ever attempted.[18] Even though the Accords were formulated specifically for internationally active banks, its compliance transcended to include large financial institutions. The Accords provided an effective framework for banks round the globe to assess their capital adequacy and ensure their safety. The Accords partly attained its aim of promoting financial stability and helped in providing for an equitable basis for competition among internationally active banks.

These standards, however, were overly simplistic and, quickly, their weaknesses were noticeable. The Accords did not provide a method for differentiating risks in individual loans, which led to instances of regulatory arbitrage. Another fallacy was that it neglected operational risk by focusing only on credit and market risk. The Accords failed to address the activities of large, complex banking organisations. Some of the other criticism levelled against the Accords were that it lacked risk sensitivity and attempted to establish a one size-fits-all approach as the requirements under the Accords were virtually the same irrespective of the risk level, sophistication, and the activity type of the bank.

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[18] Michael S. Barr & Geoffrey P. Miller, *Global administrative law: the view from Basel*, 17 EUROPEAN JOURNAL OF INTERNATIONAL LAW 1, 15-46 (2006).

The Accords, despite aiming to attain financial stability, failed to prevent multiple crises of the 1990s.[19] The second set of substantive standards set by the Committee (hereinafter '**Basel II**') stemmed out of the inadequacies of the Accords. Development of Basel II began at the wake of the Peso Crisis of 1994 and the Asian Crisis of 1997-98, which demonstrated that banks were facing a set of complex risks, which are not limited to credit and market risks. The existing capital adequacy framework failed to capture and curb these risks. Contemporaneously, multiple international organisations like the OECD, IMF, World Bank and FSF (present FSB) promulgated international standards specifically to shape, improve, and facilitate market behaviour.[20]

The negotiators of Basel II did not come with a pre-decided agenda to the table. This was unlike the Accords, which was geared by the US-UK agreement. The second set of substantive standards by the Committee were, thus, subject to extensive negotiations.[21]

Ultimately, Basel II was published in 2004 with an objective of developing a framework that would strengthen the soundness and stability of the international banking system. Basel II was intended to have the

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[19] Some of the crisis that characterised the 1990s were the Finnish and Swedish banking crises (early 1990s), Indian economic crisis (1991), Mexican peso crisis (1994), Turkish economic crisis (1994), Asian crisis (1997-98), Russian financial crisis (1998), Argentine economic crisis (1999-2002), and Brazil crisis (1999).

[20] GEOFFREY RD UNDERHILL, JASPER BLOM & DANIEL MÜGGE, EDS. GLOBAL FINANCIAL INTEGRATION THIRTY YEARS ON: FROM REFORM TO CRISIS 115 (Cambridge University Press, 2010).

[21] DANIEL K. TARULLO, BANKING ON BASEL: THE FUTURE OF INTERNATIONAL FINANCIAL REGULATION 87, 100 (Peterson Institute, 2008). *The author notes that even though the Federal Reserve Board urged (upgrade) the Accords, it lacked a specific proposal*.

same purpose as the Accords did (system stability and competitive equalization).[22] Basel II aimed to attain this objective while maintaining sufficient consistency to ensure that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks.[23] The Basel II's market-based approach to banking supervision has a uniquely important place because, although these standards are concerned with internationally active banks, their sectorial and country coverage impact was much broader. Basel-II covered all international banking activities as well as many insurance and capital markets activities of financial conglomerates.[24] Basel II laid down a framework consisting of a three-pillar approach to banking regulations.

Continuing with the legacy of the Accords, the first pillar of Basel II (hereinafter '**Pillar I**') purported maintenance of minimum capital adequacy requirement. It introduced changes in the way certain aspects of risks and resulting capital adequacy requirements were to be calculated. The standards broadened the range of risks to include operational risk. The second set of substantive standards set by the Committee laid down

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[22] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework Comprehensive Version*, BANK OF INTERNATIONAL SETTLEMENTS, 144 (June 2006), http://www.bis.org/publ/bcbs128.htm.

[23] Basel Committee 2004c, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, June 26, 2004, ¶ 4.

[24] The Committee developed a document with the International Organisation of Securities Commission (IOSCO) which laid down the treatment of trading book of a bank and this was integrated with the main text of Basel II. Thus, while capital market *regulation* falls under other (international) organisations (such as the IOSCO), much of banks' activities in capital markets is covered by Basel II. *See* Geoffrey RD Underhill & Xiaoke Zhang, *Setting the rules: private power, political underpinnings, and legitimacy in global monetary and financial governance*, 84 INTERNATIONAL AFFAIRS, 535-554 (2008).

minimum regulatory capital based on risks assigned to each component of the portfolio of the banks. It incorporated credit risk, market risk and operational risk.

Further, the standard prescribed various methods of calculating risks in each category. The three methods of calculation of credit risk, i.e., Standardised Approach, Foundational Internal Rating-Based Approach (IRB) and Advanced IRB Approach, three for the calculation of operational risk, namely, Basic Indicator Approach, Standardised Approach and Advanced Measurement Approach (ATA), and for market risk, calculation was to be undertaken by Standardised Approach and Internal risk management Models Approaches.

The innovativeness of Basel II lay in allowing banks to use their own models for assessing risk or rely on external rating agencies. The approaches that permitted either of these routes were Standardised Approach and IRB Approaches of calculating credit risk, the Advanced Measurement Approach for operational risk assessment and internal risk management Models Approach for assessment of market risk.

The Standardised Approach, which was to be used to calculate credit risk, was to derive its risk weights from an external rating agency.[25] Further, the IRB and Advanced IRB for the calculation of credit risk allowed banks to use their own ratings system and models respectively provided they met minimum prescribed criterion.

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[25] The widely used rating agencies were Standard & Poor's, Moody's and Fitch.

Advanced Measurement Approach for operational risk assessment called for regulatory capital requirement based on a bank's internal operational risk management system. Lastly, internal risk management Models Approach for assessment of market risk encouraged banks to develop their own internal models to calculate a stock, currency or commodity's market value on a case to case basis. Further, banks were encouraged to develop their own method of calculating Value at Risk (VaR) based on last five years data on a position to position basis.

Thus, the Basel II while raising complexity of the standard, established a hybrid scheme where banks were able to calculate parameters with internal models whilst the actual capital charge were determined by inserting these parameters into the model decided by the Committee.[26]

Pillar II established principles for supervisory review and purported to provide regulators better opportunity to regulate. It provided guidelines for bank's internal performance assessment procedures as laid under Pillar I. The supervisors were directed to intervene if the banks were not complying with the minimum capital requirement.

Pillar III imposed disclosure norms to facilitate market discipline. The required disclosures range from the ownership structure, risk exposures, capital adequacy and risk profile. The standard mandated the regular publication of this information; once every six months by national

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[26] Mike Mariathasan & Ouarda Merrouche, *The manipulation of basel risk-weights*, 3 JOURNAL OF FINANCIAL INTERMEDIATION 23, 300-321 (2014).

banks and once a quarter by internationally active banks. Additionally, Basel II attempted to instil market discipline by mandating disclosures for assessment of risk exposure and capital adequacy of the bank by market participants. Basel II attempted to strengthen disclosure requirement by including the requirement to disclose bank's capital structure, method of calculating capital adequacy, its risk exposure and its risk assessment methods.[27]

Even before the Great Financial Crisis of 2008 (hereinafter '**the Crisis**'), the Committee was considering revising its standards. Basel II's rigid capital demands were criticised for its tendency to create pro-cyclicality effect, as it required banks to shed assets during a bad phase, which it could hold otherwise. This led to shrinkage in the activities of the bank during a turbulent time plummeting the economy into further perils. The Crisis reflected badly on the innovations of Basel II. The heart of the Crisis was default on mortgagees. This did not sit well with Basel II's reliance on external rating agencies, use of internal risk assessments and lower capital requirements for residential mortgages.[28] These external agencies failed to capture or assess accurately the risks related to innovative financial products. The Crisis highlighted excessive leverage and inadequate liquidity buffers of the banks. Further, banks had subpar governance and risk management practices.

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[27] DANIEL K. TARULLO, BANKING ON BASEL: THE FUTURE OF INTERNATIONAL FINANCIAL REGULATION 207 (Peterson Institute, 2008).
[28] *Id.* 132.

The Crisis drew the attention of the regulators towards major inadequacy in how solvency was perceived and tackled by the Committee. Both, the Accords and Basel II approached the issue of solvency of an individual institution. This ignored the phenomenon that failure of one large institution can affect or cause the failure of one or more institutions that deal with the former, a phenomenon that was at play in the Crisis where within weeks of the collapse of Lehman Brothers the entire international banking community was at the brink of collapsing on itself.

Basel III was negotiated in the backdrop of the Crisis. In the aftermath of the crisis, the Committee published two documents to explain the financial reasons behind Crisis. On and off-balance sheet leverage, weak capital ratios, and insufficient liquidity contributed to the bank's inability to absorb systemic risk and credit losses during (and before) the Crisis.[29] At the cusp of the crisis, banks were forced to decrease their leverage, which led to decrease in the prices of assets leading to losses for banks, and a decrease in the capital and credit reserve of the banks. This was accentuated by the loss of confidence on banks' solvency by market participants which, when transmitted to the rest of the financial system, led to massive losses.

In 2010, the Committee published preliminary proposals for a new set of standards to effectively respond to the Crisis. Two years after the Crisis, the Committee published Basel III which aimed at strengthening capital requirements, liquidity and risk assessment. It focused on

[29] BCBS (2010a).

improving the quality, quantity and transparency of the regulatory capital base and, for the first time introduced macro-prudential elements in banking supervision to cub systemic risk.

Various shortcomings of Basel II were addressed by Basel III. The definition of capital was revamped to enhance transparency, consistency and quality. The risk coverage of Basel III was expanded to include securitization and off-balance sheet items. Basel III while acknowledging the various shortcomings of Basel II, in particular, the issue of inaccurate risk-weights, formulated new and more restrictive and demanding requirements (like un-weighted leverage constraint or higher capital charges for sovereign debt).[30]

Basel III is an extension of Basel II Framework. It introduced new capital and liquidity standards to strengthen the regulation, supervision, and risk management for the entire banking industry. It introduced two types of liquidity requirement – banks needed to ensure that they have sufficient liquid assets to meet their requirements in the short (one month) and the long term. The short-term requirement would be fulfilled by the banks by maintaining the LCR – liquidity coverage ratio for short – term; which requires that a bank's high-quality liquid asset should be at least equal to its cash outflows for the forthcoming 30 days. To fulfil long-term requirement under this standard, banks need to maintain NSFR or the Net Stable Funding Ration which requires banks to have access to stable

[30] Mike Mariathasan & Ouarda Merrouche, *The manipulation of basel risk-weights*, 3 JOURNAL OF FINANCIAL INTERMEDIATION 23, 300-321 (2014).

sources of funding in a long- term time-period. Further, it introduced buffers for capital conservation and countercyclical effects, and a leverage ratio. Basel III introduced further regulations for systemically important banks.[31]

II. TRANSNATIONALISM IN BANKING

The Committee is a self-enforcing institution, which promulgates minimum banking standards at an international level. It is an example of a transnational regulatory network (hereinafter '**TRN**')[32] that does not have any formal legal personality.[33] It does not possess supranational authority and its decisions do not carry any legal force.[34] It derives its authority from the membership of sovereign states and relies on its members commitments to achieve its mandate. [35] A transnational regulatory network like the Committee functions as an alternative mode of international governance that exists in consonance with formal sovereigns and markets.

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[31] These included requirements for supplementary capital, augmented contingent capital and strengthened arrangements for cross-border supervision and resolution.

[32] As opposed to formal treaty-based international organisations, transnational regulatory networks are informal multilateral forums that bring representatives from national regulatory agencies or departments to facilitate multilateral cooperation on issues of mutual interest within the authority of the participants. *See* Pierre-Hugues Verdier, *Transnational regulatory networks and their limits*, 113 YALE J. INT'L L, 113 (2009).

[33] CHARLES GOODHART, THE BASEL COMMITTEE ON BANKING SUPERVISION: A HISTORY OF THE EARLY YEARS 1974–1997 Chapter 14 (Cambridge University Press, 2011).

[34] The rules of the Committee is enforced via soft law mechanism. *See* Robert E. Scott & Paul B. Stephan, *Self-Enforcing International Agreements and the Limits of Coercion*, WIS. L. REV. (2004), 551.

[35] *Charter of the Committee,* BANK FOR INTERNATIONAL SETTLEMENTS, https://www.bis.org/bcbs.

The Committee is not an inter-state or an international organisation. Its status is not the same as WTO or the UN. It is not conceived by a treaty or an agreement and thus, in strict terms, has no place in international legal system.[36] It functions like a private, non-governmental corporation, with its shares owned by the central banks that make up its membership.[37] The participants of the Committee are central banks and/or supervisory or regulatory authorities. The Committee carries no coercive or legal force; rather, it secures compliance owing to its members' mandates.

Historical circumstances aside, international cooperation in financial, especially banking regulations is critical because absence of such a regulatory framework would lead to a race to the bottom, implying that large banks capable of shifting their operations across border would simply begin operating from the jurisdiction with the least stringent set of regulations.

The creation of the Committee resulted in the dawn of the international financial regulatory system of the modern world. IFR relies on soft law mechanism perpetuated by informal networks. IFR differs from international trade regime as it does not rely on global coordination via treaties, agreements or formal organisations. IFR is often implemented

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[36] ANNE-MARIE SLAUGHTER, A NEW WORLD ORDER 38 (Princeton University Press, 2009).

[37] Lawrence L. Herman, *The New Multilateralism: The Shift to Private Global Regulation*, COMMENTARY NO. 360, INSTITUTE C.D. HOWE INSTITUTE (2012); Samuel P Huntington, *Transnational organizations in world politics*, 25 WORLD POLITICS 3, 334-368 (1973).

through inter-agency institutions with ambiguous legal status.[38] A reason for this occurrence is that nations do not wish to surrender their autonomy on issues of money, taxes and security. Soft law incurs lesser *sovereignty costs* because nations are not curtailed in their ability of pursuing its own national prerogatives.[39] Cooperation through soft law is preferable to unilateral action in IFR as it facilitates cross-border supervision and assistance in enforcement, and harmonises regulatory requirements, objectives that are inconceivable by means of unilateral actions of a nation.[40]

Trans-governmental relations, or sets of direct interactions among units of different governments that are not strictly controlled by the stance of the top leadership of the government, has been a functional channel used for various purposes since as early as the 1950s.[41] Under the Bretton Woods system, the central banks were *de facto* in-charge of international monetary cooperation. During this time, coordination of macroeconomic policy was sacrificed, as central banks did not wish to compromise on monetary autonomy in lieu of global cooperation.[42] The creation of the Committee, as an order of trans-governmental-ism that involves the

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[38] Rolf H. Weber, *Overcoming the Hard Law/ Soft law Dichotomy in times of (financial) Crisis*, 1 JOURNAL OF GOVERNANCE 1, (2012).
[39] Kenneth Abbott & Duncan Snidal, *Hard and soft law in international governance*, 54 INTERNATIONAL ORGANIZATION, 421-456 (2000).
[40] Pierre-Hugues Verdier, *The political economy of international financial regulation*, 88, IND. LJ, 1405 (2013).
[41] Robert O. Keohane & Joseph S. Nye, *Transgovernmental relations and international organizations,* 27 WORLD POLITICS 1, 39-62 (1974) (examples of how sub-units of different governments come together to exert influence).
[42] CLAUDIO BORIO et al., THE PAST AND FUTURE OF CENTRAL BANK COOPERATION 4, 5 (Cambridge University Press, 2008).

creation of a technical problem-solving network, revised this passivity of central banks.[43]

The Committee's existence is regarded as an experiment in international governance, which created an architecture of cross border, or global rules without treaties, diplomats and state customs could be established.[44] It has been hailed as the poster-child of how a new world where national officials cooperate to agree on common standards to solve a collective action problem via cooperation should ideally work.[45] The Committee is an example of a horizontal informal regulatory network, which exists as links between counterpart national officials across nations.[46] The main features of such a body include: firstly, autonomous status of the organisation, i.e. these organisations are not a part or have not been incorporated into any international organisation, secondly, they are not regulated by treaties, and thirdly, they exist for different reasons which may vary from information sharing to standard-setting. The Committee has styled itself as a transnational regulatory networks and prefers to work with minimum physical or legal infrastructure and a short set of objectives and bylaws.[47]

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[43] Andrew Baker, *Deliberative Equality and the Transgovernmental Politics of the Global Financial Architecture*, 15 GLOBAL GOVERNANCE, 195 (2009).
[44] David Zaring, *Legal obligation in international law and international finance,* 48 CORNELL INT'L LJ, 175 (2015).
[45] Philip Alston, *Remarks on Professor BS Chimni's A Just World Under Law: A View From the South,* 22 AM. U. INT'L L. REV., 221 (2006).
[46] ANNE-MARIE SLAUGHTER, A NEW WORLD ORDER 13 (Princeton University Press, 2009).
[47] *Id.* 48.

Patent advantages of TRNs are that it allows domestic officials to keep pace with developments in globalisation and establish relationships among the participants creating incentives for goodwill. TRNs aid fostering cooperation in creating regulatory regime through persuasion, information exchange and sharing, development of, arguably, best practices and deeper socialisation processes that cultivate trust, mutual accountability, relationships and reputational concerns vis-a-via norms of the network. It provides a platform to respond effectively and flexibly to the growing market demands and technological changes. TRNs solve the globalisation paradox, i.e., the inability of national governments to solve collective problems created by globalisation and the infeasibility of a world government by expanding global governance without creating a centralised policy making power.[48]

IFR is dominated by TRNs and soft law mechanism because the latter provides incentives for compliance while ensuring timely-action, flexibility and engagements of experts.[49] Other merits, generally, include lower cost of contracting[50] and provision of efficiency. Hard or codified international law may not be negotiated as quickly owing to multiple rounds of negotiation between heads of states, their representatives and

[48] We need more governmental intervention at a global scale but the concept of a world government is infeasible and undesirable. Even though such a government might be needed, a world government would threaten individual liberty and nations' sovereignty; *See* ANNE-MARIE SLAUGHTER, A NEW WORLD ORDER 8 (Princeton University Press, 2009).

[49] CHRIS BRUMMER, SOFT LAW AND THE GLOBAL FINANCIAL SYSTEM: RULEMAKING IN THE 21ST CENTURY 63-67 (Cambridge University Press, 2015).

[50] Chris Bummer, *Why Soft Law Dominates International Finance-not Trade*, 13(3) JOURNAL OF INTERNATIONAL ECONOMIC LAW (2010).

domestic legislatures. On the contrary, soft law mechanism provides a cheaper way for states to reach an agreement due to low bargaining costs due to its informal nature. It allows nations to not be strictly bound by the policies that have been decided at an international level. Nations have a cheap way out and the ability to cherry-pick or softly defect from its commitments.[51] TRNs, usually, work alongside the international organisations and in theory, the primary political authority still resides at the national level since the TRNs only perform the tasks that are explicitly delegated.[52]

The negotiations and the implementation of the standards also reflect the darker side of TRNs. The explicit and implicit participation at TRNs do not necessarily pursue the objective of optimal global public policy and are often governed by domestic constrains. Further, IFR may lead to distributional issues[53] when diverging interests exist[54] and adoption of a system that incentivises one-size-fits-all model of regulation may create several problems without improving the robustness of the financial system.

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[51] Kenneth W Abbott & Duncan Snidal, *Hard and soft law in international governance,* 54 INTERNATIONAL ORGANIZATION 421-456 (2000).
[52] ANNE-MARIE SLAUGHTER, A NEW WORLD ORDER 7 (Princeton University Press, 2009).
[53] In the instant case, the distributive problem refers to a situation where the Committee pursues the interest of certain member states at the cost of others.
[54] For example, the first set of standards promulgated by the Committee was, partly and allegedly, a product of coercive pressure by US and UK regulators.
See Pierre-Hugues Verdier, *Transnational regulatory networks and their limits*, 34 YALE J. INT'L L., 113 (2009).

D. The Committee: Implication of Compliance

After the Crisis in 2008, G20 world leaders urged major standard-setting bodies to expand their membership to include emerging economies.[55] To regulate effectively in the global economy, clubs like the Committee had a choice of expanding or ultimately expiring. The Committee, which was an exclusive club from 1974, expanded its membership in 2009,[56] and 2014,[57] to include emerging market economies. Expansion of membership was intended to aid in enhancing the Committee's ability to carry out its core mission of strengthening regulatory practices and standards worldwide. Even though emerging economies are members of the Committee, their level of engagement not been quite at the levels of the group of developed nations that had been a

[55] G20 DECLARATION, http://www.g20.utoronto.ca/2008/2008declaration1115.html#reform.

[56] The Committee announced expansion of membership and welcomed new members (Australia, Brazil, China. India, Korea, Mexico and Brazil) on March 13, 2009. (Press release accessed at https://www.bis.org/press/p090313.htm). Via another press release in 2009 (https://www.bis.org/press/p090610.htm), Basel expanded its membership to Argentina, Indonesia, Saudi Arabia, South Africa, Turkey, Hong Kong SAR and Singapore.

[57] The Committee’s membership, at present, consists of 28 jurisdictions and 45 institutions. It includes Argentina, Australia, Belgium, Brazil, Canada, China, European Union, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Netherlands, Mexico, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, UK and the USA. Observers include Chile, Malaysia, and UAE.

member of the Committee since its birth[58] owing to institutional capacity, incentives to influence at a global level and regulatory expertise.[59]

Even though the engagement levels may not be as high, developing nations are encouraged and provided incentives to adhere to best practices in the domain of IFR. IFR is dominated by TRNs and soft law mechanism because the latter provides incentives for compliance while ensuring timely-action, flexibility and engagements of experts.[60] Although in theory, IFR is manifested via soft law mechanisms, the ground reality suggests that international financial law might be harder, if not as hard as traditional public international law. The reasons for this can be attributed to reputational concerns and institutional sanctions. Compliance with best practices or standards positively portrays an institution and allows it access to markets and capital.[61] In today's era of globalisation, it is practically impossible for a nation to not adhere to international standards lest they be shunned by global markets.[62]

The Committee carries no coercive or legal force; rather, it secures compliance owing to its members' mandates and other reasons attributed

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58 Andrew Walter, *Emerging Countries and Basel III: Why is Actor Mobilization so Low?*, UNIVERSITY OF MELBOURNE (2014), https://government.unimelb.edu.au/__data/assets/pdf_file/0007/2654431/Emerging_markets_and_Basel_III_Andrew_Walter.pdf.

59 Emily Jones & Peter Knaack, *Global Financial Regulation: Shortcomings and Reform Options*, 10 GLOBAL POLICY, 193-206 (2019).

60 CHRIS BRUMMER, SOFT LAW AND THE GLOBAL FINANCIAL SYSTEM: RULEMAKING IN THE 21ST CENTURY 63 - 67 (2 ed., Cambridge University Press 2015).

61 Chris Brummer, *Why soft law dominates international finance—and not trade,* 13 JOURNAL OF INTERNATIONAL ECONOMIC LAW 623–643 (2010).

62 DUVVURI SUBBARAO, WHO MOVED MY INTEREST RATE: LEADING THE RESERVE BANK OF INDIA THROUGH FIVE TURBULENT YEARS 289 (Penguin London 2017).

to reputational concerns, international competitiveness, peer pressure and being in the good books of institutions like the International Monetary Fund among others. Many nations adopt these standards owing to the motivation of following world's important economies, or the fear of being viewed as a signal of risk[63] or of the isolation by the international community.[64]

Albeit not being a part of the negotiating table, RBI had adopted the Accords in 1992 and the second set of substantive standards by the Committee in 2007. India is largely compliant with the standards and regulations prescribed by the Committee. In certain respects, Indian regulations are stricter than the regime created by the Committee.[65]

Such compliance comes with a multitude of ramifications. For example, the Basel capital adequacy requirement may be too high for firms in emerging economies that do not have a sufficiently developed capital market. In such scenarios, banks may either end up reducing their lending activities to reduce risk to increase costs to the consumers. Further, the priorities of emerging economies are different from those of developed nations. Emerging economies may prioritizes financial

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[63] N.S. Vishwanathan, *Basel III Implementation - Challenges for Indian Banking System*, presented at the NATIONAL CONFERENCE ON BASEL III IMPLEMENTATION, Mumbai, (2015), http://www.bis.org/review/r150917a.pdf.
Aurelio Gurrea-Martínez & Nydia Remolina. *The Dark Side of Implementing Basel Capital Requirements: Theory, Evidence, and Policy*, 22 JOURNAL OF INTERNATIONAL ECONOMIC LAW 125-152 (2019).

[64] Chris Brummer, *Why soft law dominates international finance—and not trade,* 13 JOURNAL OF INTERNATIONAL ECONOMIC LAW 623–643 (2010).

[65] Regulatory Consistency Assessment Programme (RCAP), *Assessment of Basel large exposures regulations – India* (July 2019), BANK OF INTERNATIONAL SETTLEMENTS, https://www.bis.org/bcbs/publ/d474.pdf.

inclusion through their financial regulation as opposed to investor protection, the prevention of financial crime, and the promotion of competition, market efficiency, and financial stability.[66] An unintended consequence of adopting the newer Basel standards developed after the Crisis is increased cost of maintain higher capital requirement leading to disincentive to investment in the market. This is especially true for markets that have higher risk profiles than developed markets.[67] Thus, even though India has attempted to comply with the standards set by the Committee, it is time that emerging nations like India not just get a seat at the negotiating table but also have adequate incentive to participate in the negotiating process. Indian banking sector has different demands than that of other nations.

Basel III aims at strengthening the financial sector. It imposes additional disclosure requirements, and prescribed leverage ratios, capital requirements ratios and liquidity ratios. Complying with these standards mandates banks to have higher capital reserve. This means that the banks have a lesser capacity to invest. Owing to this reduced capacity, banks tend to invest in sectors that are highly profitable which does not necessarily further the social and welfare needs of the society. In developing nations, like India, where essential industries are

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[66] Aurelio Gurrea-Martínez & Nydia Remolina, *The Dark Side of Implementing Basel Capital Requirements: Theory, Evidence, and Policy*, 22 JOURNAL OF INTERNATIONAL ECONOMIC LAW 125-152 (2019).

[67] Alberto Burchi & Duccio Martelli, *Possible Unintended Consequences of Basel III on Emerging Markets and Developing Economies: Assessment of Stressed VaR and Effects on Banks' Investment Decisions*, RISK MANAGEMENT IN EMERGING MARKETS 645-682 (2017).

underdeveloped, complying with a regulatory regime which does not prioritises investment in such industries is counter-intuitive.[68] Additionally, although compliance of Basel Standards signals positively to foreign investors, the cost of compliance with these standards, reportedly, are quite high. International financial regime and regulations need to take into account the national circumstances to be able to prescribe a truly global set of regulations.

[68] Earlier in the introduction, we witnessed how an essential industry, which would curb pollution due to agricultural waste disposal, could not secure funding owing to high standards.

EMERGING TRENDS OF INSIDER TRADING: A LAW AND ECONOMICS INTERPLAY

- Insaf Ahamad T.K. and Mathangi K.*

ABSTRACT

The legalisation for the practice of insider trading has always remained a bone of contention. But with the USA setting standards and the rest of the world ensuing it, a justified trend has been set- insider trading cannot be legal. With the advent of an era of internationalisation of securities market, the rush to regulate insider trading is witnessed as a worldwide phenomenon. India also followed trails by enacting the Securities and Exchange Board of India (SEBI) Regulations, 2015 and the SEBI (Amendment) Regulations, 2018. However, while the law holds great potential, what appears to be void is the enforcement mechanism. The law and economics analysis of the system corroborates the failure of the system in place of curbing insider trading. The enforcement mechanism in India acts as an infamous example for a system that has failed due to the interplay of various contributing factors. For India to truly deal with the problem of insider trading, what it needs, is an effective enforcement mechanism. It is high time that the law-makers of the country realise that change comes not only with the enactment of stringent laws, but also with the enforcement of the same.

I. INTRODUCTION

"Every Degree of Business has its Invitation to do Evil: 1. Necessity tempts the poor man. 2. Avarice tempts the rich" observed English writer Daniel Defoe in the eighteenth century.[1]

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Media reports on professional misconduct like insider trading, tax fraud, embezzlement etc. have become a common phenomenon these days.[2] Historically these types of acts were not considered as a part of criminal milieu. However, the assessment of crimes committed by "business and professional men" began to change as sociologist Edwin Sutherland coined the term "White collar crimes "in 1939.[3] It is very important to regulate them as they cause enormous economic damage mostly at the expense of the poorer sections of society.

The act of trading of securities of a company by an insider on the basis of unpublished price sensitive information (UPSI) is known as insider trading. An insider is any person who, is or was connected with the company or is deemed to have been connected with the company, and who is reasonably expected to have access, by virtue of such connection, to unpublished price sensitive information in respect of securities of the company, or who has received or has had access to such unpublished price sensitive information.[4]

Any information related to any state of the company (past, present or probable future) that has not been made public and has the potential to

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[1] Hartmut Berghoff & Uwe Spiekermann, *Shady business: On the history of white-collar crime*, 60(3) BUSINESS HISTORY 289–304 (2018).

[2] *One-third of Indian businesses hit hard by internal, external fraud*, ECONOMIC TIMES, Oct. 1 2019, https://economictimes.indiatimes.com/news/company/corporate-trends/one-third-of-indian-businesses-hit-hard-by-internal-external-fraud report/articleshow/71393811.cms.

[3] Edwin H. Sutherland, *White-Collar Criminality*, 5 AMERICAN SOCIOLOGICAL REVIEW 1 (1940).

[4] Securities and Exchange Board of India Act, 1992, No. 15 of 1992, Acts of Parliament, 1992 (India), § 2(e).

influence the value of securities of a company in the market is an 'unpublished price sensitive information'. Access to such unpublished material information will help the insider himself or any other person to whom the information is made available to trade in securities of the company for their own benefit, thus putting those who do not possess such information at a disadvantage.

Despite this, there has always been a divisive opinion regarding the regulation of insider trading itself. While many economists contend that insider trading, in fact boosts the efficiency of the security market[5], others argue the various economic and moral reasons that justify the prosecution of insider trading.[6]

The legalization debate is as old as insider trader trading regulations. Legal scholars and economists like Milton Friedman, Henry Manne, Daniel Fischer, Thomas Sowell, and Frank H. Easterbrook have been proponents of legalization of insider trading.[7] Nobel Prize winning economist Milton Friedman said, "You want more insider trading, not less. You want to give the people most likely to have knowledge about deficiencies of the company an incentive to make the public aware of that".[8]

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[5]Hsiu Kwang Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934*, 68 COLUMBIA LAW REVIEW 260 (1968).
[6] Ronald Gilson & Reiner Kraakman, *The Mechanisms of Market Efficiency*, 70 VIRGINIA LAW REVIEW 549–629 (1984).
[7]Anthony Randazzo, *Legalize Insider Trading?*, REASON FOUNDATION (Jul 25, 2019), https://reason.org/commentary/7256.
[8]*Id.*

The difficulty in differentiating insider information and proprietary research is a main argument for legalization of insider trading. Trading on the basis of data or information of sales of a particular company collected by conducting market research through survey, analysis etc. is allowed, but the same becomes illegal when done on the basis of same or similar information received from an insider. The question here is that if the data is the same, should the methodology by which it is collected make a difference.[9] Also, when insider trading has no identified specific victims, then the basis upon which it is termed as a crime is questionable.

However, these claims have been criticized as a level playing field and is fundamental to capital markets. Insider trading is a faceless crime but not a victimless crime. Further, corporate insiders will have the opportunity to make substantial gains by hiding the information from the public and their board of directors by maximizing their personal trade profits.[10] On the basis of this rationale, the US was the first country to prohibit insider trading which was then followed by a multitude of countries.

The enforcement of insider trading laws has been a challenge globally. While countries like U.S and U.K have very stringent laws, the same is not the case with all countries. [11] The existence and enforcement

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[9] *It's time to legalize insider trading: Roth CNBC (2014)*, CNBC, (Jul 20, 2019), https://www.cnbc.com/2014/06/17/its-time-to-legalize-insider-tradingwall-streetcommentary.html.
[10] George Dent, *Why Legalized Insider Trading Would Be a Disaster*, 38 DELAWARE JOURNAL OF CORPORATE LAW 247 (2013), https://ssrn.com/abstract=2313456.
[11] Kirthana Singh, *Insider Trading: Legal Position in India vis-à-visthe UK and the US*, 4 THE WORLD JOURNAL ON JURISTIC POLITY 25 (2018).

of insider trading laws in stock markets is a phenomenon of the 1990s. A study of the 103 countries that have stock markets reveals that insider trading laws exist in 87 of them, but enforcement-as evidenced by prosecutions-has taken place in only 38 of them.[12]

In India, insider trading is governed by the Securities and Exchange Board of India regulations which overlook the trading activities in the Bombay Stock Exchange and National stock exchange. There has been little and shoddy enforcement in India due to inadequacies in investigation and low level of penalties. This failure has been attributed to numerous reasons like lack of human resources for investigation or basic investigation tools.[13]

II. THE RUSH TO REGULATE INSIDER TRADING

The insider trading laws in India, especially after the 2018 amendment which has brought in stricter punishments including longer terms of imprisonment and higher rates of fines that are applicable, has become one of the strictest in the world,[14] at least on record. Since the inception of the securities market and the setting up of SEBI, India has strongly asserted the need for regulation of insider trading. It has since the beginning followed the guidelines and principles of the International

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[12] Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57(1) THE JOURNAL OF FINANCE 75–108 (2000), https://ssrn.com/abstract=249708.
[13] DEVESH KAPUR & MADHAV KHOSLA, REGULATION IN INDIA: DESIGN, CAPACITY, PERFORMANCE 115 (Bloomsbury Publishing 2019).
[14] Singh, *supra* note 11.

Organisation for Securities Commission (IOSCO)[15] and the US[16] which have been the pioneers in the regulation of insider trading.

But, given the long-standing inefficiency in the enforcement of existing laws and the not so rare incidents of huge insider trading cases, the sudden rush to regulate [Prohibition of Insider Trading Regulations, 2015 and the subsequent Amendment Regulations, 2018] is quite striking. Upon analysis of the trends, there appear to be three important elements that seem to have motivated this sudden rush to regulate:[17]

A. Global Competition Regulation in India: Design, Capacity, Performance

1. Global Competition

The globalisation of the world's securities market is considered as one of the most astonishing growth of cross-border transactions.[18] Recent years, have especially witnessed a more dramatic globalisation of the securities markets as investors worldwide seek a wider range of portfolio

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[15] *Objectives and Principles of Securities Regulation*, INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, (May 2003), https://www.iosco.org/about/?subsection=display_committee&cmtid=19&subSection1=principles.

[16] Harvey Pitt & David Hardison, *Games without Frontiers: Trends in the International Response to Insider Trading*, 55 LAW AND CONTEMPORARY PROBLEMS 199–229 (1992).

[17] *Id.*

[18] James Thompson, *A Global Comparison of Insider Trading Regulations*, 3(1) INTERNATIONAL JOURNAL OF ACCOUNTING AND FINANCIAL REPORTING 1 (2013).

investments and corporates and businesses are in search for new sources of finance across and beyond their national borders.[19]

Foreign Portfolio Investments (or) Foreign Institutional Investments have been one of the biggest driving forces in the Indian securities markets where, India attracted an investment of USD 171.81 trillion between FY 12-18.[20] Though India has been one of the most attractive destinations for foreign investors, 2018 appeared to be the darkest year for India as foreign investors pulled out a record Rs. 81,912 crores from the Indian equity and debt market .[21] While the same has been due to global trends and policies like a hike in the US Federal Reserve rates, rising crude oil prices, etc., it nevertheless increases the pressure on India to make its markets more secure and profitable by bringing in transparency and stricter regulation.

Though these pressures may not be fundamentally different in character from that of domestic pressures that have led India to prohibit insider trading,[22] in the International patois, insider trading is more often condemned to be inconsistent with the move towards transparent markets,

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[19] David Michaels, *Subject Matter Jurisdiction over Transnational Securities Fraud: A Suggested Roadmap to the New Standard of Reasonableness*, 71(4) CORNELL LAW REVIEW 919 (1986), https://scholarship.law.cornell.edu/clr/vol71/iss4/6.
[20] Brand India, *Foreign Institutional Investors*, IBEF (Jul 21, 2019) https://www.ibef.org/economy/foreign-institutional-investors.aspx).
[21] *2018 in review: Why foreign investors gave India a miss this year,* BUSINESS TODAY, (Jul. 21, 2019), https://www.businesstoday.in/markets/stocks/foreign-investors-india-a-miss-sensex-nifty-rupee-ltcg-tax/story/303823.html
[22] Joseph Blum, *The Regulation of Insider Trading in Germany: Who's Afraid of Self-Restraint*, 7 NORTH-WESTERN JOURNAL OF INTERNATIONAL LAW & BUSINESS 507–531 (1986).

and markets with well laid down standards and procedures, that are easily comprehensible to foreign investors.[23] Also, countries that appear lackadaisical in taking steps to prohibit insider trading are often criticised harshly by international bodies as well as other countries with competing securities market

For instance, within the European Economic Community itself, it is highly predicted that a handful of financial centres with established regulations and enforcement will soon be dominating the European markets.[24] The criticism and backlash extend to major economies as well, where, the British Press pounced upon the report finding insider trading in Germany.[25]This, as a result, led to German bankers voicing their support for additional insider trading regulations and a much stricter enforcement of the same.[26]

In such a frenzy international scenario, it becomes imperative for India to improve and strengthen its insider trading regulations and make the implementation stricter as well. Therefore, in anticipation of a positive response, India made changes by setting up two committees for the same purpose- N.K. Sodhi committee which recommended the Prohibition of

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[23] *Europeans Are Steering for Market Reform: Push Is toward Stiffer, Uniform Disclosure Laws*, LOS ANGELES TIMES, August 17, 1988, https://www.latimes.com/archives/la-xpm-1988-08-17-fi-629-story.html.

[24] Stephen Greenhouse, *An Old Club Transformed*, THE NEW YORK TIMES, July 23, 1991, at 6.

[25] Katherine Campbell, *Spotlight Falls on German Trading Practices*, FINLAND TIMES, July 3, 1991.

[26] Harvey Pitt & David Hardison, *Games without Frontiers: Trends in the International Response to Insider Trading*, 55 LAW AND CONTEMPORARY PROBLEMS 202 (1992).

Insider Trading Regulations, 2015 and the T.K. Vishwanathan committee that recommended the amendments to the regulations in 2018.

2. International Regulation and Enforcement

Globalisation not only facilitates foreign investments, but also provides unintended opportunities for insider trading, market manipulations, etc. Insider trading more often than not crosses boundaries of a nation where a foreign national engages in insider trading in the national market. The successful investigations and prosecutions of these trans-national cases thus require international cooperation among countries and their regulatory bodies.

In view of the same, mandating members to cooperate with each other for the purposes of carrying out their duties according to EC Directive has been one of the most laudatory aspects of the EC Directive.[27] In fact, India is also a signatory of the IOSCO Memorandum of Understanding, the first worldwide multilateral enforcement cooperation arrangement among securities and derivatives regulators.[28] This requires SEBI to cooperate with other signatories and aid their national cases. India, being a major financial market in the world, thus

[27] Directive 2003/6/EC, of the European Parliament and OF THE COUNCIL of 28 January 2003 on insider dealing and market manipulation (market abuse), (2003), https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:096:0016:0025:EN:PDF.

[28] The Board of the International Organization of Securities Commissions, *IOSCO Standards Implementation Monitoring (ISIM) on Secondary and Other Market Principles*, INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS (Jul 26, 2019), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD623.pdf.

requires the aid of other countries for successful prosecution and investigation of its own insider trading cases that may be trans-national and is also required to return the favour.

3. Development of Technology

Across the globe, technological progress has brought various developments-one of them being a paradigm shift in stock market operations.[29] The stock exchanges across the globe have realised the potential of information technology and have upgraded to electronic trading systems, which have a much wider reach as well as better mechanism for pre-trade, trade and post-trade transactions.

At the same time, conventional wisdom holds that with advancement in technology, along with multiple listing of securities, scope for twenty-four-hour trading, it not only brings the desired advantages, but also other undesired effects such as vast increase in the opportunities for insider trading, market manipulation etc. Unfortunately, today, this holds true since the surveillance mechanisms lag far behind the technological developments in the stock exchanges.[30]

India is far behind other countries in the use of advanced technology in its surveillance mechanisms. SEBI lacks the much-needed powers like the power to wiretap phone calls, which has been denied time and again despite several recommendations by high level committees and

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[29] *Our Trading Technology*, NATIONAL STOCK EXCHANGE OF INDIA LTD. (Jul 21, 2019), https://www.nseindia.com/global/content/about_us/trading_technology.htm.

[30] Craig Forman, *Old World Traditions Include Insider Trading*, THE WALL STREET JOURNAL, February 8, 1989.

panels.[31] Even the power to call for phone records was given to SEBI only in 2013 after the Rs.10 billion Sharada scam.[32] In such a scenario of towering technological advancement in stock markets and exchanges, without substantial increase in that of surveillance, it becomes imperative for India to bring in stricter regulations through other means, thus bringing in the need for the 2015 regulations and the 2018 amendment.

III. EMERGING TRENDS AND RECENT LEGAL DEVELOPMENTS: AN ANALYSIS

While the Securities and Exchange Board of India (Prohibition of Insider Trading) Act came in 2015 with various new concepts such as trading plans, unlisted companies etc., this paper focuses on the most recent legal development- The Securities and Exchange Board of India (Prohibition on Insider Trading) (Amendment) Regulations, 2018.

Securities and Exchange Board of India (Prohibition of Insider Trading) (Amendment) Regulations, 2018 came after a 116-page report was submitted by the fair market committee headed by T.K.

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[31] SEBI, *Report of committee on fair market conduct under the chairmanship of Dr. T. K. Viswanathan* (2018), GOVERNMENT OF INDIA, https://www.sebi.gov.in/reports/reports/aug-2018/report-of-committee-on-fair-market-conduct-for-public-comments_39884.html.

[32] ET Bureau, *Amendment to SEBI Act will give more power to watchdog related to Ponzi schemes*, THE ECONOMIC TIMES (Jul 21, 2019), https://economictimes.indiatimes.com/news/economy/policy/amendment-to-sebi-act-will-give-more-power-to-watchdog-related-to-ponzi-schemes/articleshow/39785617.cms?from=mdr () (2014).

Viswanathan.[33] This amendment is a much needed one for various stakeholders in the stock market. [34]

To start with, the new amendment has given clear and well laid down definitions that were missing in its previous regulations. The term "legitimate purposes" was not defined under any previous acts, and was open to various interpretations. The issue came to light when Cyrus Mistry alleged Ratan Tata to have sought confidential information including UPSI from the company.[35] SEBI, taking cognizance of the same, established that sharing UPSI with the Chairman of the company fell under the ambit of legitimate purposes.[36] This incident led to the need for defining the term legitimate purposes, which was addressed by the Committee and later included in the Amendment Act, 2018.[37]

The Amendment act requires the Board of Directors of the company to determine what constitutes "legitimate purpose" as a part of its "Code of Fair Disclosure and Conduct".[38] The act also moves a step

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[33] *Id.*
[34] Sara Jain & Swapnil Singh, *The 2018 Insider Trading Amendment: A Step in The Right Direction?,* INDIA LAW JOURNAL https://www.indialawjournal.org/the-2018-insider-trading-amendment.php (last visited Jul 25, 2019).
[35] Mobis Philipose, *Did Tata Sons violate insider trading norms?*, LIVEMINT, (Jul 21, 2019), https://www.livemint.com/Opinion/KHA3k8guR1GIAjAXCJYFhI/Did-Tata-Sons-violate-insider-trading-norms.html.
[36] Moneycontrol.com, *SEBI observation on insider trading puts Ratan Tata in the clear,* MONEYCONTROL (Jul 21, 2019), https://www.moneycontrol.com/news/business/companies/sebi-observationinsider-trading-puts-ratan-tatathe-clear-943636.html.
[37] Regulation 3(2A), SEBI (Prohibition of Insider Trading), Regulations, Gazette of India, pt. III sec. 4, 2015.
[38] "Codes of Fair Disclosure and Conduct" formulated under regulation 8, SEBI (Prohibition of Insider Trading) Regulations, Gazette of India, pt. III sec. 4, 2015.

forward and provides an illustrative list of all that could constitute as legitimate purposes in the explanation.[39] Despite the above definition being laid down, there still exist an ambiguity in the legal implementation and enforceability of the same since it is unclear whether the illustrative list acts merely as an example or mandates a bare minimum circumstance which ought to be included in the ambit of the definition.

Unlisted companies came under the purview of insider trading regulations only after the 2015 Regulations. Until then, the regulations laid down were applicable only for the listed companies in India. Even after the introduction of the concept of "proposed to be listed companies" in the 2015 Regulations, there was widespread ambiguity and confusion as to the stage at which a company would be recognised as one. Absence of clarity led to the term being open to various interpretations such as Board's approval of an IPO or red herring prospectus with SEBI or any other event. Thus, the insertion of the definition of the same in the 2018 Amendment is seen as a laudatory recommendation by the Committee. The Amendment clearly lays down that a company would be "proposed to be listed" if the company has filed the relevant documents for listing to the relevant authorities[40] or due to an amalgamation or a merger and has filed a scheme for the same under the Companies Act, 2013.[41]

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[39] Philipose, *supra* note 35.
[40] Regulation 3, SEBI (Prohibition of Insider Trading) Regulations, Gazette of India, pt. III sec. 4, 2015.
[41] Regulation 2(ha), SEBI (Prohibition of Insider Trading) Regulations, Gazette of India, pt. III sec. 4, 2015.

While the above two definitions have come as the much needed ones, the 2018 Regulation has also inserted certain other definitions such as "financially literate" [42] and has also amended the definition of the term UPSI to remove the clause "material events in accordance to the listing agreement" since it may or may not include price sensitive information as per Regulation 30[43] of the SEBI listing regulations.

Secondly, the Amendment also brings in the concept of institutional framework for the first time in India, in which front India has been lagging behind the other countries for quite some time now. The new regulation, for the first time has taken into consideration the recommendation of a decade and a half old World Bank report (2004) on Indian capital markets where it strongly recommended an institutional framework in India.[44] The responsibility for establishing and maintaining internal controls has been laid on the CEO, MD or such other analogous person of a company to ensure that the basic requirements to prevent insider trading are complied with.[45] To add to this, the Audit Committee of the company is now required to review and assess if the internal controls are effective and adequate and monitor the compliance of the company

[42] Regulation 2(1)(c), SEBI (Prohibition of Insider Trading) Regulations, Gazette of India, pt. III sec. 4, 2015.
[43] Regulation 30, SEBI (Prohibition of Insider Trading) Regulations, Gazette of India, pt. III sec. 4, 2015.
[44] Report on the observance of standards and codes (ROSC), Corporate Governance Country Assessment, INDIA, April 2004, http://documents1.worldbank.org/curated/en/790421468033284999/pdf/350840IN0REV0Corporate0rosc1cg.pdf.
[45] Regulation 9A(1),SEBI (Prohibition of Insider Trading) Regulations, Gazette of India, pt. III sec. 4, 2015.

with the regulations.[46] Along the same lines, the Amendment also requires the Board of Directors to maintain a digital database of all those in possession of the UPSI and subsequent flow of the same within the organisation.[47] The inclusion of the Amendment is seen as a move that propels India towards achieving an at par status with the regulations of other countries.

In the recent times, the Indian stock market has witnessed a series of cases involving leaks of UPSI.[48] Leaking of UPSI has become quite a common phenomenon due to the loose reins of SEBI on the same. With a view to eliminate such incidents in the future, individuals and entities circulating unpublished price sensitive information (UPSI) of listed firms over social media platforms have come under the regulator's glare.[49] The Amendment mandates every listed company to formulate written policies and procedures for inquiry in case of leak or even suspected leak of UPSI.[50] It is high time that such provisions came into place since cases of leaking UPSI have lately emerged even in top companies like HDFC and leaking UPSI seems to have missed scrutiny by SEBI's sight to such a great extent that they are being circulated on WhatsApp chats and groups.

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[46] Regulation 9A(2) & (3), SEBI (Prohibition of Insider Trading) Regulations, Gazette of India, pt. III sec. 4, 2015.
[47] *Id.*
[48] Shrimi Choudhary, *SEBI moves to curb sensitive information leak, seeks trading details Business Standard (2019)*, BUSINESS STANDARD (Jul 21, 2019), https://www.business-standard.com/article/markets/sebi-moves-to-curb-sensitive-information-leak-seeks-trading-details-119061801398_1.html.
[49] *Id.*
[50] SEBI (Prohibition of Insider Trading) Regulations, Gazette of India, pt. III sec. 4, 2015, Regulation 9A(5).

Investigations by SEBI into the National Stock Exchange (NSE), Sun Pharmaceutical Industries Ltd, ICICI Bank Ltd and Infosys have one thing in common- all of them have been based on whistle-blower complaints.[51] This led to SEBI's introduction of the concept of the whistle blower policy into regulations. All entities are now required to create whistle blower policies for any employee who comes forth to share information of a leak in UPSI.[52]

Along the same lines of the whistle blower policy, the SEBI recently floated a discussion paper describing the informant mechanism that has been devised. SEBI has laid down that in case information by the informant lead to a disgorgement of at least Rs.5 Crore, a reward of 10% shall be given.[53]

India is known to have one of the strictest laws in the world since it follows the classical theory where the onus to prove that an insider in possession of the UPSI did not trade based on that UPSI lies on the insider. Due to the presumption of guilt of the insider, the Amendment thus sought to dilute the scope of applicability of insider trading in order to prevent the chance of prosecution of an innocent person by inserting

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[51] Jayshree Upadhayay, *SEBI seeks to address frivolous insider trading complaints,* LIVE MINT (Jul 25, 2019), https://www.livemint.com/market/stock-market-news/sebi-seeks-to-address-frivolous-insider-trading-complaints-1560224586571.html.

[52] Regulation 9A(6), SEBI (Prohibition of Insider Trading) Regulations, Gazette of India, pt. III sec. 4, 2015.

[53] Jash Kriplani, *SEBI suggests Rs 1 crore for whistle-blowers who expose insider trading,* BUSINESS STANDARD (2019), https://www.business-standard.com/article/markets/sebi-suggests-rs-1-crore-for-whistle-blowers-who-expose-insider-trading-119061001325_1.html. (last visited Jul. 21, 2019).

certain necessary defences[54] including Off-market inter-se transactions between insiders, transactions through the block deal window mechanism, statutory or regulatory obligation to carry out a bona fide transaction like achieving Minimum Public Shareholding Requirements as per the exercise of stock options in respect of which the exercise price was predetermined in compliance with SEBI (Share Based Employee Benefits) Regulations, 2014.

Despite the plethora of Amendments brought in by the regulation, the Committee recommendations as well as the provisions cannot be called perfect and flawless.[55]

Various recommendations of the committee have also gone under the logs since they find no place in the Amendment. The committee had recommended several powers such as powers to conduct searches and seizures, obtain call records, wiretap suspects, etc. to be granted to SEBI.[56] Nevertheless, these powers were not to be found in the Amendment. The denial of the power to wiretap phone calls to SEBI is not a recent phenomenon. SEBI has been continuously requesting the Government to allow it to wiretap with a view of improving the conviction rates, but time

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[54] SEBI (Prohibition of Insider Trading) Regulations, Gazette of India, pt. III sec. 4, 2015, Regulation 4(1).

[55] Sara Jain, *The 2018 Insider Trading Amendment: A Step in The Right Direction?*. INDIA LAW JOURNAL, https://www.indialawjournal.org/the-2018-insider-trading-amendment.php (last visited Jul 25, 2019).

[56] SEBI, *Report of committee on fair market conduct under the chairmanship of Dr. T. K. Viswanathan* (2018), GOVERNMENT OF INDIA, https://www.sebi.gov.in/reports/reports/aug-2018/report-of-committee-on-fair-market-conduct-for-public-comments_39884.html

and again has been denied so. The Government has always rejected such powers owing to the protection of privacy of its citizens. While the committee recognises and acknowledges the possibility of misuse of such powers[57], it has asserted that call interception would be a substantial improvement and a huge leap forward in the present scenario, for instance, the U.S. Securities and Exchange Commission unearthed crucial information and evidence by wiretapping the conversations between Raj Rajaratnam and Rajat Gupta, that ultimately resulted in their conviction. This tool is a long shot for SEBI, especially considering the fact that it took a USD 6 million scam – the Sharada scam[58] for the SEBI to be granted the basic power to call for phone records.

Also, SEBI has been granted the power to petition before a criminal court and institute criminal proceedings against the insider; for which the punishment includes imprisonment up to 10 years.[59] In spite of this, until today, no man has ever been sent to the prison for insider trading. The reason for this can be traced to the lack of powers in the hands of SEBI. White collar crimes usually require a solid strong string of evidence in order to be proven. Also, for criminal prosecution, it is required to be proved beyond reasonable doubt. And SEBI is in no position to submit such proofs since it has no access to the bare evidences

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[57] Keshav Malpani, *Amendments to SEBI's Regulations on Insider Trading Are they Sufficient?* INDIACORPLAW (2019), https://indiacorplaw.in/2019/03/amendments-sebis-regulations-insider-trading-sufficient.html. (last visited Jul 21, 2019).

[58] Umakanth Varottil, *Power of SEBI to Seek Call Data Records*, INDIACORPLAW (2017), https://indiacorplaw.in/2014/05/power-of-sebi-to-seek-call-data-records.html. (last visited Jul. 21, 2019).

[59] The Securities and Exchange Board of India Act, 1992 No.15, Acts of Parliament, 1992 (India), § 24.

and lacks the much-needed powers like that of intercepting phone calls. With no substantial evidence with SEBI, moving to a criminal prosecution is nothing but a wild goose chase.

In some ways, SEBI has been granted at par powers with the SEC and other enforcement agencies around the world; what is lacking is enforcement and implementation by SEBI authorities. While, it is obviously fair of SEBI to demand additional powers from the Government, it has failed to look into the existing powers that have been granted to it.[60] For instance, SEBI has been granted the power to impose a penalty of up to Rs. 25,00,00,000 or 3 times of profit made, whichever is higher.[61] But the maximum penalty that has till date been imposed by SEBI is a mere Rs.60,00,000. For instance, in the case of insider trading in the Sun Pharmaceuticals Ltd that affecting thousands of small retail investors, a settlement with SEBI was reached at a meagre Rs.70,00,000.[62] The leniency of SEBI, the sole regulatory authority increases and gives way to further insider trading. The failure of SEBI to impose higher penalties increases the lackadaisical behaviour of the company in maintaining strict confidentiality of UPSI.

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[60] Malpani, *supra* note 57.

[61] Securities and Exchange Board of India Act, 1992 No.15, Acts of Parliament, 1992 (India), § 15(H)A.

[62] ET Bureau, *Sun Pharma lab's senior exec, wife settle insider trading case with SEBI*, THE ECONOMIC TIMES (2019), https://economictimes.indiatimes.com/markets/stocks/news/sun-pharma-labs-senior-exec-wife-settle-insider-trading-case-with-sebi/articleshow/68842504.cms (last visited Jul 21, 2019).

While on one hand, SEBI lacks various powers that the regulatory bodies around the world possess, on the other hand, SEBI fails to use the powers already granted despite the autonomy and discretion it possesses. It appears to be an irony where SEBI has been constantly seeking for various powers that it does not possess, while fails to fully use the powers it has already been granted.

IV. LAW AND ECONOMICS: THE PRACTICAL CONUNDRUMS

The law and economics analysis of insider trading seeks to identify the behavioural tendencies of an insider in relation to the laws in place and their enforcement. While the legal analysis sought to reflect the need and the prospective effect it has on the society, the eco-legal analysis seeks to reflect the behaviour of an insider with respect to that of the regulations and enforcement.

The white-collar crime of insider trading can be ranked in accordance to its seriousness where x denotes the seriousness of the crime. Let y denote the insider's payoff from the trading. The seriousness of insider trading in this case depends on the value of trading that is done, where when y increases, then f(x) will also increase proportionately.

The punishment for insider trading can also be ranked by the severity of punishment where 's' denotes the severity of punishment. The severe the crime, the severe the punishment i.e. f increases with the increases in f(x). To punish the crime of insider trading, the fine or penalty collected must exceed the payoff of the criminal- f(x)>y. Accordingly, in India the severity of punishment does increase with the increase in the seriousness where the penalty for insider trading is three times the amount of profit earned by the insider. Thus, if every insider trading was punished with a fine that exceeded the payoff, then committing insider trading would not be efficient or result in a payoff to the criminal, deterring him/her from committing the crime i. Thus, the criminal would choose x=0.

But, in reality, punishment is probabilistic and not certain. Thus, the expected punishment not only depends on the severity of punishment but also on the probability of punishment (p) where the expected punishment is *pf*. For instance, an insider gets a profit of Rs.30,00,000 from trading in shares based on UPSI and the penalty is Rs.90,00,000(three times of the profit made) and the probability of punishment is 0.30. The expected punishment is only Rs. 27,00,000 because there is a 70% chance that the insider goes unpunished or even undetected where the punishment is Rs.0 and only a 30% chance where a punishment of Rs. 90,00,000 is imposed. This makes the expected punishment a mere Rs. 27,00,000 thus making the expected punishment lesser than the expected payoff for the criminal. Since the payoff is higher than the punishment of the insider trading, the insider will not be deterred and will still go ahead with insider trading. As stated above, the insider in most cases in India escapes detection, apprehension or conviction.

In India, the probability of punishment depends on the seriousness of the crime committed. The deterrence is almost nil or very minimal for insider trading where the payoff is very less since the probability of punishment in such cases is 0. In cases where the payoff to the insider is considerable, then the increase in probability is too gradual or too slow with the increase in the seriousness of the insider trading committed. In India, in the financial year 2016-17, only 34 cases were taken for investigation and the number fell in financial year 2017-2018 when only 15 cases were taken up. In India, the focus is only on the big fish, thus deterrence is visible only in substantially large cases since the probability of punishment increases proportionately with that of the seriousness of the crime in this category.

The difference between the insider's payoff *y(x)* and the expected punishment *p(x)f(x)* amounts to the insider's net gain from the insider trading committed. While, in countries like the US, insiders are mostly in situations where the crime doesn't pay due to the increased severity and probability of punishment, in India an insider mostly finds himself in a situation where the crime pays off. This is because the probability of punishment in India is abysmally low. In India, where 5461 companies have been listed on BSE and NSE as in May 2019, in the financial year of 2017-18, only 15 cases of insider trading were even taken up for investigation. Out of the 15 cases, a mere number of 6 cases were completed and the reports were submitted only for those 6 and the rest still lie incomplete. The investigation rate was thus less than 50% in the year 2017-18. The probability of punishment is very less when compared to its

US counterpart SEC. The SEC handles more than 50 cases of insider trading cases in a year. Also, in the US, individual stock exchanges also have certain mechanisms other than the SEC where NASDAQ, which has more than 3300 listed companies investigates around 400 cases per annum and sends 125-130 in a year to SEC for adjudication and prosecution. In comparison, the probability of punishment in India is very low, and thus is unable to deter the insider from indulging in insider trading. Also, the severity of punishment is less in India where it is noted that the maximum penalty of 3 times of the profit has never been imposed. Also, in India though insider trading has been criminalised, no man has ever gone to jail for insider trading. This makes the commission of insider trading in India all the more lucrative since the probability of getting caught and the severity of the punishment, in case an insider gets caught also is less thus making the expected punishment less than the expected payoff for the criminal, i.e. $y(x) > p(x)f(x)$.

In India, the number of insider trading cases is huge and rampant since the expected punishment is very less when compared to the payoff from insider trading. The above analysis of law and economics thus establishes the relation between the severity, probability of punishment and the seriousness of the insider trading cases. It has also reflected the reason for proliferation of insider trading cases in India despite the measures taken to improve the laws and regulations. It has established that since the probability of punishment is low due to lack of proper enforcement mechanisms, insider trading still exists rampantly in India.

Thus, it becomes imperative to analyse the reasons for the low rate of probability of punishment in India.

V. THE CHALLENGE TO OVERCOME: INEFFICIENT ENFORCEMENT

A number of reasons contribute to the abysmally low rate of enforcement of insider trading regulations. Although some of these may be changed most of them are sui generis. There are dual fundamental reasons for this problem:

A. Scarcity of resources

B. Problem of detection

A. Scarcity of Resources

The poor enforcement rates in India need to be viewed from the cost-benefit aspect of enforcement. Even though the prohibition of insider trading looks extremely desirable, the sound implementation of the same is extremely expensive. In India, since anyone who in possession of UPSI is considered as an "insider", the enforcement becomes all the more difficult and runs the high risk being a wild goose chase.[63]

The budgetary constraints of SEBI inhibit prohibition of insider trading and keep a close check on the market at all times. While the total income for the FY 2018-19 was estimated to be at Rs.631.92 crore, the

[63] Ajay Shah, *Why Forbid Insider Trading Ajay Shah writing for the mass media (1998)*, MAYIN, http://www.mayin.org/ajayshah/MEDIA/1998/index.html (last visited Jul 24, 2019).

total revenue expenditure during the FY 2018-19 was estimated to be Rs.469.59 crore.[64] Additionally, the 2019 Union Budget has proposed that 75% of the surplus of SEBI would be contributed to Government funds.[65]

And a majority of the resources of SEBI are exhausted in routine regulations such as reviewing audits and reports, overseeing general market well-being and rule-making. Given the low resources available in relation to the high costs, insider trading falls outside the radar of SEBI's highest priorities. Also, the personnel available with SEBI are lesser than what it ought to have. According to present statistics, one SEBI employee will have to be as efficient as 10 of USA's Securities Exchange Commission [SEC] employees in order to attain the same level of efficiency as the USA.[66] In 2017, SEBI had just 1 employee for every 6 listed companies in the market[67] and at the end of FY 2017 SEBI had 1,800 pending enforcement cases.[68]

The adverse resource scarcity thus mandates SEBI to adopt a selection policy that gives priority to cases that are highly sensitive, involve a large amount of money or are comparatively less costly and

[64] Securities and Exchanges Board of India, *Memorandum to the Board Budget Estimates for the Financial Year (FY) 2018-19*, GOVERNMENT OF INDIA https://www.sebi.gov.in/sebi_data/meetingfiles/may-2018/1525328189491_1.pdf.
[65] Palak Shah, *SEBI's 75 per cent cash surplus to go to government*, THE HINDU (July 5, 2019), https://www.thehindubusinessline.com/markets/stock-markets/sebis-75-per-cent-cash-surplus-to-go-to-government/article28298168.ece
[66] Krishnamurthy Subramanian, *Opinion: Bridge the human resources gap at SEBI*, LIVEMINT (2018), https://www.livemint.com/Opinion/P5feaU36POSSV97V9t0Y7J/Opinion--Bridge-the-human-resources-gap-at-Sebi.html (last visited Jul 21, 2019).
[67] Malpani, *supra* note 57.
[68] *Id.*

requires lesser enforcement and investigation costs. These criteria thus result in a very narrow range of choices that phases out most of the insider trading cases. It thus follows that most violations are not usually subjected to enforcement actions.

B. Problem of Detection

One major problem is that these trades are hardly ever detected by the regulatory agency.[69] In order for SEBI to suspect an unusual activity, it needs to connect various dots acting as clues simultaneously. First and foremost, a notable material event needs to happen, for instance a merger or a takeover. In the absence of this event, then considerable increase in the volume of the shares traded and fluctuations in the market, unless extremely haphazard, are disregarded to be random market fluctuations in the usual course of operations.

Even in case of happening of a substantial event, SEBI will be unable to connect the events if the insider is successfully able to defer public announcement until few months from the date of trading in shares. Despite this, if SEBI establishes a connection, the work is only half done. SEBI has a series of job after this where it should scrutinize trading accounts to learn about the identities of the traders, formulate a criterion to winnow the trades, search long lists of trades in order to establish and detect a pattern or any other indication that establishes insider trading. It is necessary for SEBI to get through this exhaustive process before it can

[69] Peter Demarzo, Michael J Fishman & Kathleen M Hagerty, *The Optimal Enforcement of Insider Trading Regulations*, 106 JOURNAL OF POLITICAL ECONOMY 602–632 (1998).

even decide if it has to take up the case for investigation and enforcement. Thus, the long and tedious process in addition to the lack of technology for better methodology makes the enforcement ineffective.

VI. CONCLUSIONS AND RECOMMENDATIONS

There is absolutely no doubt that India has come a long way and has now joined the League of Nations with strict laws against insider trading. The recent laws enacted in India appear to be more hopeful and pragmatic in meeting the needs of India's growing capital market. But it is equally important to understand that India has still got a long way to go. India now stands still at crossroads- Strict regulations and laws in place; but lack of surveillance mechanism to enforce the same.

"For years, traders in the financial markets stood more risk of getting struck by lightning on the golf course than they did of being arrested for swapping a few share tips on the same fairways".[70]

The above statement was made in light of the Great Recession in the USA at a time when the enforcement of insider trading regulations became rigorous. It is high time that the statement becomes felicitous to India.

The efficient enforcement of regulations in India will remain a distant goal until SEBI is granted the much-needed powers required for

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[70] Christopher Montagano, *The Global Crackdown on Insider Trading: A Silver Lining to the "Great Recession"*, 19(2) INDIANA JOURNAL OF GLOBAL LEGAL STUDIES 575–598 (2012).

investigation like wiretapping and is allocated more resources in order for it to carry out its regulatory activities in a better manner. The paradox between the toothless enforcement and the right to privacy of citizen's is here to stay. So, instead of being cynical of the consequences of the wiretapping power of SEBI, it is time that the power is granted to the regulatory body. Though the misuse of such a power by powerful players in control such as the ruling party etc. acts as a cause of concern, the mere apprehension of the same cannot be a barrier in the implementation or the granting of such powers to SEBI. It is perhaps the duty of SEBI to decipher and draw an effective line in order to prevent its misuse. Since the power has proved to be very effective in various jurisdictions like the US, France etc., it is the right time to grant SEBI such powers amidst the proliferation of insider trading cases.

The Government needs to decipher that the menace of insider trading cannot be curbed merely by creating more and more laws; the proper enforcement of the same is equally important. Overregulation and excessive authority can never act as an adequate alternate for the proper enforcement of the regulations. Effective enforcement of the insider trading regulations is the need of the hour in India in order for India to maintain and develop as a global financial centre. At a time when India's rankings in the ease of doing business and safety of capital markets are gaining stability, effective enforcement is the key to maintain and improve the global stance of the Indian market.

ALTERNATIVE INVESTMENTS: ANALYSING ITS PRACTICAL APPLICATION IN INDIA

- Ananya Shruti and Shashank Saurabh*

ABSTRACT

In 2012, the Securities Exchange Board of India (SEBI) introduced the concept of Alternate Investment Fund (AIF) in India with a view to make a major overhaul in the then SEBI (Venture Capital Funds) Regulations, 1996 and enact a law which would encompass all pooled structures that were not regulated by the earlier regime. In the last 7 years, we have witnessed a steep growth in the number of Registered AIFs depicting its popularity among the investors. In light of this, we attempt to analyse the expanding horizons of AIFs in India. Broadly, this article is divided into 4 parts: The first part outlines the meaning, scope, forms and advantages of an AIF. The second part, then, provides the existing legal framework within which AIF is governed. It lays down the key features of the 2012 Regulations, its co-existence with other laws such as Tax and FDI norms, and its pitfalls in the present scenario. In the third part, we assess the practical application of AIF with a specific case of Real Estate Sector in India. Here, we analyse the recent move of the government to revive the real estate industry by infusing Ten Thousand crores through Category II- AIF. Lastly, an attempt is made to re-define the role and functions of SEBI vis-à-vis AIFs. In connection to this, various reports by Alternative Investment Policy Advisory Committee have also been considered. Finally, it is concluded that in the imminent future, Indian economy will see an evolution in the investment sector in the form of a developing scope in AIF requiring the laws to expand accordingly.

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I. INTRODUCTION

The Securities and Exchange Board of India (SEBI) introduced the SEBI (Alternative Investment Funds) Regulations in 2012. Before the enactment of a special Regulation for AIF, the Investment Management Regulation was restricted to Collective Investment Scheme (CIS) Regulations, Regulation of Portfolio Managers, Mutual Fund Regulation and Venture Capital Fund (VCF) Regulation. SEBI came up with a regulation for AIF in 2012 after which the VCF Regulation was repealed and was subsumed in AIF.

The funds have to compulsorily get registered according to the AIF Regulations and follow the compliances prescribed by the Regulation. The scope of an AIF is wide enough as it includes both domestic and AIFs set up in International Financial Services Centres (IFSC) which are subjected to the SEBI (International Financial Services Centres) Guidelines, 2015.

In the last 7 years, we have witnessed a steep growth in the number of Registered AIFs depicting its popularity among the investors. In the imminent future, as per the growing number of registered AIFs in India[1] and increase in capital inflow through AIF[2], Indian economy will see an

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[1] SEBI, *Registered Alternative Investment Funds*, GOVERNMENT OF INDIA (Dec. 6, 2019, 6:54 AM), https://www.sebi.gov.in/sebiweb/other/OtherAction.do?doRecognisedFpi=yes&intmId=16.

[2] SEBI, *Data relating to activities of Alternative Investment Funds (AIFs)*, GOVERNMENT OF INDIA (Dec. 4, 2019, 5:25 PM), https://www.sebi.gov.in/statistics/1392982252002.html.

evolution in the investment sector in the form of a developing scope in AIF requiring the laws to expand accordingly.

II. INVESTMENT STRUCTURE AND THE INDIAN ECONOMY

A. Major Investment Routes in India

Investment can either be made through financial assets – which can be further divided into market-linked products like stocks, bonds and mutual funds and fixed income products like Public Provident Fund, bank fixed deposit, non-financial assets – real estate, gold, etc.[3]

1. Domestic Investment Avenues in India

a) **Direct Equity:** This involves investing in a company by purchasing its shares through the stock exchange market. In long term, these have been able to generate higher returns compared to other forms of asset.[4]

b) **Public Provident Fund:** This is a comparatively safer investment as it is supported by a sovereign guarantee and has a long term of 15 years.

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[3] Sunil Dhawan, *Top 10 investment options*, THE ECONOMIC TIMES (Dec. 8, 2019, 3:46 PM), https://economictimes.indiatimes.com/articleshow/64066079.cms?from=mdr&utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst.

[4] *Id.*

c) **Real Estate:** This is a highly illiquid asset and includes investment in residential property, retail and commercial projects. The location and proximity of the property to certain other properties determines the return.

Other forms of investment includes National Pension System, Bank fixed deposit, Bonds, Gold, etc.

2. *Major Foreign Investment Avenues in India:*

a) **Foreign Direct Investment (FDI):** Investment can be made by non-residents into an Indian Company, Partnership Firm/Proprietary Concern, Trusts, Limited Liability Partnerships (LLPs), Investment Vehicle, Start-up Companies and other Resident Entities. In 2019, the Government allowed 100% FDI under automatic route in coal mining. Also, in Union Budget 2019-2020, the government came up with a recommendation to open FDI in media, insurance sector and aviation.[5]

b) **Foreign Portfolio Investment (FPI):** FPI is an avenue through which foreign investors can invest in Indian listed equities and other securities.[6] There are two categories of FPI.[7] Category I includes

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[5] *About FDI in India*, IBEF (Dec. 8, 2019, 8:24 PM), https://www.ibef.org/economy/foreign-direct-investment.aspx.

[6] Rajesh Gandhi & Karamjeet Singh, *Foreign portfolio investment in India*, DELOITTE (Dec. 8, 2019, 7:50 PM), https://www2.deloitte.com/content/dam/Deloitte/lu/Documents/financial-services/performancemagazine/articles/lu-foreign-portfolio-investment-india.pdf.

[7] Regulation 5, Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, Gazette of India, pt. III sec. 4, (2019).

"government and government related investors such as central banks, sovereign wealth funds"; "pension funds and university funds"; "appropriately regulated entities such as insurance or reinsurance entities, banks"; "entities from the Financial Action Task Force member countries"; etc. Category II includes "all the investors not eligible under Category I foreign portfolio investors such as – appropriately regulated funds not eligible as Category I foreign portfolio investor; endowments and foundations; charitable organisations; corporate bodies".[8]

a. With the recent change brought by SEBI despite the route chosen, an investment will be considered an FPI if the foreign fund buys less than 10% stake in a company. Above 10%, the investment will be regarded as an FDI.[9]

c) **External Commercial Borrowings (ECB):** ECB is a method through which Indian companies raise capital in foreign currency through suppliers' credit, bank loans, securitized instruments and buyers' credit. Through automatic route ECB can be raised up to USD 750 million.[10] ECB is governed by the guidelines set by RBI.

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[8] *Id.*

[9] Pavan Burugula, *New FPI/FDI classification by SEBI to hit many offshore funds*, ET MARKETS (Dec. 8, 2019, 5:04 PM), https://economictimes.indiatimes.com/markets/stocks/news/new-fpi/fdi-classification-by-sebi-to-hit-many-offshore-funds/articleshow/71532706.cms?from=mdr.

[10] *New External Commercial Borrowing (ECB) Framework*, AZB & PARTNERS (Dec. 8, 2019, 5:28 PM), https://www.azbpartners.com/bank/new-ecb-framework/.

B. Indian Economy – Contribution from Domestic and Foreign Avenues of Investment

Investment is an important source of capital flow in India and an essential part of India's GDP. A major source of growth, investment produces profit for several years by enhancing operational efficiency and promoting innovation.[11]

Public and private sector have together contributed towards an increase in the domestic investment which has consequently led to growth of the Indian economy. While investments in Private Equity (investment is made primarily in equity or equity linked instruments or partnership interests of investee companies according to the stated objective of the fund) and Venture Capital (investment is primarily made in unlisted securities of start-ups, emerging or early-stage venture capital) escalated to US$ 35.8 billion in 2018, in 2019 it further grew to US$ 36.7 billion before September, 2019.[12]

According to Goldman Sachs India Securities, India acquired a capital of $13 billion through investments in 2019 by the month of July.[13]As per the data of RBI, capital inflow through FDI in 2019 by the

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[11] Amit Kapoor, *The dynamics of India's growth slowdown*, THE ECONOMIC TIMES (Dec. 8, 2019, 5:54 PM), https://economictimes.indiatimes.com/news/economy/indicators/the-dynamics-of-indias-growth-recession/articleshow/71020942.cms?from=mdr.

[12] *Domestic Investment in India*, INDIAN BRAND EQUITY FOUNDATION (Dec. 6, 2019, 4:45 AM), https://www.ibef.org/economy/domestic-investments.

[13] IANS, *India already received $13 billion foreign capital inflows: Goldman Sachs*, THE ECONOMIC TIMES (Dec. 8, 2019, 5:17 PM), https://cfo.economictimes.indiatimes.com/news/india-already-received-13-billion-foreign-capital-inflows-goldman-sachs/70659206.

month of September was $62 billion.[14] Investment through FPI in India reached Rs 82,575 crore in 2019 by the month of October and was ranked the second highest among the emerging markets, following China.[15]

As of 30th June, 2019, Rs. 14,4479.629 crore fund was raised through Alternative Investment Fund in India**[16]**, thus clearly showing that AIF is a major avenue of investment in India in the current scenario.

III. UNDERSTANDING ALTERNATIVE INVESTMENT FUNDS (AIFS)

A. Meaning

AIF has been defined in Regulation 2 (b) of the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012[17] (the Regulation): "Alternative Investment Fund or AIF means any

[14] Pavan Burugula, *New FPI/FDI classification by SEBI to hit many offshore funds*, ET MARKETS (Dec. 8, 2019, 5:04 PM), https://economictimes.indiatimes.com/markets/stocks/news/new-fpi/fdi-classification-by-sebi-to-hit-many-offshore-funds/articleshow/71532706.cms?from=mdr.

[15] Rajesh Mascarenhas, *Rs 82,575 crore: FPI inflows in 2019 highest in Modi Era*, ET (MARKETS) (Dec. 8, 2019, 5:07 PM), https://economictimes.indiatimes.com/markets/stocks/news/rs-82575-crore-fpi-inflows-in-2019-highest-in-modi-era/articleshow/72048314.cms.

[16] SEBI, *Data relating to activities of Alternative Investment Funds* (AIFs), GOVERNMENT OF INDIA (Dec. 4, 2019, 5:25 PM), https://www.sebi.gov.in/statistics/1392982252002.html.

[17] The Securities and Exchange Board of India (Alternative Investment Funds) Regulations, Regulation 2(b), Gazette of India, pt. III sec. 4, (2012): (b) "Alternative Investment Fund" means any fund established or incorporated in India in the form of a trust or a company or a limited liability partnership or a body corporate which,-

(i) is a privately pooled investment vehicle which collects funds from investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors; and fund established or incorporated in India which is a privately pooled investment vehicle which collects funds from sophisticated investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors".[18]

The proviso to this regulation excludes family trusts (trusts set up for the benefit of 'relatives' as defined under Companies Act, 2013) ESOP (Employee Stock Option Plan) trusts, employee welfare trusts or gratuity trusts (trusts set up for the benefit of employees), 'holding companies' (defined under sub-section 46 of section 2 of Companies Act, 2013), other special purpose vehicles not established by fund managers, funds managed by securitisation company or reconstruction company and any such pool of funds which is directly regulated by any other regulator in India from the category of AIF.

B. Why AIF was introduced in India?

Before the enactment of a special Regulation for AIF, the Investment Management Regulation was restricted to CIS Regulations, Regulation of Portfolio Managers, Mutual Fund Regulation and Venture Capital Fund (VCF) Regulation. The reasons behind the introduction of AIF in India were:

(ii) is not covered under the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996, Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999 or any other regulations of the Board to regulate fund management activities.

[18] SEBI, *Frequently Asked Questions (FAQs): SEBI (Alternative Investment Funds) Regulations 2012*, Gazette of India, pt. III sec. 4, GOVERNMENT OF INDIA (Dec. 6, 2019, 4:45 AM), https://www.sebi.gov.in/sebi_data/faqfiles/jan-2017/1485861425527.pdf.

1. Economic Issues and Conundrums

The VCFs are investments aimed at financing new ventures. The fund regulates the money of investors who desire to invest in start-ups and Small and Medium Enterprises that have strong growth potential, thus it is aimed at promoting companies at its nascent stage, were being used as a vehicle pool for other types of funds like real estate, private equity and PIPE (Private Investment in Public Equity), thus creating certain economic issues and conundrums discussed below:

a) The use of VCF in other funds could lead to dereliction of new companies, thus, defeating the basic purpose of VCF.

b) The concessions provided to the VCF by the Government could not be effectively targeted and utilized as the probability of them being used by established companies was very feasible.

c) The restrictions imposed by the Government through the VCF Regulations aimed at start-up companies were not suited to other funds.

d) Some concessions regarding investment sought by PE or PIPE funds were not pertinent for the VCF.

e) AIF such as PE or VC are essential for the growth of corporate industry of a country as “they bring a lot of governance and good quality money on the table of investee company."[19] Thus, SEBI considered the requirement of a special legal framework targeted towards AIF.

f) AIF is susceptible to certain risks; to address these issues arising out of these funds a special legal framework was crucial according to SEBI.

2. Global Influence

The G-30 Report: The Report gave the following recommendation:

> Managers of private pools of capital that employ substantial borrowed funds should be required to register with an appropriate national regulator (….). The regulator of such managers should have authority to require periodic regulatory reports and public disclosures of appropriate information regarding the size, investment style, borrowing, and performance of the funds under management.[20]

a) **Directive on Alternative Investment Fund Manager (AIFM) by the European Parliament and Council:** SEBI had referred to the directive on AIFM that addressed the requirement and duties of an authorizing and supervisory regime that would be legally binding on all AIFM governing AIF in the European Union.

[19] SEBI, *Concept Paper on Proposed Alternative Investment Funds Regulation for Public Comments*, SECURITIES AND EXCHANGE BOARD OF INDIA (Dec. 5, 2019, 6:42 PM), https://www.sebi.gov.in/sebi_data/commondocs/alternativeinvestment_p.pdf.

[20] *Id.*

b) **Private Fund Investment Advisers Registration Act, 2010 of USA:** The Act mandated the registration of all Investment Advisors to private funds with the Securities and Exchange Commission (SEC) which would subject them to anti-fraud rules, record-keeping and reporting obligations.

c) **The IOSCO Consultation Report on Hedge Funds Oversight (2009):** Regulatory hedge fund oversight must be risk-based that concentrates on hedge funds that are susceptible to more risk and are all together important.

d) **The IOSCO Report on Private Equity Conflicts of Interests (2010):** The report specified the principles to be addressed while assessing the quality of mitigation of conflicts of interests by private equity firms.

e) **The Institutional Limited Partners Association (ILPA) Principles:** These principles aim at enhancing the PE sector by governance, alignment of interest and transparency practices.

C. Types of AIFs in India

According to Regulation 3 of the Regulation, AIF in India can be registered under three categories:

a) **Category I:** This category includes infrastructure funds, Small and Medium Enterprise Funds (SME), venture capital funds, social venture funds, and such other AIFs that the Government may cite.

These funds have "positive spill over effect"[21] on the economy thus Government provides concessions and incentives for the same.

b) **Category II:** This category includes AIFs such as private equity funds or debt funds that engage in borrowing to meet the everyday practical functions. Government does not provide incentives and concessions for this category funds.[22]

c) **Category III:** This category includes hedge funds, funds that trade to gain short term returns or open ended funds. These involve complex and diverse trading approach. Government does not provide incentives and concessions for this category funds.[23]

D. Domestic and Foreign Investment in AIF

While domestic AIF is regulated by SEBI with help of the Regulation of 2012 that enumerates all the categories of AIF and holds certain guidelines for these funds to function in India, in 2016-17 Budget, the Government of India authorized the Foreign Investment in AIF.[24] This was implemented by the amendment brought to the Securities and Exchange Board of India (International Financial Services Centres)

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[21] Regulation 3(4) (a), Securities and Exchange Board of India (Alternative Investment Funds) Regulations, Gazette of India, pt. III sec. 4, (2012).
[22] Regulation 3(4) (b), Securities and Exchange Board of India (Alternative Investment Funds) Regulations, Gazette of India, pt. III sec. 4, (2012).
[23] Regulation 3(4)(c), The Securities and Exchange Board of India (Alternative Investment Funds) Regulations, Gazette of India, pt. III sec. 4, (2012).
[24] Samrat Sengupta, *The Viewpoint: Alternative Investment Fund - Regulations and Perspectives*, BAR & BENCH (Dec. 6, 2019, 8:11 PM), https://barandbench.com/alternative-investment-fund-regulations-perspectives/.

Guidelines, 2015 that provided for operation of AIF in IFSC.[25]Further, in 2019 vide a circular SEBI eased the norms of investment for the AIF operating in IFSC.[26] Therefore, the provisions applicable to domestic AIFs regarding investment stands the same for ones operating in IFSC. In 2015, Gujarat International Finance Tec-City (GIFT City) was introduced which helped the development of financial services within the territories of India that were otherwise being carried out offshore by the foreign subsidiaries or branches of Indian financial institutions.[27]

E. Foreign Investments by AIFs

AIFs can invest in the securities of companies incorporated outside India depending on the RBI and SEBI guidelines.[28]

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[25] SEBI, *Securities and Exchange Board of India (International Financial Services Centres) Guidelines, 2015 - Permissible investments by Portfolio Managers, Alternate Investment Funds and Mutual Funds operating in IFSC*, SECURITIES AND EXCHANGE BOARD OF INDIA (Dec. 7, 2019, 11:29 AM), https://www.sebi.gov.in/legal/circulars/may-2017/securities-and-exchange-board-of-india-international-financial-services-centres-guidelines-2015-permissible-investments-by-portfolio-managers-alternate-investment-funds-and-mutual-funds-operatin-_34951.html.

[26] SEBI, *Securities and Exchange Board of India (International Financial Services Centres) Guidelines, 2015-Permissible investments by Alternative Investment Funds operating in IFSC*, SECURITIES AND EXCHANGE BOARD OF INDIA (Dec. 7, 2019, 5:13 AM), https://www.sebi.gov.in/legal/circulars/aug-2019/securities-and-exchange-board-of-india-international-financial-services-centres-guidelines-2015-permissible-investments-by-alternative-investment-funds-operating-in-ifsc_43867.html.

[27] Sharda Balaji & Avaneesh Satyang, *India: Opportunities and Challenges for AIFs in India's First IFSC, GIFT City, Gujarat*, MONDAQ (Dec. 8, 2019, 11:06 AM), http://www.mondaq.com/india/x/824084/Fund+Management+REITs/Opportunities+And+Challenges+For+AIFs+In+Indias+First+IFSC+GIFT+City+Gujarat.

[28] Subramaniam Krishnan & Mamta Shroff, *Alternative Investment Funds and Venture Capital Funds – An Overview*, 10 THE CHAMBER'S JOURNAL 9, 15 (2018).

a) Investment by an AIF in Venture Capital Undertakings (VCUs), a domestic company with shares that are not listed on a stock exchange, can be made subject to the overall ceiling of USD 750 million.

b) For investing in an offshore VCU a prior approval of SEBI is required.

c) Only up to 25% of the investible funds of a scheme of the AIF can be invested in foreign investments.

F. Advantages of AIFs

AIF are non-traditional forms of investments that have certain advantages listed below:

a) They offer diversification as the investors are allowed access to assets that are not just associated to the stock market.

b) The returns are likely to be higher than the ones from bonds, mutual funds and stocks.

c) If a resident Indian citizen is in control of the sponsor and manager of AIF, the capital incoming from AIF is not subjected to restrictions by the FDI norms like sectoral caps, limited choice of instruments etc.[29]

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[29] Swaraj S. Dhanjal, *Investors committed ₹1.17 trillion in alternative investment funds in FY19*, LIVEMINT (Dec. 6, 2019, 7:03 PM), https://www.livemint.com/market/stock-market-news/investors-committed-1-17-trillion-in-alternative-investment-funds-in-fy19-1557937382176.html.

d) Certain treaty benefits are provided to the foreign investors while tax benefits in the form of 'tax pass through' are available to the category I and II AIFs.

e) Since AIF have nominal association with stocks and bonds, they are not very affected by struggling markets and are likely to perform their best at these times.

f) They can grow long-term returns as part of a balanced investment portfolio, particularly in times of financial unpredictability.

g) As AIFs are rarely assigned or handed over, they lead to lower transaction costs than standard ones.[30]

G. The New Mode of Investment and Its Growing Impact- Statistics

1. Registered AIFs in India and Increase in the Number

Currently, 628 AIFs are registered with SEBI[31]; some of them are '021 Capital Trust', '2Point2 Capital Trust', '3F Ventures', 'A91 Partners Trust', etc. In 2016 the number of registered AIFs was 235[32]. This shows the upward moving trend of AIF.

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[30] Jamie McGeachie, *Alternative investing: Is it right for you?*, SWITZERDAILY (Dec. 6, 2019, 8:51 PM), https://switzer.com.au/the-experts/jamie-mcgeachie/alternative-investing-is-it-right-for-you/.

[31] SEBI, *Registered Alternative Investment Funds*, SECURITIES AND EXCHANGE BOARD OF INDIA (Dec. 6, 2019, 6:54 AM), https://www.sebi.gov.in/sebiweb/other/OtherAction.do?doRecognisedFpi=yes&intmId=16.

[32] PTI, *Sebi registered Alternative Investment Funds count touches 235*, ET (MARKETS) (Dec. 6, 2019, 7:00 AM),

2. *Year-Wise Growth in the Data relating to Activities of AIFs*

It is clear from the tables provided below that the AIF industry in India is rapidly growing after the enactment of the Regulations for AIFs by SEBI:

Category	As on 31st December, 2012			As on 30th June, 2019		
	Commitments Raised	Funds Raised	Investment Made	Commitments Raised	Funds Raised	Investment Made
Category I:						
Infrastructure Fund	301	0	0	12441.72	6428.7	5520.94
Social Venture Fund	0	0	0	1338.12	967.77	874.37
Venture Capital Fund	36	6.65	0.2	21078.495	7143.442	5296.75
SME Fund	0	0	0	119.68	95.98	40.94
Category I Total	**337**	**6.65**	**0.2**	**34978.0**	**14635.89**	**11733**
Category II	0	0	0	208306.486	89998.06	74816.695
Category III	22.5	0	0	47055.429	39845.677	33208.433
Grand Total	**359.5**	**6.65**	**0.2**	**290339.93**	**144479.629**	**119758.128**

- Comparative Table showing amount of funds raised through AIF in 2012 and 2019[33]
- (All figures in Rs. Crores)

//economictimes.indiatimes.com/articleshow/53430941.cms?from=mdr&utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst.

[33]SEBI, *Data relating to activities of Alternative Investment Funds (AIFs)*, SECURITIES AND EXCHANGE BOARD OF INDIA (Dec. 4, 2019, 5:25 PM), https://www.sebi.gov.in/statistics/1392982252002.html.

IV. LEGAL FRAMEWORK GOVERNING AIFS

A. Definitions

1. Updated definitions through Amendments are:

a) "Custodian"[34] has been defined as a person who has registered himself as thus under the Securities and Exchange Board of India (Custodian) Regulations, 1996.

b) "Goods"[35] have been defined to include the ones notified by the Central Government under Section 2 (bc) of the Securities Contracts (Regulation) Act, 1956.

c) The definition of "investee company"[36] was expanded to include real estate investment trust or infrastructure investment trust by the SEBI (Real Estate Investment Trusts) Regulations, 2014.

d) Angel fund was included in the definition of "venture capital fund" by the SEBI (Alternative Investment Funds) (Amendment) Regulations, 2013.

2. Certain lacunae in the definitions provided

[34] Regulation 2 (ha), SEBI (Alternative Investment Funds) (Amendment) Regulations, Gazette of India, pt. III sec. 4, (2019).
[35] Regulation 2 (ka), SEBI (Alternative Investment Funds) (Amendment) Regulations, Gazette of India, pt. III sec. 4, (2019).
[36] Regulation 2 (o), SEBI (Alternative Investment Funds) (Amendment) Regulations, Gazette of India, pt. III sec. 4, (2019).

a) *Sponsor:* "Sponsor" is defined as any person who sets up the AIF.[37] In case AIF is a trust, approval of Foreign Investment Promotion Board would be required if SEBI considers the sponsor to be the 'settlor' of AIF. This would lead to an added burden of setting up of trust on the sponsor who was introduced to provide reassurance to the investors regarding the credibility of the fund.

Recommendation: SEBI can separate the functions of the sponsor and the 'settlor' so that the administrative functions like setting up of the Trust does not fall under the functions of the sponsor.

b) *Corpus*: The manager or the sponsor of the Fund is required to hold a minimum amount of interest in the corpus as provided in Regulation 10 (d).[38] The bare reading of this provision leads to the understanding that such interest will have to be maintained until the entire capital of the fund is paid back to the investors. Such ambiguity is adverse to the interest of the sponsor who is solely appointed to reassure the investors.[39]

Recommendation: It can be clarified that the manager or the sponsor who is required to hold interest in the AIF to maintain his 'skin in the game' for the comfort of the investors shall only be required to do so

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[37] Regulation 2 (w), SEBI (Alternative Investment Funds) Regulations, Gazette of India, pt. III sec. 4, (2012).

[38] Regulation 10 (d), SEBI (Alternative Investment Funds) Regulations, Gazette of India, pt. III sec. 4, (2012).

[39] Mukul Aggarwal et al., *Alternative Investment Funds: SEBI scores half century on debut*, NISHITH DESAI ASSOCIATES (Dec. 7, 2019, 3:17 PM), http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/alternative-investment-funds-sebi-scores-half-century-on-debut-1.html?no_cache=1&cHash=32e398826c44412ecdf4a3fd9f41edf0.

pro rata to the outstanding capital of the investors and not till the entire fund capital is paid back to the investors.

c) *Regulation 10(d) – Sponsor affiliation*: The Regulations do not mandate the sponsor to be affiliated to the investment manager. In this case the manager does not have a significant personal stake in the fund.

Recommendation: The Regulation must thus be amended to ensure that if the sponsor is the fulfilling the condition under 10(d), he must be required to be either be an affiliate of the investment manager or part of his corporate group so that investor's confidence in the fund is maintained.

B. Compliances Required According to the AIF Regulation

1. Registration of AIFs

a) AIF must attain a certificate of registration from SEBI by applying in Form 'A' OF THE First Schedule of the AIF Regulations.[40]

b) Unless the AIF is granted registration it cannot accept money from investors, however, commitments from investors may be accepted.[41]

2. Conditions put on AIFs

a) AIF can raise fund by issuance of units to Indian, foreign or non-resident Indians.[42]

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[40] *Supra* note 38, Reg. 3 (5).
[41] *Supra* note 38, Reg. 6 (5).
[42] *Supra* note 38, Reg. 10 (a).

b) The lower limit for the corpus should be Rs. 20 crore.[43]

c) The minimum amount an AIF can accept from an investor is Rs. 1 crore.[44]

d) The manager or the sponsor of the Fund is required to invest 2.5% of the fund's corpus or Rs. 5,00,00,000, whichever is lower.[45]

e) The amount of investment made by the manager or the sponsor must be disclosed to the investors.[46]

f) A particular scheme of AIF cannot have more than one thousand investors.[47]

g) The AIF can only accept or solicit fund by way of private placement.[48]

3. Tenure

a) The tenure for Category I and Category II AIF, that are close ended, is to be decided at the time of making application[49] and the minimum tenure is 3 years.[50]

b) Category III AIF can be open as well as close ended.[51]

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[43] *Supra* note 38, Reg. 10 (b).
[44] *Supra* note 38, Reg. 10 (c).
[45] *Supra* note 38, Reg. 10 (d).
[46] *Supra* note 38, Reg. 10 (e).
[47] *Supra* note 38, Reg. 10 (f).
[48] *Supra* note 38, Reg. 10 (g).
[49] *Supra* note 38, Reg. 13 (1).
[50] *Supra* note 38, Reg. 13 (2).

c) The tenure for close ended AIF may be increased by 2 years by following the procedure prescribed in the Regulation[52], in absence of which the fund will be wound up within 1 year of the expiration of the tenure.[53]

4. Listing

a) Close ended AIF's units can be listed on the stock exchange market with minimum tradable lot being of Rs 1 crore.[54]

b) After the fund/scheme closes only then can its units be listed.[55]

5. General Investment Conditions

a) Following the conditions put by RBI or the Board, AIF can invest in companies incorporated outside India.[56]

b) The terms of co-investment in an Investee company by the Manager or the Sponsor cannot be more favourable than the terms offered to AIFs.[57]

c) AIFs can only invest in associates if it receives an approval from 75% of investors according to the amount they have invested in AIF.[58]

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[51] *Supra* note 38, Reg. 13 (3).
[52] *Supra* note 38, Reg. 13 (4).
[53] *Supra* note 38, Reg. 13 (5).
[54] *Supra* note 38, Reg. 14 (1).
[55] *Supra* note 38, Reg. 14 (2).
[56] *Supra* note 38, Reg. 15 (1) (a).
[57] *Supra* note 38, Reg. 15 (1) (b).
[58] *Supra* note 38, Reg. 15 (1) (e).

d) Category I and Category II AIF can only invest up to 25% of its investable funds in each Investee Company.[59]

e) Category III AIF can only invest up to 25% of its investable funds in each Investee Company.[60]

6. Winding up

The fund is wound up according to the method prescribed in Regulation 29 and Regulation 26(2) requires the records to be maintained up to 5 years of winding up of the fund.

7. Legal structure for an AIF

The table on the next page depicts the structure of an AIF as required by the AIF Regulations.[61]

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[59] *Supra* note 38, Reg. 15 (1) (c).

[60] *Supra* note 38, Reg. 15 (1) (d). Sameer Mittal**,** *Alternative Investment Funds: An Insight*, OUTLOOK MONEY (Dec. 7, 2019, 3:17 PM), https://www.outlookindia.com/outlookmoney/investment/alternative-investment-funds-an-insight-3405.

[61] Suneet Barve, *Alternative Investment Funds (AIF) – Legal aspects*, ASSOCIATION OF INTERNATIONAL WEALTH MANAGEMENT OF INDIA (Dec. 7, 2019, 7:39 PM), https://www.aiwmindia.com/wp-content/uploads/2018/09/ICUL-Presentation-Sep-18-2018.pdf.

Criteria	Trust	Company	LLP
Compliance	Low	High	Moderate
Client Confidentiality	High	Moderate	Low
Market Practice	More than 97% of the AIFs are set up as Trusts	Minimal	Less than 3% AIFs are set up as LLP
Acceptability with Investors and Distributors	High	Low	Moderate
Ease of Operations	High	Low	Moderate
Mitigation of GST on Management Fee	Debatable	No	Yes

8. For operation of AIF in IFSC following are required:

a) AIF must attain a certificate of registration in conferment with the provisions of Chapter II of AIF Regulations along with payment of the non-refundable application fee.[62]

b) The lower limit for the corpus should be USD 3 million.[63]

c) The minimum amount an AIF can accept from an investor is USD 150,000.[64]

d) The manager or the sponsor of the Fund is required to invest 2.5% of the fund's corpus or USD 750,000, whichever is lower.[65]

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[62] SEBI, Operating Guidelines for Alternative Investment Funds in International Financial Services Centres, Guideline 2 (2015).
[63] *Id.* Guideline 6.
[64] *Id.* Guideline 7.
[65] *Id.* Guideline 8.

e) Investment by an AIF in IFSC can be made in units of other AIFs in IFSC and India subject to the provisions of AIF Regulations.[66]

f) Category I and II AIF should have a custodian registered with the Board appointed if the corpus of the AIF is more than USD 70 million.[67]

C. Co-existence with Other Laws and Regulations

1. Tax Laws

Below are the various principles of taxation vis-à-vis AIFs:

a) *Pass-through' status to AIFs and taxation of unit holders:* According to the provision of Section 115UB (1) of the Income Tax, the AIFs have been granted a pass through status which essentially means that the tax is chargeable at the hands of the unit holders treating it as an income of the unit holders supposing the investment was directly made by them. However, business income is treated differently and is taxed at the AIF level. In India, the pass through status is accorded to only Category I and Category II AIFs.[68]

b) *Characterization of income*: Section 115UB (3) of the Act stipulates that wherein any income is paid or credited by the AIF to the unit holders, it shall have the same nature and in same proportion as that of the AIF.

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[66] *Id.* Guideline 9.
[67] *Id.* Guideline 11.
[68] Anish Thacker & Partha Tambday, *Alternative Investment Funds and Venture Capital Funds Direct Tax – Key Provisions*, 10 THE CHAMBER'S JOURNAL, 28, 30 (2018).

c) *Losses to be passed on to unit holders*: Earlier, according to the Section 115UB (2) of the Act, where the net result of the assessment was a loss, it could not be set-off against any other head of income and hence such a loss did not pass to the unit holders, rather got carried forward and set-off by the AIF in accordance with the provisions of the Act. However, the Finance Bill, 2019 brought amendment to this provision and now the loss (not being in the nature of business losses) are subjected to passed on to the unit holders.[69]

d) *Tax rates applicable to AIFs*: In terms of Section 115UB (4), the income of the AIF is supposed to be charged in accordance with rates specified by Finance Act of the relevant year (in case AIF is set-up as a company or LLP) and in case where AIF is set up as a trust, then the applicable rate is 30% as Maximum Marginal Rate.

e) *Taxability of undistributed income on accrual basis*: The provision of Section 115UB (6) of the Act clearly states that when, in any financial year, the income of an AIF is remains unpaid or credited to the unit holders, then such undistributed income shall have the effect to be credited to the unit holders on the last day of the relevant year.

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[69] *Finance bill, 2019: Key highlights for taxation of Alternative Investment Funds and IFSC units (June-July 2019 edition, Part II),* NISHITH DESAI ASSOCIATES (Dec. 3, 2019, 8:40 AM), http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/finance-bill-2019-key-highlights-for-taxation-of-alternative-investment-funds-and-ifsc-units-jun.html?no_cache=1&cHash=d7b4d0313bb44395b5c7dd45cf63c663.

2. *FDI and FEMA Norms*

a) In all Categories of AIFs a 100% FDI is allowed under Automatic route.[70]

b) According to FEMA Regulations, an AIF is not subject to the FDI downstream norms if its Sponsor and Manager are "owned and controlled" by Indian resident citizens.[71]

c) To determine whether downstream investment by AIF is a foreign investment, the extent of foreign investment in the corpus will not be factored.

d) A foreign downstream investment by an AIF has to adhere to the sectoral caps and conditions/restrictions that are applicable to the company in which the downstream investment is made.

e) According to FEMA Regulations, portfolio investment can be made by a Category III AIF with any foreign investment in only those securities or instruments in which a FPI is allowed to invest.[72]

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[70] Suneet Barve, *Alternative Investment Funds (AIF) – Legal aspects*, ASSOCIATION OF INTERNATIONAL WEALTH MANAGEMENT OF INDIA (Dec. 7, 2019, 7:39 PM), https://www.aiwmindia.com/wp-content/uploads/2018/09/ICUL-Presentation-Sep-18-2018.pdf.

[71] Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, Regulation 14, Gazette of India, pt. III sec. 4, (2017).

[72] Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, Schedule 8 Regulation 1 (5), Gazette of India, pt. III sec. 4 (2017).

D. AIF as an Alternative to other Routes of Foreign Investment in India

1. AIF Regime alternative to FDI regime

AIF allows foreign investors to invest in India via the automatic route and there is no requirement to adhere to the FDI norms if the fund has an Indian in control and ownership of the management and the sponsor. Therefore, for investments that may have otherwise not been permissible or practicable under FDI route the investors are opting for AIF.[73]

2. AIF Regime alternative to External Commercial Borrowings (ECB)

ECB is a way through which Indian citizens can borrow capital from foreign investors in the form of finance lease, bank loans, foreign currency convertible bonds of investment etc. The ECB Regulations put too many limits on investors including the pay-out limit on coupons, restrictions on the end use and class of lenders, etc., thus, AIF is also becoming an alternative to ECB.

3. AIF Regime alternative to FPI regime in listed securities and debt investments

AIF route can be opted for investment in listed securities and IPOs if due to some reason the FPI registration is not granted. Also, since

[73] *Supra* note 70.

corporate debt is insufficient to meet the FPI limits, AIF can be used to route such money to the Indian economy.

E. Ambiguities in the Legal Framework of AIF in India

1. Loans by an AIF

While SEBI has clarified in its FAQs that AIF being a privately pooled vehicle cannot provide loans[74], however, in its order in the matter of *SREI Multiple Asset Investment Trust,*[75] SEBI held that "'financing' is included in the Defined Investment Policy (DIP) of the fund, the AIF can use the amount contributed by the investors for the purpose of giving loans,"[76] thus contradicting itself.

2. Category III AIF

The Regulation is not clear about the exit/redemption option available to the investors in a close ended fund and the restrictions and right connected to the same. Also, the Regulation does not go in detail about the rights, compliances and other provisions in case the AIF manager/sponsor is under foreign ownership or control.

[74] SEBI, *Frequently Asked Questions (FAQs),* SECURITIES AND EXCHANGE BOARD OF INDIA (Dec. 4, 2019, 5:25 PM), https://www.sebi.gov.in/sebi_data/faqfiles/jan-2017/1485861425527.pdf.
[75] 2017 SCC OnLine SEBI 136: [ADJUDICATION ORDER NO. RA/JP/235 -236/2017]
[76] Vallari Dubey, *Can AIFs grant loan?,* VINOD KOTHARI CONSULTANTS (Dec. 4, 2019, 6:06 AM), http://vinodkothari.com/2018/03/can-aif-grant-loans/.

3. Category II AIF

Since SEBI requires the fund's portfolio to be more in unlisted companies it must come up with a strategy to make sure that the AIFs are complying with this requirement and maintaining the expected ratio.

V. UNDERSTANDING THE PRACTICAL WORKING OF AIFS VIS-À-VIS REAL ESTATE SECTOR

A. Dismal Picture of the Real-Estate Sector

Real-estate projects totalling to 5.76 lakh units in the top seven cities in the country, which were either started in 2013 or before are supposed to be struck in various stages of non-completion.[77] According to statistics supplied by ANAROCK, a real estate services company in India, real estate projects worth ₹1.77 Lakh crore are pending in the top 7 cities in India.[78]

Presently, with approximately 4,00,000 units, the Mumbai Metropolitan Region (MMR) and National Capital Region (NCR) [2,10,000 and 2,00,000 respectively] tops the list of stalled projects. These

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[77] Virendra Joshi et al., *Addressing Challenges & Progressing Ahead in REAL ESTATE*, ANAROCK (Jan. 13, 2019, 10:15 PM), https://api.anarock.com/uploads/research/Addressing%20Challenges%20&%20Progressing%20Ahead%20in%20Real%20Estate.pdf.

[78] Kailash Babar, *Total 5.6 lakh housing units delayed across India's top 7 cities: Report*, THE ECONOMIC TIMES (Dec. 3, 2019, 8:05 AM), https://economictimes.indiatimes.com/industry/services/property-/-cstruction/total-5-6-lakh-housing-units-delayed-across-indias-top-7-cities-report/articleshow/68784014.cms?from=mdr.

projects in the MMR and NCR regions are valued at Rs. 3,60,000 crore (Approx.).[79]

Notably, the NBFCs act as a prominent source of funding for the realty projects in India. Henceforth, as a result of collapse of IL&FS, the real-estate sector is struggling to find capital to meet its requirements to complete its stalled projects.

1. Possible reasons for its deplorable condition are:[80]

a) *Almost Negative Rate of Investment*: There has been a significant drop in the rate of investment in the residential real-estate sector, from two to three digit value to a low single-digit with a negative return in certain places in the last decade.

b) *Slowdown in the Economy*: This has to necessarily deal with employment generation and job security in the country. In such times, cash-conservation becomes a crucial aspect in a country wherein its people are uncertain with their jobs or securing new jobs.

c) *Uncertainty in Under-construction Properties*: The principle of cause and effect has a direct relation when it comes to low homebuyer sentiment which is leading to the heavy backlog of delayed and half-

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[79] Koustav Das, *Explained: Will govt's Rs 25,000 crore boost help revive ailing real estate sector?*, INDIA TODAY (Dec. 3, 2019, 8:02 AM), https://www.indiatoday.in/business/story/real-estate-sector-stress-fund-rs-25000-crore-will-it-be-enough-to-revive-ailing-sector-1616512-2019-11-07.

[80] Larissa Fernand, *10 Reasons why Real Estate Sector is in a Slump*, MORNING STAR (Dec. 3, 2019, 8:05 AM), https://www.morningstar.in/posts/54373/whats-causing-slow-real-estate.aspx.

constructed projects in the market. Notably, these under-construction homes were once the first choice of the Indian homebuyers' owing to its competitive prices.

d) *The evil named 'demonetization' eliminated the Cash Component*: For the past many years, real estate has been one of the most preferred areas for parking unaccounted money, that is, black money. Cash component was indeed a significant factor which drove this market, which ultimately got struck by the infamous move of demonetization by the Government.

B. The Recent Move of the Government to Infuse Fund via AIF

The Finance Minister on November 7, 2019 announced that the Government will pump-in Rs 10,000 crore into an Alternative Investment Fund (AIF) with a further contribution of Rs 15,000 crore by the LIC and SBI.[81] This fund is established to focus on the revival of real-estate sector. Experts consider this emergency fund "critically important" in the light of the fact that it will serve the twin of purpose, of the developer in completing the project and of the homebuyers awaiting the handover of their completed houses.[82] The key features of this fund are presented below:

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[81] Madhurima Nandy, *FAQs on government's special fund for real estate sector*, LIVEMINT (Dec. 3, 2019, 8:05 AM), https://www.livemint.com/news/india/faqs-on-government-s-special-fund-for-real-estate-sector-11573129003057.html.

[82] Das, *supra* note 79.

1. Structure

The fund is set-up under the Category- II AIF debt fund registered with SEBI. The role of 'sponsor' is to be carried by the Government and it shall invest Rs 10,000 crore into the fund. In view that this is the first AIF under the 'special window', the responsibility of 'investment manager' has been granted to SBICAP Ventures Limited. The investments in this fund are primarily intended to be structured in the form of non-convertible debentures taking into consideration the legal and regulatory aspects. The returns are supposed to be fixed by the investment manager subject to the risk profile and specifications of each project.

2. Size

With a commitment by the Government to infuse Rs 10,000 crore in the fund for the affordable and middle-income group housing sector via a 'special window', the fund expects matching contributions from the LIC and banks such as SBI amounting to Rs 15,000 crore which in the end would sum up to a total of Rs 25,000 crore.

3. Criteria

For the purpose of funding, certain criteria are laid down below:

- Where the project is stalled on account of lack of required funds
- The projects must be in the affordable and middle-income category

- Projects with net worth positive (including projects covered under NCLT proceedings and NPAs)
- Registration under RERA, 2016
- Projects which are 70% close to completion.

4. Monitoring

The stalled projects are expected to get fuel (capital) through the mechanism of this 'special window'. For ensuring that the funds are being utilized only for the purpose of completing the projects, its responsibility is cast upon the investment manager and the developer or the appointed project manager. Stipulations laid down by RERA vis-à-vis standard financial controls will be adopted.

5. Funding Process

After receiving the inputs from external due diligence bodies, the investment manager shall prepare an exhaustive investment review. The contractual arrangement with the developers would include the monitoring mechanism for funding and approval of investment therein. Only after the completion of documentation, the disbursement is to start.

6. Projects which are pending and are before the NCLT

In order to select projects for funding, the government has broadened its scope by also including NPAs and projects under the NCLT proceedings. However, these projects must be at a stage where the resolution plan has neither been accepted nor rejected by the Committee of Creditors. Notably, the projects pending before the High Court and Supreme Court excluded from the purview of this fund.

C. Analysis: Overall Benefit of the Real Estate Sector

In the words of an Industry exert, the fund size is insufficient to tackle the mammoth problem of stalled projects but will indeed serve as a "lubricant to ignite the vehicle that had been jammed."

The fund is only a fraction of total worth of the unfinished realty projects in the country's top seven cities and according to estimates it will cover 6% of the total stalled projects, but taking into consideration the move by the Government, other sovereign and pension funds have consented to pull the real estate sector out of crisis. Even if the estimated number of projects is revived, the circulation of money will start which will ultimately benefit all the developers in the market.[83]

Therefore, although the special window is created for the purpose of reviving affordable and mid-income category but minimizing the stress of developers in this category will indeed have an indirect collateral benefit to the entire sector including the luxury segment.

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[83]Abhijit Chowdhury et al., *Govt's Rs 25,000 crore realty fund can only help 6% of stalled constructions*, THE ECONOMIC TIMES (Dec. 3, 2019, 8:20 AM), https://economictimes.indiatimes.com/industry/indl-goods/svs/construction/govts-rs-25000-crore-realty-fund-can-only-help-6-of-stalled-constructions/articleshow/71953143.cms?from=mdr.

VI. REDEFINING THE ROLE OF SEBI VIS-À-VIS ALTERNATE INVESTMENT FUND

A. Risks Attached to AIFs

AIFs differ from traditional investments like stocks, bonds as they have higher fees and are comparatively more volatile. They have very high minimum ticket sizes and the tax efficiency is really low. Also, since they provide an opportunity of higher return, the scope of risk increases. Additionally, AIF generally invest in illiquid assets thus making exit difficult. AIF's do not generally declare portfolios therefore they are less transparent.[84]

Since AIFs invest in varied directions, it provides wider opportunities but also exposes the investors to the decisions of the fund management team which might be wrong and bring loss to them. Without a healthy "stop-loss strategies or hedging strategies"[85], the difference between gross returns and net returns in an AIF could be as high as 40% to 50%.

B. Steps to Be Taken By SEBI/ Role of SEBI

SEBI is gradually becoming more professional and proactive in dealing with AIFs and foreign investment into India. A number of meetings have been conducted by SEBI with the venture capital industry

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[84] Aniruddha Bose, *The Pros And Cons Of Cat 3 AIF's,* BUSINESS WORLD (Dec. 9, 2019, 10:42 AM), http://www.businessworld.in/article/The-Pros-And-Cons-Of-Cat-3-AIF-s/17-08-2018-158047/

[85] *Id.*

body, advisors, and a leading credit rating agency to decide upon the ways to increase transparency in AIFs.

1. Increasing Transparency

a) As in the current reporting system the AIFs divulge very less information, to increase transparency SEBI can take steps that may require the AIFs to disclose information regarding net asset value, performance numbers and fees and historical data in order to increase awareness among the investors.

b) A classified private document (private placement memorandum) can be made available to the investors to inform them about some essential details.[86]

2. Creating provisions for special rights in some cases

a) There can be provisions for presenting certain discretionary terms to some sophisticated external investors who are provided with some special rights.

b) There can also be a provision to allow large institutional investors with more information regarding the fund than individual investors.

[86] Sugata Ghosh, *Sebi nudges AIFs to make more disclosures for better transparency*, ET MARKETS (Dec. 9, 2019, 10:42 AM), //economictimes.indiatimes.com/articleshow/69884129.cms?from=mdr&utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst.

3. *Ensuring that the fund is credible and trustworthy*

a) SEBI can take steps for developing a benchmark that can evaluate the performance of AIFs and rate them accordingly.

b) It can also take measures to oversee the source of funding of an AIF so that the investor's money is not misused.[87]

4. *Creating platforms for registration of complains against false tips*

a) For cases where investors lose money on receiving tips through email or SMS, a particular number or email can be created where the complains regarding these tips can be registered to SEBI.

b) Also, ids can be created on social media platforms where such tips can be forwarded and SEBI can act on such complains without waiting for a formal complaint.[88]

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[87] Ashley Coutinho, *SEBI may tighten AIF regulations to better monitor the source of funding*, BUSINESS STANDARD (Dec. 9, 2019, 10:42 AM), https://www.business-standard.com/article/economy-policy/sebi-may-tighten-aif-regulations-to-better-monitor-the-source-of-funding-118022200265_1.html.

[88] Narendra Nathan, *How Sebi can control 'tips' on social media*, ET MARKET (Dec. 9, 2019, 10:42 AM), //economictimes.indiatimes.com/articleshow/57178093.cms?from=mdr&utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst.

C. Changes in Regulations

1. Recommendations by the Alternative Investment Policy Advisory Committee in its 3rd Report are:

a) For the promotion of IFSCs with regard to AIFs:

i. Subject to sufficient safe guards like additional reporting requirements and private placement of fund unit only with credited investor, the Report recommended providing relief in the form of lowering the maximum leverage for IFCS-domiciled AIFs.

ii. Issuance of a circular with respect to the circular issued by SEBI on 1st October, 2015 to clarify that the AIFs in IFSC do not require the authorization of SEBI or RBI to invest outside India.

b) Regarding Income Tax Act, 1961

i. The income of a foreign investor earned by investing outside India through an IFS fund should be exempted from payment of tax.

ii. Foreign investors in an AIF in IFSC should be exempted from acquiring PAN number and filing return of income except when they earn any other income from India.

c) GST-Related Recommendations

i. Management and other services should be exempted from paying GST.

ii. The liability of paying GST on directors contingent upon default made by a private company should not be advanced to the nominee/non-executive directors, particularly when they are appointed by AIFs.

d) Suggested New Tax Code for Listed AIFs

i. While interest for the domestic investors are taxed at their respective tax rates, the foreign investors should be taxed at 5%

ii. Tax on dividend should be exempted in the hands of the investor.

Few others recommendations were provided in the Alternative Investment Policy Advisory Committee (AIPAC) 3rd report along with some Important Pending Recommendations from Previous AIPAC Reports.[89]

2. Other probable amendments

a) *Investors' consent*: The Regulation requires 75% of the investors assent for any change to be implemented in the fund, however, it very often happens that a change is rejected because all the investors are not available to vote even if the ones voting are all in favour of the change, hence, the Regulation could be amended to allow changes if 75% of the members present and voting agree to the change.

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[89] AIPAC, *3rd Report submitted by Alternative Investment Policy Advisory Committee*, SECURITIES AND EXCHANGE BOARD OF INDIA (Dec. 4, 2019, 5:25 PM), https://www.sebi.gov.in/reports/reports/jan-2018/3rd-report-submitted-by-alternative-investment-policy-advisory-committee-_37460.html.

b) *Investors' consent for the change of manager*: SEBI requires 75% of the investors assent for changing the manager. Thus, the Regulation must clarify that unless the manager makes any contract that specifically asks for the approval of each investor for such removal or the private placement memorandum states so, the change shall be implemented.

c) *Tax liability at the time of winding up*: The regulation must clarify that at the end of the tenure of the fund, the company, LLP or the trust will not be considered wound up unless all its tax liabilities are fulfilled or the limitation period is over. The fund will only cease its operation after the completion of such tenure.

d) *A permanent capital vehicle* ***(****PCV****)*****:** A comparatively new concept, PCV can allow the availability of capital over an unlimited period. This would remove the liability of liquidating the fund's portfolio at the end of its tenure.[90]

VII. SUGGESTIONS AND RECOMMENDATIONS

Few suggestions that the Government could work on to improve and increase the scope of AIF in India are:

a) Syncing its policies regarding AIF involving foreign investors with the economically developed countries to attract more investments;

[90] Vinod Joseph & Deeya Ray, *India: SEBI's AIF Regulations 2012 - A Few Tweaks Required*, MONDAQ (Dec. 9, 2019, 10:42 AM), http://www.mondaq.com/india/x/859964/Securities/SEBIs+AIF+Regulations+2012+A+Few+Tweaks+Required.

b) Adopting certain rules and norms regarding AIF from other countries with high rate of investment through AIF;

c) Forming strict laws to curb the scope of fraud or negligence that may lead to loss to the investors, thus, increasing the confidence and trust of both foreign and domestic investors;

d) Forming simple and attractive tax regime for foreign investors, widening the scope of AIFs in India.

e) To increase the confidence in investors, the AIFs could be made to reveal not only their financial details but also their process of decision making and other details like process of entry and exit of investors, the records of previous returns.

f) Disclosure of objectives of the fund can also increase the ease of investment.

VIII. CONCLUSION

India is a developing country with a Government that is laboriously concentrating on making India a hub of international business by gradually increasing the convenience of transacting with the country. To achieve this goal the policies need to be abreast with the global infrastructure and a rich economy is needed for the same. Investment is an important source of capital flow in India and an essential part of India's GDP. A major source of growth, investment produces profit for several years by enhancing operational efficiency and promoting innovation.

Presently, with many amendments and clarifications the regulatory framework for AIFs has developed a regime that has strengthened the scope of AIF in India. However, few ambiguities and lacunae need to be addressed to provide a more flexible structure for this avenue of investment to grow. The current data as discussed in the paper shows that the AIF sector, both domestic and foreign, will only grow in the future and the Government must make India ready to make maximum gains from the same.

SEBI'S JURISDICTION TO DECIDE AUDITOR'S LIABILITY IN LIGHT OF THE *PRICE WATERHOUSE & CO.* ORDER OF 2019

- Binny Kumari[*]

ABSTRACT

The Securities and Exchange Board of India (SEBI) cannot adjudicate any matter unless the question as to its jurisdiction is decided on merits. A similar question arises while initiating a proceeding against Auditors to protect the interest of investors under section 11 of the Securities and Exchange Board of India Act, 1992. As per section 11(2)(b) of the Act, the SEBI has power to take measures against intermediaries associated with securities market in any manner. The aforesaid section provides the right to the SEBI to take remedial action against certain persons/entities to protect the interest of investors. To hold any auditors liable, it is necessary to determine whether they are covered under section 11 of the Act or not. Even if the auditors are included under the very section, can the SEBI encroach upon the power of Institute of Chartered Accountants of India (ICAI) that is a statutory body established by the Chartered Accountants Act, 1949 to pass an order against any auditors? In 2019, Special Appellate Tribunal (SAT), while deciding an appeal filed against the order of the SEBI against Price Waterhouse and Co., held that Auditors' gross negligence amounts to professional misconduct and is within the jurisdiction of the ICAI. While holding so, the SAT relied upon Bombay High Court (HC) judgment of 2010 where HC held that where there is an omission, not having the element of mens-rea, then the SEBI does not have any jurisdiction under section 11 of the SEBI Act. In case of *Bharjatiya Steel Industries v. Commissioner, Sales Tax, UP*,[1] it was held that if

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[1] Bharjatiya Steel Industries v. Commissioner, Sales Tax, UP, (2008) 11 SCC 617.

any discretion is vested in the authority while imposing penalty then intention of the legislature is always that mens-rea should be proved beyond a reasonable doubt. SAT also said that the directions by SEBI under these cases, were remedial and not punitive, and hence require mens-rea to be proved beyond a reasonable doubt. In this paper, the author deals with the question of jurisdiction of the SEBI to initiate proceedings against auditors, and whether such proceedings are civil or quasi-criminal, because, mens- rea is not required to be proved in criminal cases.[2] The author will also look at the requirement of *mens-rea* laid down in a recent SAT order, keeping in mind Bombay High Court Judgment.

I. INTRODUCTION

Price Waterhouse & Co., a limited liability partnership firm in India registered with the Institute of Chartered Accountants of India (hereinafter '**ICAI**') was assigned with the task of auditing Satyam Computers Services Limited (hereinafter '**Satyam Computers**'). In the year 2009, the Securities and Exchange Board of India (hereinafter '**SEBI**') came to know through an email sent by the Chairman of Satyam Computers that the statements of the books of accounts of Satyam Computers for year 2000-2008, was not fair and true. SEBI, after conducting investigation issued a Show Cause Notice (hereinafter '**SCN**') Satyam Computers as to why directions under the Securities and Exchange Board of India Act, 1992 (hereinafter '**the SEBI Act**') was not to be issued against PWC. Against this SCN, writ petitions were filed by Price Waterhouse and some of its partners before the Bombay High Court. In brief, Bombay High Court held that the jurisdiction of SEBI will depend upon proof of evidence and not on preponderance of probability. If there is an omission without *mens-rea,* it cannot trigger the jurisdiction of SEBI

[2] SEBI v. Sri Ram Mutual Funds, [2006] 68 SCL 216(SC).

however, it can trigger the jurisdiction of ICAI in the name of 'professional misconduct'.

This paper deals with the question of the jurisdiction of SEBI through a critical lens. Firstly, it is important to know whether SEBI has been vested with the power under section 11 of the Act to initiate proceeding against Auditors. And, if yes, then does it encroach upon the power vested with ICAI or are they in addition to those covered under the Chartered Accountants Act, 1949? Because, there is a specific Act[3] to regulate the behaviour of Auditors.

The direction given under section 11 of the Act is remedial in nature and in such cases a discretion is vested with SEBI to pass or not to pass an order against Auditors. However, the Supreme Court Held in a case that if an authority has discretion while imposing penalty, then *mens-rea* must be proved. This is because the intention of legislature is not clear through a plain reading of the statute.[4]

SEBI in 2018 passed an order against Price Waterhouse stating that there is no necessity to prove *mens-rea* while holding the aforesaid Auditors liable and passed some stringent orders against them. However, an appeal had been preferred Price Waterhouse against the said order of SEBI. The Special Appellate Tribunal (hereinafter '**SAT**') while deciding the appeal in 2019 held that *mens-rea* must be established. And if there is

[3] Chartered Accountants Act, 1949, No. 38, Acts of Parliament, 1949 (India).
[4] Bharjatiya Steel Industries v. Commissioner, Sales Tax, UP, (2008) 11 SCC 617.

an omission without *mens-rea* then it can be challenged before ICAI in the name of professional misconduct.

Again, the order of SAT is not final in nature and an appeal can be made by SEBI to the Supreme Court of India. And, we can observe a shift in the idea as to the requirement of *mens rea* while holding Auditors liable under SEBI Act, 1992.

II. POWER OF SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI) TO INITIATE A PROCEEDING AGAINST AUDITORS UNDER SEBI ACT, 1992

Unless the jurisdiction of SEBI is decided, SEBI cannot adjudicate any matter on merit. SEBI can only come up with a direction for regulating securities market and not anything more. However, the matters relating to scams that relate to the shares of the company, creates cascading impact on the securities market.[5] It is very hard to believe that such a scam could have gone unnoticed by the Auditors of the Satyam Computers. Under the SEBI Act, the primary function of SEBI is to regulate the security market and, has the power to take preventive steps to protect the interest of investors. The Auditors are required to take due care while certifying the accounts and balance-sheets of any company because people dealing in the securities market largely depend upon these documents while deciding financial health of that company.[6] Even though,

[5] Ravi Kadam, the learned Advocate General appearing for the respondents in Price Waterhouse & Co. v. SEBI, W.P. Nos. 5249 & 5256: 2010 SCC OnLine Bom 1197.
[6] Companies Act, 2013, No. 18, Acts of Parliament, 2013 (India), § 277.

the power of Institute[7] and SEBI are very different, if any misconduct is found in connection with auditing of a listed company, SEBI may take appropriate steps for safeguarding the interest of the investors of such companies. When Auditors act as trustees of shareholders, it cannot be said that there is no relation between investors and Auditors in any manner. Here, the Auditors are statutory Auditors and are required to give a true picture as to the affairs of the company in accordance with the prescribed auditing guidelines.

1. *SEBI's power to issue direction against Auditors under SEBI Act, 1992.*

In order to decide the power of SEBI to issue direction against Auditors, it is necessary to have a glimpse of various relevant provisions of the Act.[8]

The SEBI Act has been enacted with the main aim to:[9]

1. Provide for the establishment of a Board for the protection of interests of investors dealing with securities;
2. for the protection and regulation of securities market; and
3. for matters connected therewith or incidental thereto.

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[7] *Means Institute of Chartered Accountants of India as established under* The Chartered Accountants Act, 1949, No. 38, Acts of Parliament, 1949 (India).

[8] Securities and Exchange Board of India Act, 1992, No. 15 of 1992, Acts of Parliament, 1992 (India).

[9] Securities and Exchange Board of India Act, 1992, No. 15 of 1992, Acts of Parliament, 1992 (India), Preamble.

On a plain reading of the provisions of Act[10] along with the preamble, it discloses the ambit of power vested with SEBI that should be enjoyed by it for the benefit of the investors. Therefore, SEBI can take any measures mentioned under Section 11(2). However, the said provision is only illustrative and not exhaustive and SEBI has the duty to "take such measures as it deems appropriate". Hence, one can fairly say that the scope of provision is wide enough to include an Auditor, i.e. if his activities are detrimental to the interest of investors.

Section 11(2)(b) includes the term "such other intermediaries associated with the securities market". Therefore, measures under Section 11(1) may be for registering and regulating these intermediaries. Though a duty has been casted upon Auditors to take measures to protect the interest of investors as it falls under the ambit of section 11 (2) (b) of the SEBI Act. SEBI, after considering the duty it is given under the statute, may take such measures as it deems appropriate. The words mentioned in the aforesaid provision are of wide scope and would therefore include, within its umbrella, a chartered accountant if its activities are contrary to the both, the investor's interest and the securities market.

While exercising power under the very Act, SEBI cannot encroach upon the power vested with the Institute.[11] But, it is also important to note whether SEBI is trying to overreach its jurisdiction substantially or not. SEBI has powers to take remedial measures. An appropriate order can also

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[10] *Supra* note 5.
[11] *Supra* note 1.

be passed in the interest of investors.[12] An appropriate direction can also be passed to any person or class of person mentioned under section 12 or associated with the securities market.[13] Bombay High Court in its judgment in *Price Waterhouse & Co. v. SEBI*,[14] also held that section 11(1) of the SEBI Act empowers SEBI to enquire into and also to initiate proceedings in the matters like one in the question. In *SEBI v. Pan Asia Advisors*,[15] it was held that the paramount purpose on one hand is the protection of investor's interest and development of market on the other, "since the auditors issue audit reports for listed companies, amongst others, SEBI being the watch-dog of the securities market is entrusted with powers to go after intermediaries in the interest of the investors".

III. REQUIREMENT AS TO *MENS REA*

Now it is well settled that the SEBI has the power to encroach upon the power of Institute[16] in the interest of investors. And it can hold the Auditors liable. However, can the Auditors be held liable in all the circumstances or is there some test to decide their liability? Some say that *mens-rea* is important to be proved while holding an Auditor liable. However, the position is still not settled. This paper attempts to explain the requirement of *mens-rea* through a series of cases.

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[12] *Supra* note 5, § 11(4).
[13] *Supra* note 5, § 12B.
[14] Price Waterhouse & Co. v. SEBI, W.P. Nos. 5249 & 5256: 2010 SCC OnLine Bom 1197.
[15] SEBI v. Pan Asia Advisors, (2015) 14 SCC 77.
[16] *Supra* note 4.

It was held in *SEBI v. Sri Ram Mutual Funds*,[17] that if there is contravention of the statutory obligation as contemplated by the Act and regulations, then penalty is attracted and consequently, the intention of parties is immaterial. A breach of civil obligation that attracts penalty does not require innocence to be proved before the imposition of penalty. In the present case,[18] the Supreme Court has examined section 15-D(b) and section 15-E of the Act and said that there is nothing that is required for *mens-rea* to be proved before imposition of penalty. In another case, SC held that where there is a discretion not to award any penalty, the question of *mens-rea* becomes relevant.[19] However, it has been observed that the Supreme Court in *Bharjatiya Steel Case* does not state anything contrary to the *Sri Ram Mutual Funds Case.*[20] The statute where no discretion is conferred upon adjudicating authority, *mens-rea* is imperative and are not required to be proved. The reason may be that various market players can plead ignorance of law and *mens*-rea to escape from liabilities. Unless the language of the statute suggests the discretion to be enjoyed by the adjudicating officer while levying penalty, it is wholly unnecessary to prove intention. Therefore, it becomes clear that necessity to prove *mens-rea* depends upon the wording of the statute. Imposing *mens-rea* into provisions mentioned under Chapter VIA of Act[21] is against the plain language of the statute and can frustrate the entire purpose to give tooth to SEBI.

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[17] SEBI v. Sri Ram Mutual Funds [2006] 68 SCL 216(SC).
[18] *Id.*
[19] *Supra* note 4.
[20] Adjudicating officers SEBI, *Inland printers limited case*, 2017.
[21] *Supra* note 5.

IV. UNDERSTANDING THE REQUIREMENT OF *MENS REA* THROUGH RECENT SAT ORDER IN PWC CASE IN LIGHT OF THE BOMABAY HIGH COURT'S JUDGMENT, 2010.

In the year 2019, SAT, while deciding the legality of SEBI's 2018 decision wherein it banned audit firm Price Waterhouse, based and restricted its enquiry only on the grounds of fraud and conspiracy and not on preponderance of probability. This led to the questioning of the findings of the Whole Time Members (WTM) of SEBI in year 2018, of misconduct, where it held that gross negligence inferred the fudging of accounts of Satyam. And the Act[22] and Regulations[23] did not consider *mens-rea* as an essential element to be proved.

Whole Time Members held that:

1. Entities or firms that are practicing as CA and are associated with Price Waterhouse shall not be engaged with issuance of any certificate, in any way, of audit of companies that are listed for two years.

2. Auditors[24] will not issue a certificate of audit or compliance certificate for three years.

3. Both the individual Auditors shall jointly and severally disgorge the wrongful gain along with the interest of 12% p.a.

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[22] SEBI (PFUTP) Regulations, Gazette of India, pt. II sec. 4, 2003.

[23] Individual Auditors, namely, S. Gopalakrishanan and Srinivas Talluri, shall not issue an audit certificate or any certificate of compliance with respect to a listed company for a period of three years.

[24] For the duration of 2000-07, the engagement partner was S. Gopalakrishnan and for 2007-08 was Mr. Srinivas Talluri.

4. Companies and intermediaries that are listed and are registered with SEBI will not engage any audit firm associated with Price Waterhouse network for the issue of any certificate to ensure compliance of provisions under various laws for a duration of exactly two years.

1. The Bombay High Court's Judgment, 2010

The issue giving rise to this appeal was that the company was assigned with the task of audit of Satyam Computers Services Limited (SCSL). The two engagement partners were employed for the purpose.[25] SEBI received an email disclosing that the entries in the books were not fair and true. SEBI after conducting an investigation issued a Show Cause Notice by exercising its power under the SEBI, Act, 1992. Against this SCN, writ petitions were filed in Bombay HC by Price Waterhouse and other CA firms along with their partners alleging that the SEBI is not empowered to issue SCN as the appellants are CA professionals covered under the ICAI Act.[26]

2. Jurisdiction of SEBI under SEBI Act,1992

As discussed earlier, SEBI has the jurisdiction to initiate proceedings against the Auditors in the interest of investors and the same has been supported through the interpretation of various provisions of the Act. However, such power comes with a caveat, that evidence on record should establish the question as to "jurisdictional fact", before SEBI exercises any kind of jurisdiction under the under the Act against

[26] *Supra* note 18.

Chartered Accountants.[27] The jurisdiction will purely depend upon the availability of evidence during enquiry. The court concluded that if no evidence will be available as to falsification, SEBI cannot come up with any direction.[28]

3. *Question of 'mens-rea'*

It was held that if any omission was not supported with *mens-rea*, then SEBI cannot issue any further direction. SEBI being a quasi-judicial body, has the power to look into the matter and decide whether any Chartered Accountants or particular firm plays any role to attract the attention of SEBI.

4. *SEBI's order 2018*

The finding of SEBI[29] was that *mens rea* is not relevant in criminal cases and is not required to be proved either under PFUTP Regulation or SEBI Act.[30] Thus, reliance on the judgment of the Bombay High Court was unnecessary by the applicants. The failure to ask for external confirmation of the fixed deposits, bank balances, and so on, without following requisite procedure as mentioned under Accounting Standards draws an inference as to gross negligence and accounts fudging. And in such cases *mens-rea is* not important to be proved. Under the PFUTP

[27] *Id.*
[28] *Id.*
[29] *Id.*
[30] SEBI v. Kanaiyalal Patel, (2017) 15 SCC 1.

Regulations, Fraud includes an omission without deceit also if it has the effect of inducing another person to deal with securities.[31]

5. SAT order 2019

SAT while deciding the issue largely relied upon the Bombay HC judgment of 2010 and held *mens-rea* should always be proved to hold an auditor liable under the SEBI Act. Therefore, court restricted its enquiry only under the head of fraud and conspiracy and did not include *mens - rea*. Because if there is no *mens-rea,* SEBI does not have the jurisdiction and it falls under the domain of ICAI.

Even though, PFUTP regulation applies only to the person who deal in securities, its applicability can extend to persons who either directly or indirectly, are associated with securities market. Admittedly, it includes Auditors also and, in order to make them culpable, fraud is needed to be proved on the production of evidence. If there is gross negligence while complying with AAS *(Accounting Standards)*, it can only point to professional negligence and such misconduct can only be taken by ICAI.[32] The SEBI, as a regulator does not have any authority under SEBI laws.[33] Thus, all the powers given to SEBI under Sec. 11 and 11B are there to protect the investor's interest, development and regulation of market. Hence, measures to be adopted by SEBI is only remedial and never punitive. Creating an entry barrier while entering the market can be justified, however, banning them from practice of audit activities can

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[31] *Id.*
[32] Price Waterhouse & Co., Appeal No. 6 of 2018, SAT Order (2019).
[33] *Id.*

never be justified.[34] The order of SEBI was neither preventive nor remedial. Actually, it was in violation of Article 19(1)(g) of the Constitution of India and hence can be challenged before Supreme Court as a writ.

Another very important point made by SAT in 2019 was that the partner firms were not Auditors that are statutory in nature and not in any way engaged in audit of the books of Satyam Computers. Any evidence of sharing of revenue between them were also not available. Misconduct committed by one partner can never be held as liable as there is no *mens-rea,* Auditors cannot be held as responsible. Even though professional negligence is evident on the part of auditors, it only triggers the jurisdiction of ICAI as they failed to comply with minimum degree of care.[35]

V. CONCLUSION WITH SUGGESTIONS

After the above discussions, it is evident that the term 'any other person' under section 11 includes Auditors also. And therefore, SEBI has the jurisdiction to pass an order against them in the interest of the securities market and investors attached to it. SEBI can encroach upon the powers of ICAI only when interest of investors is involved subject to proof of evidence. Bombay High court has clearly laid down that SEBI has power to initiate a proceeding against Auditors.

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[34] *Id.*
[35] *Id.*

It has also been shown in the present paper that *mens-rea* should be proved only in cases where discretion it vested with the authorities while imposing penalty. In wholly criminal cases, no discretion is vested with the authorities. But the power vested with SEBI, under section 11 are remedial and not punitive, it is quasi criminal in nature and requires *mens-rea* to be proved beyond a reasonable doubt. Where there is a scope for discretion, legislature intends for the proof of innocence.

Therefore, the recent SAT order clearly mentioned that SEBI in its order against Price Waterhouse & Co., was wrong while classifying this case as a criminal one and holding that *mens-rea* is not an essential requirement. While doing so, it went against the findings of Bombay High Court in year 2010. Therefore, SAT, sat aside the order of SEBI while holding that *mens-rea* needs to be proved to trigger the jurisdiction of SEBI. And, if it is not proved, it will only amount to 'professional misconduct' and will be enquired by ICAI.

It is very difficult to determine whether discretion is vested in authority or not because even though section 11 is remedial in nature but Chapter VIA of the SEBI Act provides for imposition of penalty in cases. And interpretation of Chapter VIA makes it clear as a whole that Auditors are also covered. Therefore, there is no clear test as to the proof of innocence and that is why the decision of SAT can also be challenged before Supreme Court.

In the year 2009, five-member disciplinary committee of ICAI took first step towards disciplinary action against the two partners of

Satyam Computers who were involved in the scam. A case was registered against the partners and information was sought against the firm.