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# Report of the Working Group on Conflicts of Interest in the Financial Sector

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# Chapter 1

# Executive Summary

## Chapter II

**Conflicts of interest in the Financial Services Industry – A growing concern**

**Basics of conflicts of interests (Introduction, Sections I and II)**

a) Exploitation of conflicts of interest has been found to be, at or near the centre of scandal-driven financial storms in recent years. Consequently, the still continuing epidemic of corporate fraud has pushed issues relating to conflicts of interest, particularly in the financial services industry due to its inherent vulnerability, to the mainstream of public discourse, the world over.

b) Certain basic, simple and profound home-truths, that the *terra firma* of all business activity is the human society and that such social underpinnings nurture and thrive on the bedrock of trust, which in turn, is paramount in safeguarding sustainable long-term business interests, seem to have been all but forgotten, if the continuing saga of corporate misdemeanours is any indication.

c) Globalisation has hastened the process of financial convergence – both domestically and internationally. Remarkable innovations in Information and Communication Technology (ICT) have led to a blurring of boundaries between the different sub-sectors of the financial system and the emergence of financial conglomerates.

d) Financial conglomerates / superstores represent the most prominent institutionalization of the convergence in the financial sector. They offer multiple products and services through multiple delivery channels, to customers under one roof; primarily, to take advantage of the synergies of economies of scale and scope.

e) While potential conflicts of interest have been there all through history and are inherent in all economic activities, they tend to be more in the case of financial conglomerates. The seemingly all-powerful presence of financial lure has put a premium on exploiting conflicts of interest for selfish reasons.

**Issues in principal-agent relationship (Section III)**

f) The agency theory provides a lens for examining conflicts of interest situations. All professionals – doctors, lawyers, bankers, etc., play a dual role of being the principal and an agent to their customers, in the discharge of their functions. For instance, financial intermediaries simultaneously act as an agent of the customer when they provide the diagnosis to their finance related problems and as a principal in executing with the customer the prescribed action.

g) Financial intermediaries, as such, fall under the category of classic principal-agent relationship with their customers. In the course of performing such agency functions, the principals expect financial intermediaries to act as faithful agents. A faithful agent is one who does not engage in the dissemination of disinformation or withhold proper information.

h) Financial services come under the category of 'experience and credence goods'; entailing that experience becomes the foundation of establishing credence / credibility.

i) All markets, including financial ones, suffer from problem of Information Asymmetry (IA), which is a crucial impediment in their effective functioning.

j) IA leads to the twin problems of adverse selection and moral hazard. Both these terms have originated in the insurance literature.

k) Adverse selection is caused due to hidden information, leading to a situation where some of the good proposals may get rejected, while the relatively not so good ones get accepted. For example, businesses with relatively less inherent merit / managers with ulterior motives, are likely to be most eager to raise funds.

l) Moral hazard arises out of hidden actions. For instance, if the business is not doing well, there may be an inclination to have an accident (a fire). Not taking appropriate care was thought to be “immoral,” and hence the name.

m) Conflicts of interest situations can also be explained in terms of incentive-related problems. A modern corporate entails a co-operative process, which brings together, a large number of players with a variety of interests, for primarily producing value to the shareholders. It is but natural, for such a situation, to provide tremendous potential for numerous conflicts of interest, in the sense of individuals placing their personal interests, ahead of those on whose behalf they are working.

n) Due primarily to the corporate structure, it is often difficult to make sure that the agent does what he is supposed to do and because of the failure to align incentives properly, it is often the case that he does not.

o) It has been recognized that in almost all the recent corporate scandals, incentives got badly misaligned. Consequently, the CEOs and Top Management acting in their own interests, did not serve well those they were supposed to be working.

**Regulator’s interest in conflicts of interest (Section IV)**

p) Illegal nature of conflicts of interest, public policy argument, controlling the major externalities in the financial services industry viz., like information asymmetry, imperfect alignment of interests in the principal-agent relationships of the financial intermediaries; which in turn may lead to market crises / failures due to loss of trust, are among the more important reasons for regulators to care about conflicts of interest.

**Trends in Indian financial services sector (Sections V and VI)**

q) Indian financial sector is marked by increasing sophistication and maturity with growing inter-faces and inter-relationships among various players across all the segments, on a continuing basis. This is mainly due to ICT enhanced institutional and networked infrastructure; increasing number of private sector players in all the three segments of the market, actively spurring innovations in all aspects of financial intermediation; emergence of home-grown financial conglomerates; increase in the number of composite products - embedding elements of securities, insurance and / or banking products, increase in sophisticated financial instruments like various types of derivatives, securitization deals and their downstream securities; besides, greater degree of outsourcing by economic agents across all segments, leading to veritable explosion in the conflicts of interest situations.

r) With the benefit of hindsight and the results of studies on the recent scandals, which thoroughly analysed as to what went wrong in the individual cases, one can think of

suitable corrective action/s required by all the players involved. The report tries to actively draw on such experiences to draw inferences, suitable to Indian conditions.

**Chapter III**
**Concepts and Taxonomy**

a) Conflict of interests, fundamentally, represents a 'Dharma Sankat,'- an ethical dilemma.

b) Conflicts of interest arise in any situation in which an interest interferes, or has the potential to interfere, with a person, organization or institution's ability to act in accordance with the interest of another party, assuming that the person, organization or institution has a (legal, conventional or fiduciary) obligation to do so.

c) The more important of the characteristics of conflicts of interest are that they are ubiquitous in nature, represent governance issues in operational risk and arise basically out of information asymmetry and improper alignment of interests.

d) Conflicts of interest, as per their nature, can be classified as actual, perceived / apparent and potential; as pecuniary or non-pecuniary depending on whether a financial interest exists or not; individual or institutional conflicts, based on their sphere of influence; and type 1 and 2 conflicts, depending on whether they are between financial intermediaries and the customers, or among various classes of customers.

e) The interests which lead to conflicts may be pecuniary or non-pecuniary, personal / social / other competing professional interests or human emotions of greed / kinship or friendship / anger / hatred.

f) An ethical evaluation of conflicts of interest points out to the possibility that exploitation thereof constitutes a financial crime / corruption.

**Chapter IV**
**Major conflicts of interest in the Financial Sector (Section I)**

a) The closely held structures of Indian corporates – both in the public and private sectors, inhibits implementing robust corporate governance practices.

b) Major conflicts of interest in the Indian public sector arise due to multiple layering of 'principal-agent' chains, weak accountability chain and cross-holding among Public Sector Enterprises (PSEs).

c) The structure of Indian corporates comes closer to the East Asian 'insider' model, where the promoters dominate governance in every possible way.

d) Tunneling / diversion between firms in business groups, following the lines of ownership, flowing from firms near the bottom of the pyramid (where the ultimate owner's cash flow rights are weak) to firms near the top of the pyramid (where the ultimate owner's cash flow rights are strong); represents exploitation of material and pecuniary conflicts of interest, to the detriment of especially the minority shareholders and other stakeholders, in general.

**Conflicts of interest in case of Information Gatekeepers (Section II)**

e) Several types of agents like auditors, lawyers, investment analysts, rating agencies, brokers, agents, etc., have privileged access to proprietary information about the economic agents and the same flows through them to the markets and hence the name.

f) Three classes of information gatekeepers – investment banks, accounting firms and credit rating agencies are especially significant in the context of financial markets.

g) Conflicts of interest arise due to multiple roles played by these agencies. The dual roles of underwriting and research in the case of investment banks, auditing and consulting in accounting firms, and credit assessment and consulting in the case of rating agencies, are the predominant causes for conflicts of interest.

**Pan-sectoral conflicts of interest (Section III - A)**

h) Certain material conflicts of interests like dealings involving insiders, tying, misuse of fiduciary role and churning are found be pan-sectoral in nature.

**Conflicts of interests in the Securities markets (Section III - B)**

i) In the case of stock exchanges, both mutual and for-profit exchanges have their own set of conflicts of interests, which need to be effectively mitigated if they are to fulfill the SRO functions expected of them.

j) In the wholesale segment, significant conflicts of interests are in the context of tying, misuse of fiduciary role, spinning and front-running.

k) In the retail segment, churning, inappropriate margin lending, misleading disclosure and reporting embed significant conflicts of interest.

**Conflicts of interest in the Banking markets (Section IV)**

l) In the case of universal banks, conflicts of interest are of concern in the areas relating to stuffing fiduciary accounts, risk transfer in the case of non-performing assets, loans against IPOs / debenture issues and research.

m) In banking institutions, in general, conflicts are particularly intense in the functions of lending, asset management, risk management, internal control and merchant banking.

**Conflicts of interest in the Insurance markets (Section V)**

n) In the general insurance segment, conflicts of interest are observed especially in underwriting of risks, claims settlements and provisions for outstanding claims.

o) In life insurance industry, the appointed actuary system and actuarial valuation of liabilities and distribution of surplus are major areas of conflicts of interest.

p) The intermediaries in insurance markets – surveyors and loss assessors, Third Party Administrators (TPAs), agents, brokers and corporate agents - are especially prone to severe conflicts of interests.

**Conflicts of Interest in other areas (Section VI)**

q) Self Regulatory Organisations are handicapped in taking action against their constituent members, who in substance, control them. This is the most glaring conflict of interest in their functioning.

r) Financial Planning profession which is going to grow by leaps and bounds, due to the fast pace of economic growth embeds major conflicts of interests, which given our overall literacy levels may be compounded. Strict codes of ethics and conduct should be designed by the apex organization of the profession in India.

## Chapter V
## Measures adopted for mitigating conflicts of interest – Nationally and Internationally

### Measures undertaken nationally (Sections I, II and III)

a) In the banking sector, RBI has taken various steps to improve corporate governance. The more important of them pertain to composition of the Board, transparency and disclosure, related party lending and relationship with connected entities.

b) In the securities segment, SEBI under SEBI Act, 1992 has framed several guidelines which are quite detailed in scope and content with regard to corporate governance practices, disclosures, misuse of position or information available in professional capacity and dealings among associate / group concerns.

c) SEBI has also framed codes of conduct for almost all categories of intermediaries – merchant bankers, registrars to an issue and share transfer agents, stock brokers and sub-brokers, credit rating agencies, mutual funds, etc., aimed at ensuring that conflicts of interest situations are mitigated effectively.

d) As regards the insurance sector, IRDA has framed a number of regulations for the control of activities of various insurance activities / intermediaries – insurance advertisements and disclosure, insurance agents, actuaries, protection of policy holder's interests, etc.

### Measures undertaken internationally (Section IV)

e) The international community has taken significant steps for mitigating major conflicts of interest in the context of stock analysts, financial conglomerates, credit rating agencies and the auditor's role.

**f)** As regards controlling conflicts of interest among stock analysts, the Sarbanes-Oxley Act, 2002 gives sweeping powers to Securities and Exchange Commission (SEC) to control their activities. The European Union (EU) has issued the market abuse directive, revised investment services directive and in Nov, 2002 set up a Forum Group on Financial Analysts to frame recommendations on the best regulatory and market practice framework for financial analysts.

g) As regards financial conglomerates, in USA the SEC has further fine-tuned its consolidated supervised entity rules, while EU has enacted the Financial Conglomerates Directive in Jan 2005, to tackle emerging conflicts of interest situations.

h) As regards credit rating agencies, in USA, Nationally Recognised Statistical Rating Organisation (NRSRO) has initiated a number of steps to assure the independence and objectivity of the rating process. Further, International Organisation of Securities Commissions (IOSCO) has, in 2004, framed a 'Code of Conduct for credit rating agencies.'

i) As regards the role of auditors which was the foremost issue highlighted by Enron collapse, in USA a new private-sector regulatory body Public Company Accounting Oversight Board (PCAOB) has been set up to oversee the accounting industry.

## Chapter VI

## Suggested measures for mitigating conflicts of interest in the Indian financial sector

### Principles (Section I)

a) The principles for management / mitigating conflicts of interest – protecting the customer interest, supporting transparency and accountability, promoting institutional and individual responsibility and personal example and building a supportive organizational culture – should guide and underpin the development of all systems, policies and procedures in this regard.

### Measures at the individual level (Section II)

b) The primary and clinching condition to mitigate conflicts of interest situations effectively, in any type of organization, is the value-orientation of the individual; with all others measures only reinforcing and providing incentives to the ethical behaviour of such an individual.

c) As famously said, 'the greatest conflicts are not between two people / institutions / nations, but between one person and himself.' Since mitigation of conflicts of interest is an exercise in resolving this greatest internal conflict, the society including, but not limited to, parents / teachers / organizations / professional bodies, etc., should actively strive to germinate and fortify the value-orientation in an individual, constantly from a very early age.

### Measures in the context of Public and Private sectors in India (Section III)

d) In the case of Public Sector Enterprises (PSEs), governance mechanism can be improved by transferring the actual governance functions from the concerned administrative ministries to the boards and also strengthen them by streamlining the appointment process of directors. The issue of proper alignment of interests needs to be addressed, by suitably revamping the compensation and remuneration structures.

e) Alternatively, the government could also think of exercising its ownership rights through specialized agencies (trusts, SPVs, etc), to be created for the specific purpose. Such agencies should create, develop and renew the governing board so as to ensure the highest qualities of leadership, enterprise, integrity and judgment among its members. These agencies only should deal with the PSEs as an owner, so as to provide a reasonable hedge between ownership and management.

f) The process for professionalisation of directors on the lines of practices being employed in UK, Australia and New Zealand, merits serious consideration.

g) In the case of private sector, control structures should be so devised as to be consistent with the interest of share holders who are the owners, especially as control is often exercised through thin holdings and cross holding through a complex pattern of subsidiaries, companies and investment companies, with the added dimension of investments by institutions incorporated abroad.

h) The wide-ranging work of the 12 Advisory Groups (formed by RBI's Standing Committee on International Financial Standards and Codes) and the Synthesis Report prepared by the Standing Committee, outline the daunting legal and regulatory agenda necessary to improve corporate governance in India – both in the public and private sectors, which is a pre-requisite for effective mitigation of conflicts of interest.

**Measures in the context of Information Gatekeepers (Section IV)**

i) The measures in the case of important gatekeepers should be in consonance with the principles enunciated for mitigating conflicts of interests, taking into account the unique characteristic of each institution.

**Internal Measures at the institutional level (Section V)**

j) An appropriate framework for managing conflicts should be developed by each institution / profession, by which a commensurate premium / discount is placed on the ethical / unethical behaviours of the individuals or the institutions, as they may be.

k) There are detailed steps to be followed for identification, management and monitoring of conflicts of interest situations.

l) Conflict Management Policy (CMP) lies at the heart of the process relating to conflict management. CMP should, inter alia, invariably contain the ingredients of corporate governance / oversight, disclosures and transparency, separation of functions / Chinese walls, alignment of interests, organizational ethics and whistle blowing including blogging.

m) Responsibilities for conflict management lie with all the constituents – organizations, management and individual officials. The responsibility of Top Management in fostering an enabling organizational culture is paramount in this regard.

**External Measures (Section VI)**

***Role of the regulators***

n) Certain important caveats, relating to regulatory actions, need to be taken care of, ex-ante. The regulators should ensure that the policy responses are appropriate and pass the twin tests of relevance and rigour, that they do not stifle risk-taking by ensuring that while guarding against future problems of conflicts of interest, also preserve and protect those traits of financial system, which are the source of its creative and competitive genius.

o) The greatest challenge for regulators today is to be in lock-step with the market. In this context, a revamped architecture for increasing co-ordination among regulators, preferably in the form of a Joint Forum, as is obtaining internationally, could be considered seriously.

p) The revamped architecture is considered necessary since, while the Indian financial market is integrating into a seamless entity simultaneously resulting in increased sophistication and maturity, the regulators who are overseeing their functions continue to be separate, with co-ordination being still weak. This may lead to loss of valuable time in framing effective policies and strategies; to deal with emerging situations, on as real-time basis, as is possible.

q) The more important factors which are driving seamless integration, besides increasing sophistication and maturity of the Indian financial sector, inter-alia, are enhanced use of Information and Communication Technology (ICT), rise in the number of financial conglomerates – both domestic and international ones, increase in the number of composite products embedding features of securities, insurance and / banking products, greater outsourcing by economic agents across all segments, rise in new financial services like web or internet banking, wealth management, financial planning, etc.

r) All the financial regulators should strive at crafting an overarching ethical framework for financial services, as the one developed by Financial Services Authority of UK, which at the moment is not available in India.

s) The regulators, given the Indian societal conditions, also have an important role to play in public awareness and education.

**Role of the Government**

t) The government has an important role in ensuring that the politico-judicial reforms are calibrated to meet the enhanced needs of a growingly complex financial sector.

u) Defining financial crime and crafting technology neutral laws are the most imperative tasks in this context, which would go a long way in mitigating conflicts of interest, which are definitely going to grow in line with increasing sophistication and maturity of Indian financial markets.

**Role of the society and general public**

v) Financial services is too crucial an industry in a country's economy and hence, its monitoring cannot be left solely in the hands of the respective institutions and the regulators. An enlightened public, which is aware of its rights and obligations, is the best safeguard for ensuring non-exploitation of conflicts of interest by the financial intermediaries. In the Indian conditions, the government and the regulators have an important role in enlightening the public of its rights and obligations.

w) The society at large should send a strong message, through all possible means available, that pro-consumer behaviour would be rewarded, while anti-consumer behaviour would be appropriately punished, expeditiously. This would be a strong dis-incentive for all concerned with the financial world, to indulge in exploitation of conflicting interests.

**Classification and evaluation of Strategies / Remedial measures (Section VII)**

x) Depending upon their nature, all the remedial measures – whether internal or external, can be classified as non-intrusive or intrusive, along a continuum. Generally, market solutions or voluntary measures are least intrusive; while non-market solutions are more intrusive.

y) Andrew Crockett, *et al,* have suggested that answer to two questions would help in evaluating the effectiveness of the remedies –

1) Do markets have the information and incentives to control conflicts of interest? and

2) Even if the incentives to exploit a conflict of interest are strong, would a policy that eliminates the conflict of interest destroy economies of scope, thereby reducing information flows?

z) If the answer is 'yes' to either question, then the case for a policy to remedy a particular conflict of interest is substantially weakened. Putting in place such a policy would do more harm than good. Hence, the choice of policy should be tested against this touchstone, to be efficacious and least harmful in the long run.

## Chapter VII
## Concluding Remarks

a) At first sight, there would be a temptation to prescribe ever more detailed "Rules of the Road," to mitigate conflicts of interest, on realizing that they weave a web of complexity in the financial sector, given their sheer number, variety and all-pervasiveness. However, it is to be appreciated that the principles / rules enunciated are by no means substitutes for the overriding importance of the time-honoured basics of managerial competence, sound judgement, common sense and presence of a highly disciplined system of corporate governance, of which, mitigation of conflicts of interests is but an integral part.

b) While regulation should take care of all the financial entities in the system, the focus should be relatively more on universal banks and financial conglomerates / supermarkets, in the context of corporate governance in general and conflicts of interest in particular.

c) Exploitation of conflicts of interest by financial intermediaries due to agency problems, away from the public glare, would lead to loss of trust in the financial market. As Walter Bagehot put it so elegantly, "One terra incognita seen to be faulty; every other terra incognita will be suspected." The inevitable financial market contagion will catch on, for which the regulators should keep an eagle's eye on material and pecuniary conflicts of interest which may affect the integrity of the system.

d) A value-oriented individual is the cornerstone in the entire process of mitigation of interests. As famously said, "the greatest conflicts are not between two people / institutions / nations, but between one person and himself." Hence, ethical conduct should be developed, sustained and fostered in the work atmosphere through enabling legal, regulatory and institutional environment.

e) The truth that conflicts of interest cannot be legislated / regulated away, despite having the best standards has been convincingly proved by the fact that Refco has happened in the post 'SOX clean' corporate environment.

f) A comprehensive definition for 'financial / economic crime' and framing of a technology-neutral law are two imperatives which, if attended to, would go a long way in fostering such an enabling legal environment, in our country.

g) Regulatory environment should be based on principles rather than rules and should actively promote transparency and market discipline.

h) The concerned institutions / professions should develop an appropriate framework by which a commensurate premium /discount is placed on ethical / unethical behaviour, respectively of the individuals (or institutions, as the case may be).

i) The source-code emanating from the discussions in the report, for scandal-proofing the financial system, from exploitation of conflicts of interest situations or for that matter from any form of unethical acts, points out to building the primary infrastructure by way of value-orientation of individuals; and simultaneously, providing supporting infrastructure through appropriate measures by the government, the regulators, press and the society at large.

* * *

# Chapter II

## Conflicts of Interest in the Financial Services Industry – A growing concern

### Introduction

The world community is earnestly and eagerly seeking answers to fundamental questions relating to ethics and morality in the conduct of businesses, in the light of the saga of recent epidemic of corporate fraud which is still continuing - with top-level executives being led away in handcuffs, trusted accounting systems failing, multibillion-dollar bankruptcies abounding, and suspicions spreading far and wide that markets are rigged and as public faith in corporate leaders continues to deteriorate in a seep of corruption. As things are getting unraveled, the needle of suspicion in almost all the cases is increasingly pointing towards exploitation of conflicts of interest, of the powers that be. Consequently, issues relating to conflicts of interest, more so in the financial services industry, have come to occupy the mainstream in public discourse, the world over; triggering a wave of corrective legal, regulatory and other measures across continents, perhaps, overdue in certain advanced jurisdictions. It would not be out of place to mention that with the recent revelations relating to collapse of Refco, one of the largest foreign exchange and commodities broking companies in USA and the subversion of Iraqi "Oil-for-food" Programme; there is a sense of outrage fatigue, engulfing the general public. It is against this background that this report is being presented.

The introductory chapter is presented in VI Sections. Section I provides the social underpinnings of business. Section II outlines the overall scenario as obtaining in the international financial services industry, while the next section discusses the nature of financial services and financial markets. The reasons for which regulators need to care about conflicts of interest are analysed in Section IV. The emerging scenario in the Indian financial services sector is drawn in Section V and the concluding Section VI draws a reference to the inferences, which can be drawn from the still unfolding saga of corporate scandals.

*The layout and the drafting of the report have been done assuming a minimum understanding of the concept of conflicts of interest, on the part of the reader. For such of those who are uninitiated or relatively new to the subject, they are requested to read Chapter 3 (concepts and taxonomy) after completing Section I of this chapter, before proceeding further. This would facilitate easy understanding of the rest of the report. Further, keeping such readers in view, some of the more important points have been repeated at appropriate places, in the interests of ready recall value.*

### Section I

### Social underpinnings of business

The *terra firma* of all business activity is the human society. A lack of proper appreciation of the strong social underpinnings of business could prove to be very costly for business entities, by way of both direct and indirect fallouts. Business, as an economic activity is fundamentally based on transactions between human beings and thereby is a highly social activity. Human beings have not changed much since the dawn of civilization. Before undertaking any transaction, answer to one fundamental question is always sought –"Can I trust you?" Thus, trust is the social currency of business. Viewed in this context, trust is the bedrock of any business activity and more so in the case of financial intermediaries, since they act in a fiduciary (trust) capacity in handling other people's money. As fundamental differences amongst goods and services offered by competing providers have increasingly become harder to identify; the final judgment call

to a great extent, rests on the answer to the question – "Whom do I trust the most?" Consequently, of late, business entities characterizing themselves as 'progressive,' 'innovative' and 'dynamic,' have fallen progressively out of favour with the customers, due to the still continuing saga of financial scandals, and those which are 'trustworthy' are being relied upon to undertake continued business activity. Research has conclusively revealed that 'trust' is positively correlated with attributes like 'reliability,' 'integrity' and 'empathy;' while being negatively correlated with attributes like 'unapproachability' and 'arrogance' – which essentially express a certain distancing or aloofness from the stakeholders. Further, it also establishes the presence of a strong and continued link between trustworthy and attributes like 'reliable,' 'cares for customers,' 'leaders' and 'straightforward' across the product, service and corporate contexts.

The reputation for trustworthiness is hard to gain and easy to lose. Viewed from the short-term perspective, the behaviours that are required for being trust worthy may appear to be idealistic and rather un-commercial. They may involve passing up opportunities for short-term profit that would leave one richer, but less desirable as a business partner in the future. Recognising the social basis of business and the importance of a reputation does emphatically confirm the basic self-interest in acting in a trust worthy fashion. As such, trustworthiness is a form of social capital, perhaps every bit as important to a business as money, its financial equivalent. This truth is applicable with the greatest emphasis in the context of financial intermediaries.

These relatively simple, yet profound home truths seem to have been all but forgotten by many, if the continuing saga of corporate misdemeanours is any indication.

The frequency of economic and financial crises, since the 1980s has almost doubled**.** For instance, an inventory of major crises reads relatively long. Beginning with the Least Developed Countries (LDC) debt and banking crisis of the early to mid 1980s; the stock market crash of 1987; the Asian currency, Russian government debt and Long Term Capital Management (LTCM) crises that culminated in the latter half of 1998, there have been a series of financial disturbances, including but not limited to: the bursting of the technology bubble in the late 1990s; a mild recession, September 11, 2001; two wars; an oil shock and a wave of corporate scandals (including a handful of major bankruptcies). Due to globalisation, these crises are resulting in increased risks since they threaten becoming contagious and largely, self-fulfilling. Rather ironically, the rise in speed and complexity and the attendant tightening of linkages, are driven by the very same advances in technology and telecommunications that are driving the profound positive changes we are witnessing in financial practices.

These crises are promoting financial instability causing in its wake economic upheavals and heightened social tensions in the affected countries. Growing financial openness, globalisation and liberalization, have provided a fertile ground for increasing situations leading to conflicts of interests in financial institutions; the exploitation of which affects financial stability. The important link between financial market integrity and financial stability is underscored in the Basel Core Principles for Effective Supervision and in the Code of Good Practices on Transparency in Monetary and Financial Policies, particularly those principles and codes that most directly address the prevention, uncovering and reporting of financial system abuse, including financial crime. Consequently, the issues relating to exploitation of conflicts of interest resulting in financial instability have assumed added significance.

The ongoing string of financial scandals in recent years, especially involving high profile companies like Enron, WorldCom, Arthur Andersen, Tyco in USA; Ahold, Parmalat in Europe, Citi bank's activities in Europe and Japan etc. – the latest in the series involving Refco whose story is still unfolding, has lead to an increased debate on issues of available weak corporate governance structures and lack of ethicality in their

operations. All these scandals highlighted the presence of conflicts of interest in all types of organizations and the ruthless exploitation thereof. Indeed, many observers have concluded that exploitation of conflicts of interest as being at or near the centre of scandal-driven financial storms of recent years. Most recently, conflicting interests in a multi-national banking institution – BNP Paribas, have also cast their ominous shadow on the Iraqi 'Oil for food' programme, which facilitated unauthorized payments.

Several initiatives have been instituted at the international and individual countries levels to tackle the underlying problems as part of a larger corporate governance framework. Among the international initiatives, the ones taken by Financial Stability Forum (FSF), Organisation for Economic Co-operation and Development (OECD), Basle Committee on Banking Supervision (BCBS), International Association of Insurance Supervisors (IAIS), International Organisation of Securities Commissions (IOSCO) and International Accounting Standards Board (IASB) have developed as international benchmarks, in their respective areas. A reference is drawn to them, wherever warranted, in the report.

## Section II

## Trends in international financial scenario

Rapid on-going globalisation has been one of the major defining characteristic / feature of the world economy, since the last quarter of the previous century. It has profoundly changed many aspects of how people, organizations, businesses operate. It is affecting societies and countries all over the world in ways that are often difficult to predict. Perhaps, more than in any other domain of economic activity, globalisation has had profound repercussions on the financial sector and on international financial system.

Globalisation has hastened the process of financial convergence, internationally. The resultant on-going integration of financial markets the world over has spawned a myriad variety of new players, products and delivery channels. Deregulation in line with the growing influence of the market economy coupled with remarkable improvements in Information and Communication Technology (ICT) has made it possible for a single financial service provider – variously called as financial superstores or conglomerates to offer multiple products and services (covering credit, insurance, savings and investment aspects) through multiple delivery channels, to customers under one roof; primarily, to take advantage of the synergies of economies of scale and scope. This has lead to a blurring of the boundaries between the different sub-sectors of the financial system and to the formation of increasing number of financial conglomerates. In fact, financial conglomerates represent the most prominent institutionalisation of the convergence within the financial services industry. Consequently, large-scale financial intermediaries with pan-continental presence have sprung up, in almost all the countries, especially since the 1980s.

The fundamental role of financial intermediaries in the financial system is to provide the market function of matching borrowers / investors and lenders / savers. In the discharge of their functions, the intermediaries act as both principal and agent for different stakeholders. The business of a firm, from a stakeholders' point of view, can be described as a nexus of contracts. Financial institutions, by definition represent a nexus of financial contracts, undertaken in a fiduciary (trust) capacity. Consequently, financial intermediaries fall into the category of classic principal-agent relationship (popularly known as agency theory); with the attendant advantages and disadvantages. In the course of performing their agency function, the principals expect financial intermediaries to act as faithful agents. A faithful agent is defined as one who is firm in adherence to promises or in observance of duty. An important trait of a faithful agent is not to engage in the dissemination of disinformation or withhold proper information. Since the financial intermediaries in general and large financial conglomerates in particular operate on both

sides of the savings and investment relationships, potential conflicts of interest are inherent in the activities of such institutions. The seemingly all-powerful presence of the financial lure, further exacerbates conflicts of interest situations and puts a premium on exploiting the same for selfish reasons. In such situations, the financial intermediaries tend to become rather unfaithful agents.

While serving different set of clients, a large financial intermediary may not have necessary incentives and hence will not be willing to provide necessary information to all / part of stakeholders for taking informed decisions, thereby affecting adversely the functioning of financial markets. Information asymmetries are situations where the participants in the financial transaction do not have the same quality of information to evaluate the prospects of the transactions being carried out. This information asymmetry may lead to adverse selection, moral hazard besides regulatory arbitrage. Among the 'market failures,' agency problems were the foremost, where one person has to act on behalf of another. Because of corporate structure, it is often difficult to make sure that the agent does what he is supposed to do and because of the failure to align incentives, it is often the case that he does not. Especially problematic are situations, where there are conflicts of interests, which were so prominent in the corporate scandals of the recent years, which are discussed at appropriate places in the report.

Conflicts of interest are a fact of life as analysed in chapter III and the exploitation thereof is much more attractive in financial intermediation, as already stated, due to the seemingly all-powerful presence of financial lure. Under perfect competition and in the absence of asymmetric information, exploitation of conflicts of interest cannot rationally take place. Consequently, the necessary and sufficient conditions for agency costs associated with conflict of interest exploitation centre on market and information imperfections. Information imperfections are pervasive in the economy. Indeed, it is hard to imagine what a world with perfect information would be like. In the circumstances, arguably, the bigger and broader the financial intermediaries, the greater the agency problems associated with conflicts of interest exploitation. It follows that efforts to address the issue through improved transparency and market discipline are central to creating viable solutions to a problem that repeatedly seems to shake public confidence in financial markets.

Exploitation of conflicts of interest leading to collapse of any economic agent, in any sector, hits the financial intermediaries first via their exposures to the failing agents. It is observed that in financial intermediaries these conflicts are not always successfully counterbalanced by reputation-related incentives. The still-accruing evidence indicates that objectivity and even fiduciary responsibilities have been subjugated to self-interest by some of the service providers, despite the importance of reputation to franchise value for financial service providers. Even if financial service providers may have sufficient incentives to control conflicts of interest, question arises as how and with what incentives this will be achieved. In this connection, it has been observed that due to the higher gearing ratio and the resultant multiplier effect inherently available in the financial services industry, the stakeholders other than the financial service provider sustain great losses due to the information asymmetry / arbitrage. This contagion would impact uniformly all the participants across products irrespective of whether a participant has concealed or misused information, a disincentive for the market to self regulate. Regulators hence may have to identify the sources and nature of potential conflicts of interest and devise mechanisms to mitigate such conflicts.

Rekindling the conscience of all concerned is the best anti-dote for such scandals, which lead to economic paralysis.

## Section III

### Nature of financial services and the financial markets

An assessment of the nature of financial services and the financial markets, ex-ante, would help us in gaining useful insights into the reasons for which regulators need to be concerned about conflicts of interest. Financial markets essentially perform the function of providing professional financial services to the customers.

#### 1. Information – the lifeline of all market activities

An essential part of the provision of professional services involves the application of specialized information to dealing with customer's problems, whether accounting, legal, medical or financial. Thus, Arrow in 'Uncertainty and the Welfare Economics of Medical Care,' (1963) has noted that, "Information, in the form of skilled care, is precisely what is being bought from most physicians, and, indeed from most professions." Shortage of time (ultimate constraint on humans) and information make it harder for financial agents to match wants with endowments. As a corollary, the importance of information has been well recognized. Informational economics, especially after the work of Nobel Laureates George Akerlof and Joseph Stiglitz, has developed by leaps and bounds; since it has brought economic theory much closer to the fine grain of economic reality, by taking into account the possible imperfections in information as obtaining in the real world; as against perfect markets assumed in earlier economic models.

Financial agents / intermediaries, particularly the institutional entities, basically are in the business of risk management, usually, all across the spectrum. Consequently, they assume, trade, arbitrage, speculate and shed risk. In fact, where other businesses try to avoid and pass off risk, financial firms absorb, intermediate and advise on risk. Risk Management, by nature, is information-intensive since economic alternatives need to be carefully compared. Hence, risk management function cannot be undertaken efficiently in an environment of information asymmetry / vacuum. In this context, financial intermediaries and communication firms are similar in that both the entities establish networking relationships through which they collect, store, process and transmit information for themselves and customers' accounts.

#### 2. Categories of goods / services

Goods and services can be classified into three broad categories based on how consumers gain information about them.

- 'Search goods' are those about which consumers can get information before they are purchased. A stereo system, which one can test before buying it, would be an example.
- 'Experience goods' are those about which consumers can only obtain information after they have been purchased. All ready-to-eat food items provide good example of such goods.
- 'Credence goods' are those about which consumers may not be able to gain information even after they have been purchased. Professional services offered by doctors, lawyers, financial intermediaries etc., fall under this category.

Agency theory would suggest that firms would be honest about the characteristics of search goods, since consumers can easily ascertain any falsehood. This presumption of honesty may not hold in the other cases. Financial services, including banking services in a broader definition of goods come under the category of

experience and credence goods. Hence, experience becomes the foundation of establishing credence. Financial intermediaries may use all types of stratagems to induce consumers to try their products / services, so as to increase their profits (at least in the short run). Since good reputation is the very foundation of finance profession, credence qualities assume paramount importance, which can be disregarded by financial intermediaries only at their peril.

### 3. Principal – agent relationship

All professionals - doctors, lawyers, engineers etc., including financial intermediaries, generally, play a dual role i.e., that of being the principal and an agent to their customers, in the discharge of their functions. Consequently, financial intermediaries jointly act as an agent of the customer when they provide the diagnosis to their finance related problems and consider the best remedial action therefor, besides acting as a principal in executing with the customer the prescribed action. Mutatis mutandis, the same holds good for almost all professional services. This inherent dual capacity, common to most professional services, naturally gives rise to conflicts of interest in cases where the professional acting as an agent, prescribes actions which he knows are to his own benefit as principal, rather than to the customers. There is nothing special about financial services in this respect. The information asymmetry is a direct fall out of the very nature of financial services i.e., being simultaneously experience and credence goods. Information for such category of services, as stated above, is obtained by the customers only during / after the services have been purchased or perhaps, may not be able to obtain the same even after purchasing. In other words, the customers / consumers will find it that much more difficult in obtaining information about the quality of financial services doled out by the intermediaries, due to the inherent nature of the services. As such, 'information asymmetry' becomes an acute problem impinging adversely on information-generation activity, which is the main function of markets. Consequently, the problem of information asymmetry lies at the very core of any discussion on financial markets.

### 3.1 Information asymmetry

'Information Asymmetry,' (IA) thus, is endemic in financial services industry due to the very nature of such services, which generally involve duality of roles. It is rather ironical that while financial markets and intermediaries have arisen as a particular solution to the problems of IA, IA still remains a crucial impediment to the effective functioning of a financial system. It is one of the major areas of study in information economics since it is one of the more important reasons for market failure along with other `externalities.' When individual actions affect others, for which compensation is not rendered, the effects that arise are referred to as externalities. For example, smoke from a nearby factory may impose additional costs for cleaning in a nearby locality or a bee-keeping activity may pollinate flowers in a nearby field, improving the yield. However, these costs / benefits are not factored into economic decisions; leading to inefficient allocation of resources, eventually leading to market failures. Consequently, Information economics has gained predominant prominence in the study of markets and their dynamics. The classic example of this is the market for lemons (e.g. used cars), given by the Nobel Prize winning economist, George Akerlof. If the potential buyer of a used car (the principal) uses price to judge the quality of the used car, the seller (the agent) faces a dilemma. Cutting prices suggests that the agent has only lemons for sale. When information is imperfect or costly, market failures can result. There are avenues available to both the sellers and buyers to get over this dilemma like giving guarantees, etc. It was discovered that the informational problems that exist in the used car market were potentially present to some degree in all markets. The degree and

severity of conflicts of interest in retail financial markets is generally observed to be more severe than in the wholesale markets. To certain extent, it can be explained by the fact that the participants in the wholesale financial markets are generally large institutional players, who are professional and do have the resources in gathering appropriate and relevant information; while those on the retail side are relatively unsophisticated and short on resources for gathering the requisite information. Further, in some markets, asymmetric information is fairly easily solvable, while in certain markets like credit, insurance, securities, labour markets, etc., it is quite difficult to resolve and results in serious market breakdowns. For example, the elderly may have a hard time getting health insurance, small businesses are likely to be credit rationed, etc. Thus, the efficient mobilization and allocation of financial resources can be impeded by information asymmetry.

Information Asymmetry is a situation in which one party to a contract has better information about the true nature of the contract than the other. Imperfect information presents some individuals with the opportunity to act in ways that allow them to benefit at the expense of others, whom they are supposed to serve – “the principal-agent problem;” which arises when the individuals / intermediaries who are supposed to act for others are faced with circumstances, which give them the discretion not to do so. Information asymmetry leads to the twin problems of adverse selection (hidden information) and moral hazard (hidden action). Both these terms originated in insurance literature. Insurance firms recognized that the greater the insurance coverage, the less incentive there was for the insured to take care. If the business was not doing well, then there may be an inclination to have an accident (a fire). Not taking appropriate care was thought to be “immoral;” hence the name. Adverse selection is a situation where due to lack of proper information, some of the good proposals may get rejected, while the relatively not so good ones get accepted. For example, businesses with relatively less inherent merit / managers with ulterior motives are likely to be most eager to raise external funds. As a result, bad / adverse proposals are taken on board. Adverse selection, thus makes it more likely that investment in firms will turn out badly. Those who cannot be sure if a contract's terms are fair are likely to hold back from committing funds leading to fall in level of investment and overall growth of the economy. In other words, the interests of the principal and agent stand imperfectly aligned. A central problem facing the Government and regulators is how to align interests – how to provide incentive structures that make the agent more likely to be rightful and ethical in representing the clients.

### 3.2 Incentive-related problems

The existence of conflicts of interest can also be explained through incentive-related problems. Given the structure of a modern corporation, which brings together a number of players with a variety of interests, who co-operate in producing value for shareholders, it is but natural that there exists a tremendous potential for numerous conflicts of interest in this cooperative process; in the sense of individuals placing their personal interests ahead of those on whose behalf they are working. The list of stakeholders’ with divergent interests is increasing by the day.

For instance, shareholders are interested in increasing their value. Management is supposed to run the corporation towards that end; the board oversees the management on behalf of shareholders and selects the CEO and senior managers; the external auditors have a duty to report any concerns to the board, through the audit committee, for which they must remain independent; the customers want their needs to be satisfied; the regulators and government want them to be on the right side of law, etc.

Among the ‘market failures,’ agency problems were the foremost, where one person has to act on behalf of another. Primarily due to the structure of corporation, it

is often difficult to make sure that the agent does what he is supposed to do and because of the failure to align incentives, it is often the case that does not. Especially problematic are situations, where there are conflicts of interests, which were so prominent in the corporate scandals of recent years. The CEOs and other executives of corporations are supposed to act in the best interest of the corporation, the shareholders and workers. But in the late nineties, incentives got badly misaligned. In acting in their own interests, CEOs often did not serve well those on whose behalf they were supposed to be working. Ironically, the changes in the pay structure which misaligned interests were defended as improving incentives. The examples of the unduly fat pay packages of Richard Grass of New York Stock Exchange and Jack Welch of General Electric at the expense of the shareholders are good examples in this context. The right incentives (rewards and penalties) are important to ensure CEOs adequately fulfill all these responsibilities in an ethical way, never unduly putting their personal interests before those of the corporation.

Towards this end, Basle Committee on Banking Supervision (BCBS) discusses compensation of senior management in its paper "Enhancing Corporate Governance for Banking Organisations," (September 1999). The Board should approve the compensation and ensure that it is consistent with the institution's culture, objectives, strategy and control environment. It should not overly depend on short-term performance. The same principles are covered in the Insurance Core Principles issued by International Association of Insurance Supervisors (IAIS). Of late, equity-based remuneration (stock options, etc) is increasingly being used to motivate managers and employees. However, since a badly designed incentive system could lead to sharp increase in conflicts of interests, there is a need for a debate in our country about the appropriate use and design of such equity-based compensation.

## Section IV

### Reasons for regulators to care about conflicts of interest

The existence of potential conflicts of interest in financial institutions is not new to the regulators. The fact is that in the wake of bursting of the high-tech bubble of the late 1990s and the various scandals of the past few years, the subject has been thrust into the limelight. Financial historians and analysts have shown that, by and large, the same set of conflicts of interests which had a major role in the stock market crash of 1929 were responsible for the one in 1987, as also the bursting of the high-tech bubble in the late 1990s and the various financial scandals of the past few years, starting with Enron. They surprisingly find that the remedies have also been somewhat similar, in that while the subsequent depression of the 1930s played a significant role in shaping the heavy financial reform agenda of the 1930s (of which the Glass-Steagall Act is the most well known), the corporate and financial scandals of recent years have lead to a wave of overdue corrective actions (of which the Sarbanes-Oxley Act is the best known). Financial historians have gone on record to state that the human society does not seem to have learnt much from its past mistakes, which surprisingly, is indeed true; since strikingly strange similarities in the problems and solutions are decipherable, with a gap of more than half a century.

Financial convergence and financial conglomerates have brought about additional risks to the financial world. In the case of universal banks and financial conglomerates / supermarkets, the dual role of being a principal and an agent gets magnified many times over in a multi-functional set-up, since activities relating to banking, securities and insurance are performed by a single intermediary, leading to veritable explosion in the number, variety and complexity of conflicts of interest. This is not to suggest in the least that conflicts of interest are not present in financial

intermediaries, exclusively providing either banking / insurance or securities services. In fact, conflicts of interests are universal in financial services due to the endemic principal-agent conflicts, varying only in the degree of their intensity. Of late, exploitation of conflicts of interests – both external as well as internal have proved to be particularly problematic, as in the case of various examples given earlier; in addition to the well known other additional risks posed to the regulators/supervisors like risks of contagion, double gearing, creation of opaque structures and qualitative downgrading.

Broadly speaking, conflicts of interest are a very widespread ethical problem, which, precisely for that reason, deserves special attention, both from a legal viewpoint and from the point of view of ethics applied to organizations and professions. More specifically, illegal nature of conflicts of interest, public policy argument, controlling of the major externalities in the financial services industry leading to market imperfections like information asymmetry entailing adverse selection and moral hazard and imperfect alignment of interests in the principal-agent relationships of the financial intermediaries; which in turn may lead to market crises / failures due to loss of trust, are among the more important reasons for regulators to care about conflicts of interests. The case is all the more stronger in the Indian context, given the fact that we are at a critical juncture of our economic history and can ill-afford any reputational risks to the country in general and the financial services industry in particular.

A preliminary, narrow and insufficient reason for which we should care about conflicts of interest is that they are illegal. Of course, not all conflicts are illegal.

In a broader sense, the social harm, which they inflict on the society, justifies a public policy response. The role and functions of financial intermediaries in general and large-scale integrated financial conglomerates are inseparably linked with the broader public policy objectives, including (but not limited to) the optimal allocation of savings and investment. As such, their activities are integral to raising the standards of living, regarding which the regulators are most concerned.

Well-functioning financial markets serve the basic economic function of channeling funds from those who lack productive investment opportunities to those that have such opportunities. By increasing the level and improving the allocation of investment, well-functioning markets perform a vital role in increasing society's material well being. Reliable information, as already stated above, is the key to financial markets performing this function, professionally. In the absence thereof, information asymmetry arises leading to adverse selection and moral hazard, improper alignment of incentives of the various stakeholders, exploitation of conflicts of interest resulting in improper functioning of the markets. Hence another major reason for which regulators should care about conflicts of interest, therefore, is that the exploitation thereof damages the information generating and processing function that is at the core of the contribution the financial system makes to economic welfare.

In recent years, the role of banks, securities firms, insurance companies and asset managers (a few examples of which have been given above) in alleged conflict-of-interest-exploitation in advanced economies – involving a broad array of abusive retail market practices, in acting simultaneously as principals and intermediaries, in facilitating various corporate abuses, and in misusing private information – suggests that the underlying market imperfections are present more acutely in highly developed financial systems. Moreover, recent evidence suggests that the collective decision process in the management of major financial firms impairs pinpointing responsible individuals, and that criminal indictment of entire firms runs the risk of adverse systemic effects. Monetary penalties and negotiated settlements neither admitting nor denying guilt seem to have emerged as the principal external mechanisms to address conflict of interest exploitation. Market discipline operating through the share price may, under appropriate corporate

governance, represent an important additional line of defense. However, when financial intermediaries start exploiting conflicts of interest, market discipline starts crumbling. This occurs basically due to the fact that large institutional investors such as pension funds, mutual funds, insurance companies, securities firms, large banks, who are collectively called the "lead steers," do not fulfill their role of being the 'conscience-keepers' of the market. These large investors are known as lead steers due to the fact that they are professional and sophisticated investors who dominate financial markets by their 'value-maximising behaviour,' and provide 'finance light' to the rest of the participants. This professional behaviour goes haywire when conflicts of interest are exploited, leading to misallocation of resources, resulting in market breakdowns and ultimately to market failures.

In the normal course, banks and other financial intermediaries are expected to be delegated monitors to supervise the economic activities of their clients / customers – who are important economic agents in every sphere of economic activity. When conflicts of interest get exploited within / among financial intermediaries, they would not be fulfilling optimally their role as delegated monitors, leading to their clientele resorting to harmful practices which impede economic well-being.

When mature economies with relatively robust markets are adversely affected by such corporate misdemeanors, the need for the regulators to ensure an environment which minimizes the exploitation of conflicts of interests by financial intermediaries is all the more important in a developing economy like India. The most important reason for which the regulators need to be concerned about conflicts of interest is the fact that exploitation thereof would lead to 'loss of trust,' in the financial system. Reputational risk is the biggest risk of all. While a good reputation is an important intangible asset to any enterprise, it is paramount for banks and other financial-services firms, which depend almost entirely on trust and confidence for their business. There are always judgment calls in business. Matters are often not black and white. In such circumstances, if the people manning financial intermediation functions were to act in an unethical and immoral way, by exploiting situations away from public view, the results are bound to be catastrophic as illustrated by the examples given above. As Walter Bagehot put it so elegantly – 'One terra incognita being seen to be faulty, every other terra incognita would be suspected.' The 'ripple effect' / 'propagation crisis' of being linked, or being seen to be linked, to an unethical firm or situation can be very damaging for other parties too. Financial contagion and the fall out effects would follow soon thereafter. In a progressively shrinking globalised village, the tremors would be felt far and wide. The collapse of Long Term Capital Management (LTCM), a major hedge fund in the USA in 1998 is an excellent case in point. Loss of trust (credence / credibility) has been the most important outcome of all the scandals and renewed the demand for more regulation.

In the Indian context, the concern with the governance structure of institutions in the banking sector (public sector banks, private sector banks, Global Trust Bank and several co-operative banks) as also in the capital markets segment in the context of recent stock market scam has also been growing dramatically following events of corporate malfeasance, market volatility, inadequate disclosures due to predominantly exploitation of conflicts of interest. Furthermore, especially at the present juncture of its economic history, when it is gradually opening up its economy, it can ill-afford loss of trust in its financial system, since the latter plays a crucial part in intermediating for pooling of huge funds necessary for the desired economic progress. Attracting the huge and patient foreign capital required to upgrade vital sectors of the economy like physical infrastructure of various kinds – ports, roads etc., is a function of the integrity of our financial system, which in turn is dependent on reputation built on the bedrock of trust.

The primary role of regulators is to distinguish the Indian financial services industry as being renowned for 'good ethical practices,' which would be an invaluable intangible in the country's developmental efforts.

## Section V

## Emerging scenario of the Indian financial services sector

Till the second half of 1980s, the Indian financial sector landscape had been dominated by commercial banks. The securities and insurance sector emerged into prominence and started playing significant roles in financial intermediation from the early 1990s. The regulators have, in order to secure sound and strong regulated entities, on an on-going basis, initiated measures to liberalise and develop the markets. Significant achievements have been made in regulatory effectiveness, improving market efficiency through use of ICT, increasing transparency, integration of national markets, enhancing competitive conditions, reducing information asymmetries, developing modern technological infrastructure, mitigating transaction costs and promoting market integrity. With the emergence of securities and insurance sector as prominent players, in the last fifteen years the financial sector in India has undergone significant changes in terms of functions, structures, products, instruments, markets, institutions and delivery channels. Growing financial openness, improvement in technology, economies of scale, cross-sectoral linkages, overlapping of products and channels has led to situations where a single financial service provider serves different set of clients.

In view of the relatively late entry/development of insurance and securities players and related intermediaries in the Indian context, the concept of a single financial service provider having multiple interests, although may not be as prominent as in developed economies, is gaining prominence of late. In fact, emergence of home grown financial conglomerates has been one of the more distinguishing features of the emerging domestic financial scenario. The financial landscape is increasingly witnessing (i) entry of some of the bigger banks into other financial segments like merchant banking, insurance, securities, mutual funds etc., which have made them financial 'conglomerates'; (ii) Banks have been permitted to act as a corporate agent of insurance companies for distribution of insurance products on a fee basis; (iii) Insurance companies have also been permitted to enter into mutual fund business; (iv) emergence of several new players with diversified presence across major segments; and (v) possibility of some of the non-banking institutions in the financial sector acquiring large enough proportions to have a systemic impact. Simultaneously, it is observed that a family of complex financial products / services like derivatives of all types, securitised products like mortgage-backed securities (MBS) / collateralised debt obligations (CDOs), etc., are being increasingly put to use, by the financial players; perhaps evident of the growing demands of the customers and matching upgradation of skills by finance personnel adding to the complexity of the Indian financial sector. In view thereof, Systemically Important Financial Institutions (SIFIs) have been identified, to be worked upon as policy levers as and when the situation warrants.

Thus, even in India, the ingredients of progressive deregulation, globalization and liberalization leading to multiplicity of agents, functions and delivery channels have made the brew strong enough to tremendously increase the situations leading to conflicts of interest. The major challenge to both the players and regulators is to ensure that interests of all the stakeholders are properly aligned through appropriately crafted incentives. The challenge of setting right the various issues in agency problems (like information asymmetry leading to adverse selection and moral hazard, probable misalignment of interests in the financial intermediaries), is all the more tough in India, given the fact that the market participants, especially the commoners are comparatively less well-informed than their counterparts in advanced economies.

Indian financial sector encompasses a diverse and to some extent, disparate group / set of financial intermediaries and service providers: banks, developmental financial institutions, primary dealers, non-banking financial companies, mutual funds, housing finance companies, venture capital funds, insurance companies (both life as well as non-life), rating agencies, accounting firms, brokers, depositories, asset reconstruction companies, trustees etc. offering financial services to one or more categories of customers simultaneously. These service providers are regulated by Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI), Insurance Regulatory and Development Authority (IRDA), National Bank for Agriculture and Rural Development (NABARD), National Housing Bank (NHB) etc. Pension Fund Regulatory and Development Authority (PFRDA) is on the anvil.

## Section VI

**Inference**

The overall scenario, obtaining in the financial services industry – both internationally and domestically, has been briefly discussed above. Luckily enough, with the benefit of hindsight and the results of studies completed on the recent scandals, which thoroughly analysed as to what went wrong in the individual cases; we can think of suitable corrective action/s required by all the players involved. The inferences drawn there from would help us in establishing the proper environment and crafting appropriate policies, suitable for Indian conditions, to reduce / mitigate conflicts of interests. With a view to facilitate an insightful analysis which would help us in drawing such inferences, the anatomy and pathology of each of the major scandals of corporate misdemeanours is discussed, to the extent warranted, in the report at the appropriate places.

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## Chapter III

## Conflicts of Interest – Concepts & Taxonomy

### Introduction

Conflict of Interest is ubiquitous in every aspect of human life. It represents a situation of an ethical dilemma – 'Dharma sankat.' Ethical dilemmas – Dharma Sankats have been there all down human and financial history. They arise fundamentally due to conflicting roles played by individuals and institutions.

However, of late, as stated in the previous chapter, interest on conflicts of interest and the corresponding weak governance structures of public corporations has grown dramatically following events of corporate malfeasance, market volatility, inadequate disclosure and conflicts of interest that are injurious to the public besides undermining confidence in the market place, involving various high profile companies.

This chapter explores the contours of the concept by going into the definitional issues in Section I, examines the characteristics of conflicts of interest in Section II, attempts a taxonomy of both the conflicts and the interests underlying thereto in Sections III and IV respectively, while the last section gives an ethical evaluation of the subject.

### Section I - Conflicts of interest - Definitions

**1. A broad definition**

In a broad sense, almost all human decisions involving people give rise to conflicts of interest: for example, an employee's interest in increasing his earnings conflicts with his employer's interest in reducing the company's wage bill; and a doctor's interest in reducing his workload conflicts with his patient's interest in receiving better medical attention. But this concept is too broad and unworkable; conflicts of that kind are inevitable, and all we can do is rely on the institutions and incentives that coordinate the interests of the two parties, and ultimately on the morality of their behaviour.

Strictly speaking, a conflict of interest arises in any situation in which an interest interferes, or has the potential to interfere, with a person, organization or institution's ability to act in accordance with the interest of another party, assuming that the person, organisation or institution has a (legal, conventional or fiduciary) obligation to do so.

This definition contains the following elements:

? A person, organization or institution (company, public service, government, NGO, etc.),

? that has a legal, contractual, conventional, professional or fiduciary (and therefore ethical) obligation or duty, or holds a position of trust,

? to act, as agent or trustee, in accordance with the interests of another party, i.e., the "principal",

? which may be another person, organization or institution.

? the agent has another interest, which he wishes to satisfy (or frustrate),

? which may be a personal (financial or non-financial) interest of the agent himself,

? or of another person or institution (relative, friend, religious or ethnic community, company, NGO, union, political party, etc.)

? toward which the agent has a contractual, conventional, professional or fiduciary duty,

? and that other interest is wholly or partly incompatible (or is believed by the agent to be incompatible) with the interest of the principal.

? so that it prevents or obstructs, or has the potential (or is thought to have the potential) to prevent or obstruct, the performance of the agent's duty toward the principal.

This definition may seem too broad because it would include conflicts arising as a result of having more than one principal (for example, a lawyer who represents two clients on opposite sides of a legal dispute) and "role conflicts"(for example, when a doctor who is also a researcher advises a patient to take part in a research program in which the doctor is involved and for which she is paid). However, to discuss the legal and ethical solutions to these types of problems, it seems best to keep the definition broad.

**2. A structured definition**

A structured definition of the concept of conflict of interest, as given by Mark R. Simmons is:

- the convergence between an individual's private interests, obligations, relationships in her / her professional obligations to the organization;

- such that an independent observer might reasonably question the motive, actions and outcome regarding decisions made or actions taken by the individual as a director, officer or employee;

- the individual, the individual's immediate family or a third party or organization in which the individual or the individual's immediate family has a business interest or association receiving any "thing of value" as a result of decisions made or actions taken by the individual as a director, officer or employee of the organization.

**2.1. What are "things of value?"**

"Things of value" include, but are not limited to : salaries / direct commission; finder fees; raises, bonuses, or promotion (other than those received as an employee of the organization); receipt of automobiles, boats or any gifts than those of nominal value; receipt of paid vacations and trips; payment of credit card bills or of any other personal expenses; receipt of stocks, bonds, annuities or other investments; insurance policies paid for by a third party; an offer or promise of employment; realization of business profits or increased business value; realization of an unfair competitive

advantage; or any other means of compensation or reward other than those provided by the organization to its directors, officers and employees.

**3. Conflicts of Interest - A few other definitions**

**3.1** Conflicts of interest, in the context of public service, has generically been defined by Organisation for Economic Co-operation and Development (OECD) as "a conflict between the public duties and private interests of a public official, in which the public official has private-capacity interests which could improperly influence the performance of their duties and responsibilities." This is a very simple and practical definition, which can be used by organisations for identifying situations of conflict of interest. It can be made applicable, in a generic sense, to the financial world, at large, since the functions of the financial intermediaries predominantly impinge on public good.

Conflict of interest is generally thought as any situation involving hidden 'self-dealing,' ' related third-party transactions,' 'non-arms length relationships' or 'serving two masters' that results in gain to one party at the expense of another. Its genesis lies essentially in various interests held by an individual in the discharge of his official duties.

**3.2** Conflicts of interest exist whenever one agent serves more than one principal. Acting in the interests of one principal may run counter to the interests of others. Defined this way conflicts are endemic in virtually all aspects of economic life. Conflicts can arise between an individual and the firm for which he or she works; between the interests of a firm and those of its clients; and between the interests of various categories of clients (Andrew Crockett, Former General Manager, Bank for International Settlements, Basel).

**3.3** Conflicts of interest arise when a financial service provider, or an agent within such a service provider, has multiple interests which create incentives to act in such a way as to misuse or conceal information needed for the effective functioning of financial markets (Frederic S Mishkin Graduate School of Business, Columbia University).

**3.4** Conflict of interest is "a situation in which a person, such as a public official, an employee, or a professional, has a private or personal interest sufficient to appear to influence the objective exercise of his or her official duties (Michael McDonald of the W. Maurice Young Centre for Applied Ethics, the University of British Columbia).

## Section II
## Characteristics

An analysis of the characteristics of conflicts of interest would help in understanding the concept better and thereby the consequences thereof:

**1. Ubiquitous ethical dilemmas**

Conflicts of Interests are ubiquitous and endemic in every aspect of economic life. They cannot be fully avoided, only mitigated. In a generic sense, all professionals, generally, act both as agent for the customer, in diagnosing the problem and considering the best remedial action, and as a principal in executing with the customer the prescribed action. This inherent dual capacity, common to most professional services, naturally gives rise to conflicts of interest in cases where the professional acting as agent prescribes action which he knows is to his own benefit as principal rather to the customer's. ***There is nothing special about financial services in this respect.***

However, the chances are more in the financial sector given the inherent nature of the profession (viz., dealing with money).

The fact that conflicts are ubiquitous ethical dilemmas ingrained in every sphere of economic activity could be appreciated better, if a few examples are given which are easily observable in our day-to-day life.

- A doctor prescribes the medicines of certain pharmaceutical companies which provide him with incentives; even though cheaper / more appropriate versions are available in the market;
- A doctor may prescribe various pathological tests (whether required or not), to be undergone at a particular pathological lab which provides him with incentives. The same tests, if required perhaps, could be conducted at a more economical cost in certain other labs;
- An official in a regulating body could be unduly lenient to an erring regulatee – a bank / insurance / securities firm; due to the fact that his close relatives are working therein / or certain things of value are provided;
- A Government official may grant contracts to firms which are less efficient, in preference over the more efficient ones; for various extraneous reasons;
- Agents and brokers either in the insurance / securities / consumer goods sector or in any other sphere of economic activity, aggressively promote products / services which provide them better commission, irrespective of whether the same are appropriate for the client / customer or not.
- Quality Assurance Personnel, in any sector of the market, may certify sub-standard securities / services / engineering projects, etc., keeping in view the short-term incentives provided by the latter; to the long-term detriment of the consumers / clients / the society at large;
- A surgeon may perform a surgery on a patient, which is not so urgent or is not at all required, in order to unduly gain from the fees charged;
- An employee advises against introducing new technologies since it is beyond his technical competence;
- Financial analysts give a buy recommendation on securities that are a part of their portfolio or that of a relative;
- A bank actively promotes a public offering of shares by a company of dubious credentials; since the same would enable it to reduce its credit risk on the company;
- An auditing firm could overlook certain glaring accounting mal-practices, in order to retain the client and gain the more profitable consultancy business.
- A judge may have to decide a case that affects a company belonging to his close relative;

- A lawyer represents two of the accused in the same criminal trial.

Conflicts of interest arise in many of the decisions that professionals, managers and employees, as well as public and private companies and organizations, have to make in the course of their normal activities. However, due their innate nature (i.e., directly dealing with the use of money), financial services are probably more prone to exploitation of conflicts of interest / fraud than other professional services.

The agency theory provides a reasonably sufficient framework to explain the conflicts of interest. It may be noted that not all of the situations listed above are not necessarily immoral; but they all can lead to immoral action, and so are examples of conflicts of interest.

In fact, an individual / institution, absolutely pure, unencumbered by all conceivable potential conflicts of interest are non-existent. Therefore, the emphasis is on how to live and deal effectively with such situations.

**2. Tend to be more pervasive in universal banks / financial conglomerates**

Due to bundling of services and delivery channels in universal banks and financial conglomerates, the situations in which they act jointly as principal and agent increase tremendously and consequently, the areas of potential conflicts of interest.

**3. Represent Governance issue in Operational Risk**

Mitigating conflicts of interest is a corporate governance issue representing an operational risk. Hence, conflicts of interest are unique in each organization and the criticality of similar nature of conflicts of interest, may be different in different organizations depending on specific individual factors, notably the organizational culture.

**4. Impede market functioning**

Conflicts of interest impede smooth functioning of markets by acting as 'sands in the wheels' affecting the information generation capacity of financial institutions.

Conflicts of interest are both the cause and effect of information asymmetry, with all its negative impacts. The problem gets all the more accentuated due to the nature of financial services, being in the nature of both as 'experience' and 'credence' goods. As earlier stated, 'information asymmetry,' which leads to the twin problems of adverse selection and moral hazard, is the single most important factor which is of special interest to regulators in the context of smooth functioning of financial markets.

## Section III
## Conflicts of Interest – Taxonomy

Conflicts of interest, an umbrella term, can be classified, based on their nature into three broad classifications.

**1. Actual / Perceived/ Potential conflicts**

Conflicts of interest, can be used to describe the situations of:

• An **actual conflict of interest** which involves a direct conflict between an official's current duties and responsibilities and existing private / other professional interests.

• A **perceived** or **apparent conflict of interest** can exist where it could be perceived, or appears, that an official's private / other competing professional interests could improperly influence the performance of their duties – whether or not this is in fact the case.

• A **potential conflict of interest** arises where a public official has private / other competing professional interests that could conflict with their official duties in the future.

Potential conflicts of interest could be trifurcated as acceptable –which would not adversely effect the interest of third parties, grey areas requiring guidance and unacceptable or prohibited forms of conflicts of interest for which suitable remedial steps – external or internal, need to be taken.

Understanding and defining the differences between actual, perceived or apparent and potential conflicts of interest assists in identifying when a conflict exists and determining which type of management approach may be the most appropriate.

It is important to recognise that a poorly managed *perceived* or *apparent* conflict of interest can be just as damaging as a poorly managed *actual* conflict of interest. The critical factor is that concerned staff must not only behave ethically, they must also be seen to behave ethically.

**2. Material and non-material conflicts**

Conflicts may be material conflicts of interest or otherwise. Andrew Crockett. *et al* have defined material conflicts as those which lead to decrease in information flows that make it harder for the financial system to solve adverse selection and moral hazard problems that reduce the flow of funds to productive investments. They have the potential to damage the reputation of the firm, if not taken care of. Customer service would invariably suffer in such cases. There is nothing unusual or necessarily wrong in having a conflict of interest. How it is dealt with is the important thing.

**3. Individual and Institutional conflicts**

As obvious from the nomenclature, conflicts may be faced either by the individual or institutions as a whole. In the case of institutional conflicts, exploitation of conflicts of interest would constitute 'corporate turpitude,' in much the same way as an individual. Many times, the exploitation of conflicts of interest by a single individual may bring down the entire institution. The classic example is that of Barings collapse due to exploitation of conflicts of interest by one single individual Nick Leeson.

The reputational risks to an institution are greatest when the market perceives that one of its employees or one of the group's entities is involved in exploitation of conflicts of interest. Hence, there is a vital organic link between exploitation of conflicts of interest by and individual and the institution, to which he belongs. In fact, even if one single employee of an institution exploits conflicting interests, the market would perceive it, as if the institution itself has indulged in such practices.

In almost all the cases, like Enron or Merrill Lynch or Aon or Citigroup or New York Stock Exchange or GE, the discussions on their misdemenours are seldom in the name of the concerned individual, but in the name of the organisations themselves.

Hence, there's a very thin line segregating exploitation of conflicting interests by an individual and the concerned organisation.

Such segregation becomes all the more indistinguishable in the case of professional institutions as opposed to business entities. The examples involving professionals like auditors, rating agencies, investment bankers fall under this category. The reputational risks become, thereby, all the more fatal.

**4. Type1 and Type 2 conflicts**

Conflicts of interest are essentially two-dimensional – either between the interests of the firm and those of its client (Type 1), or between clients in conflict with one another (Type 2). They can also be multidimensional, however, spanning a number of different stakeholders and conflicts at the same time.

**Type 1 -** Conflicts between a firm's own economic interests and the interests of its clients. In addition to direct firm-client conflicts, indirect conflicts of interest could involve collusion between the firm and a fiduciary acting as agent for the ultimate clients.

**Type 2 -** Conflicts of interest between a firm's clients, or between types of clients, which place the firm in a position of favoring one at the expense of another. They may arise either in inter-professional activities carried out in wholesale financial markets or in activities involving retail clients. The distinction between these two market "domains" is important because of the key role of information and transactions costs, which differ dramatically between the two broad types of market participants. Their vulnerability to conflict-exploitation differs accordingly, and measures designed to remedy the problem in one domain may be inappropriate in the other.

The broader the activity-range of financial firms in the presence of imperfect information, the greater the likelihood that the firm will encounter potential conflicts of interest and the more difficult and costly will be the internal and external safeguards necessary to prevent conflict exploitation.

## Section IV

### Types of interests that can give rise to conflicts

The types of interest that can give rise to conflicts include:

**1. Pecuniary or non-pecuniary interests**

Conflicts of interest can also be classified into pecuniary and non-pecuniary interests, depending on whether there is a financial advantage involved.

A **pecuniary** interest is a situation where the private / other competing interests are of such a nature that the employees could generate a personal financial interest from their official duties (or there is the potential to gain financially from their official position). The gain could be actual or potential. A pecuniary interest might be any of those mentioned as 'things of value,' above.

The list is not exhaustive. Many of them don't involve a direct exchange of money, but may involve an exchange that can equate to a financial value, for example, the discharge of a debt or the receipt of goods and services that have a market value.

The employee does not need to directly experience the financial gain or loss to give rise to a conflict of interest. It will remain a conflict of interest if a family member, close associate or someone with some proximity has the pecuniary interest.

A **non-pecuniary interest** is one where an individual has a personal / other competing non-financial interests in their official duties. They include any tendency to be favourable or prejudicial resulting from friendship, animosity or other personal involvement that could bias one's judgment or decisions. In other words, human emotions of friendship ,anger, fear and greed can also be some of the interests causing conflicts of interest:

**2. Personal/Social/Business/Other interests**

Given the fact that Indian society is predominantly relationship-based, the probability of encountering conflicts relating to personal and social interests could be comparatively higher. While personal interests involve family members / close friends; social interests include being associated with a social / charitable / religious / sports / or any other type of organisation catering to one's multifarious social needs. This could, in its wake, lead to problems relating to nepotism, favouritism, corruption etc.. Hence, financial intermediaries in India need to be particularly attentive in framing their conflicts management policies and systems, to tackle such problems.

**3. Other competing professional interests**

Audit versus non-audit work in case of large accounting and auditing firms, rating versus consultancy work in credit rating agencies and research versus underwriting work in investment banks are classic examples of competing and thereby conflicting professional interests. Other professional interests may include another part time employment, as well.

Conflicts of Interests in BNP Paribas is an apt example of other professional interests or what can be classified as type 2 conflicts. BNP Paribas, a French financial conglomerate was appointed by UN as the Programme's escrow bank, in terms of a Banking Service Agreement that authorised the bank to confirm all letters of credit issued by other banks under the programme for purchase of oil and ensure that deposits were fully credited to the escrow account, maintain the account and issue letters of credit and make payments to vendors for humanitarian purchases, as also to issue letters of credit on behalf of private party oil purchasers. Consequently, BNP had an obligation to act diligently and faithfully in all matters relating to its primary customer – the UNO.

Once the bank chose to issue letters of credit (LCs) for oil transactions as well, its loyalties were divided between serving the interests of the United Nations to promote the transparency of transactions conducted under the programme and serving the interests of its private clients, to maintain the confidentiality of their business and financing arrangements. These competing interests clashed with the advent of Iraq's Oil Surcharge Scheme and the scheme's reliance on financing arrangement to conceal the true nature of oil purchases transactions.

The prevalence of shell company's purchase arrangement who are private clients of BNP Paribas was a fact well known to BNP since it had access to such information through its privities with parties engaged in such transactions. The investigations revealed that there was regular correspondence emanating from the shell companies to keep their names confidential, while the LCs purportedly were shown to be opened by parties who have been allotted rights for purchase of oil by the Iraqi regime, under the UN agreement.

In other words, BNP acquired a competing incentive to act in the interests of the private purchasers or true financer of its letters of credit rather than in the interests of the United Nations. This duty of secrecy to a private contracting or financing party was potentially inimical to the interests of full disclosure of BNP's primary customer – the

United Nations – of the true financial arrangements underlying transactions conducted under the Programme. The conflict began when the Bank agreed to the concealment of the financing party in letter of credit arrangements and in payments ordered by the financing party. It deepened when the Bank acted as agent for the financing party and facilitated the arrangement. Therefore, when the third party purchasers were thrust into these transactions unbeknownst to the United Nations and with full knowledge and participation by BNP, the Bank's actions ran afoul of its duty to the United Nations.

In short, BNP's dual role burdened it with divided loyalties that ultimately facilitated, inter alia, the success of Iraq's oil surcharge scheme. The success of the scheme relied on the ability of the true parties in interest to conceal their roles and the flow of funds stemming from oil purchase transactions. And once the surcharge scheme took root, BNP itself became an instrument for the payment of millions of dollars in illegal surcharges while doing little to detect or prevent such payment.

BNP's loyalty to the interests of its private clients – in the midst of well-publicized allegations of Iraq's surcharge policy – apparently inhibited BNP's undertaking a system-wide review of its practices to prevent such surcharge payments, much less adopting proactive measures to redress market practices that distorted the implementation. Although there is no evidence that BNP knew of, or approved of the use of its own facilities to pay illegal surcharges, BNP was uniquely positioned to probe such payments – but failed to do so. The Bank also appears not to have acted on its earlier conflict of interest policy dated December 2002. According to the statement of policy, "when conflicts of interest put at stake significant matters" certain steps should be taken including defining "a clear road map for the solution of the potential conflict" and steps ensuring "adequate communication".

**4. Human emotions**

On a number of occasions, human emotions like greed, kinship / friendship, anger, hatred, etc., form the basis for exploitation of conflicts of interest in non-pecuniary type of interests, as stated above.

For instance, the investigation of Eliot Spitzer has brought out the revelation of an e-mail from Jack Grubman, once Salomon Smith Barney's star telecoms analyst, suggesting that he had upgraded his rating of AT&T in early 2000 not to win the giant telecoms firm's investment-banking business, but to persuade Michael Armstrong, AT&T chief executive and a board member of Citigroup, Salomon's parent company, to back Sanford Weill in his (successful) attempt to oust John Reed as his fellow-boss at Citi.

While the above example is a well-publicised conflict due to the involvement of famous names, there would be countless of them literally in the work atmospheres.

When a conflict of interest arises there are a number of different management options that can be adopted to deal with the same. An approach that is too strict or attempts to corral private interests too tightly may impinge upon the rights of the individual, or prove unworkable. There is also the risk that overly strict provisions will discourage employees from disclosing conflicts of interest, or deter people from working efficiently.

**Section V**

**1. An ethical evaluation of conflicts of interest**

Conflict of interests, as stated, represents a situation of 'Dharma Sankat,'- an ethical dilemma. An ethical evaluation of the same would help us understanding the concept from an ethical and moral viewpoints. The following truisms emerge when the concept is examined against the touchstone of ethicality :

? It is ethically wrong to act against the interests of the principal in a *de facto* conflict of interest. Doing so causes injustice because the agent has a moral obligation to act in accordance with the interest of the principal.

? It is immoral to obtain an "undue" benefit, whether financial or of any other kind, through the exercise of a profession, duty or office – although what constitutes an "undue" benefit can only be established on a case-by-case basis. For example, a public official has a right to his salary, but not to additional income for actions resulting from a conflict of interest. Also, if an auditing firm delivers misleading reports that cast its client in a favourable light in order to retain that client's business, any benefit thus obtained (retaining the client) will be improper. In both cases, the benefit is improper because it is the result of the agent's putting his own interest before that of the principal, which is the interest that should rightly prevail.

? The agent has a moral obligation to provide restitution and make good any harm caused.

? Unavoidable and systemic conflicts of interest are still conflicts of interest and must be treated as such. The fact that the agent is not to blame for finding himself in a conflict of interest situation does not mean that the situation has no moral consequences.

? Finding oneself in a conflict of interest situation is not in itself immoral, if the agent has acted in good faith.

? It is ethically wrong to put oneself in a situation in which a conflict of interest is liable to arise, unless there are sufficiently important reasons for doing so. This rule applies even if the agent intends to resolve the conflict fairly and honestly – because it is wrong to put oneself at risk of acting immorally without sufficient justification.

? The agent must not only avoid any actual conflict of interest, but also the appearance of a conflict, unless there is sufficient reason, because integrity in a person's work or profession is a good that must be protected – although it is not an absolute good and therefore depends on circumstances or, as some authors contend, allows exceptions. The agent also has a duty to preserve society's trust and respect for his company, office or profession.

? It is immoral to put pressure on a person to accept a conflict of interest, because it is unjust to induce a person to do something wrong, or put him at risk of doing something wrong.

? A conflict of interest may cause harm to third parties and, therefore, be an injustice toward them. For example, if a doctor advises a patient to undergo treatment in a clinic in which the doctor has a financial interest, he may be engaging in unfair competition toward other clinics that offer the same treatment, perhaps on better terms for the patient.

? An agent involved in a conflict of interest must assume his responsibility for managing his own private interests in relation to his office, profession or job. He may not shift this responsibility onto the rules that govern the activities of the company, organization, market or profession: there is always an element of personal responsibility.

? Organizations and institutions involved in conflicts of interest must also assume their responsibility to identify and resolve such situations.

Since exploitation thereof is unethical / immoral, a natural question which follows is whether such situations can be characterised as 'financial crimes,' or 'cases of corruption.'

**2. Exploitation of conflicts of interest - a financial crime / corruption?**

There is no single, broadly accepted understanding of the meaning of the term 'financial crime.' Rather, the term has been used to describe a number of different concepts of varying levels of specificity. IMF in its background paper on "Financial System Abuse, Financial crime and Money Laundering ," (February 2001) has given the following interpretations of the term financial crime.

At its absolute broadest, the term has occasionally been used to refer to any type of illegal activity that result in a pecuniary loss. This would include violent crimes against the person or property such as armed robbery or vandalism.

At its next broadest, the term has often been used to refer only to *non-violent* crimes that result in a pecuniary loss. This would include crimes where a financial loss was an unintended consequence of the perpetrator's actions, or where there was no intent by the perpetrator to realize a financial gain for himself or a related party (e.g. when a perpetrator hacks into a bank's computer and either accidentally or intentionally deletes an unrelated depositor's account records.) Also, the term has occasionally been used slightly more narrowly to refer only to instances where the perpetrator intends to benefit from the crime. Either way, criminal fraud (i.e. the act of illegally deceiving or misrepresenting information so as to gain something of value) for personal benefit is undoubtedly the most common.

The term has been used in a more narrow sense to refer only to those instances where a non-violent crime resulting in a pecuniary loss also involves a financial institution. Financial institutions can play one of three roles: (i) perpetrator, (ii) victim, or (iii) knowing or unknowing instrumentality of crime. Of these, the most common are probably when the financial institution is a victim of fraud and when it is used as an instrumentality for money laundering. Some of the more common examples of the former include credit card fraud, cheque fraud, mortgage fraud, insurance fraud, pension fund fraud, and securities and investment fraud.

With the ongoing development and increasing sophistication of commercial and financial enterprises, coupled with the consequences of globalization, the range and diversity of financial crime is likely to increase.

Against the above background, conflicts of interests and the exploitation thereof could be categorised as financial crime, if there is a pecuniary loss, either intentional or otherwise. However, the categorisation needs to be done taking into account the factual details of individual cases of exploitation of conflicts of interest. Money laundering indulged in due to conflicting interests would be an example of financial crime.

There are both financial and collateral costs to a financial crime. The quantification of financial loss could be difficult in most cases. However, the damage inflicted by financial crime goes much beyond direct monetary loss. The collateral costs

would turn out to be more costly in the long run, by way of lowered business relationships, staff morale and reputation.

Promoters of vanishing companies are guilty of the worst type of exploitation of conflicts of interest, by which they decamp with the investors' money without any trace as it were.

**Exploitation of conflicts of interest – corruption?**

The problem of conflict of interest is closely related to the problem of corruption. Corruption can be defined as "a behaviour which deviates from the formal duties of a public role because of private interests - regarding (personal, close family, private clique) pecuniary or status gains; or violates rules against the exercise of certain types of private-regarding influence." Based on this definition, corruption is clearly a type of deliberate or accepted conflict of interest in which the interest of the agent is illegitimate.

* * *

# Chapter IV

# Major conflicts of Interest in the Financial sector

## Introduction

The chapter, over VI sections analyses the major conflicts of interest prevalent in the financial sector in general, and in the Indian context in particular. Section I describes the conflicting interests in the Indian context, Section II analyses conflicts of interest in the case of information gatekeepers. Sections III to VI analyse the conflicts of interest situations in the financial markets in general and thereafter in the securities, banking, insurance and other markets / institutions / services respectively. ***Conflicts of interests pertaining to issues relating to triple bottom line issues, which are particularly relevant in the Indian context, not only for the financial sector but also for all the sectors in the economy, are given in Annexure VII.***

As identified in the previous chapters, dual roles of being both a principal and an agent in a multiple-function scenario, existence of information asymmetry and the problems attendant thereto, human emotions of greed, anger, kinship, frustration, etc., improper alignment of interests among the various stakeholders, lack of transparency, lack of an ethics framework for institutions compounded by a myopic view of business goals by management / employees are the more important generic causes for situations of conflicting interests. Conflicts of interest stand out most sharply when an institution provides multiple financial services, thereby creating an opportunity for exploiting the synergies or economies of scope by inappropriately diverting some of the benefits. This is not to suggest that there are no conflicting interests in the case of stand-alone financial institutions, in any of the market segments. As already discussed, conflicts of interests are ubiquitous and only vary in the number, nature and intensity among market participants.

However, it is to be made clear at this stage that it is impossible to highlight all the conflicts of interest or their nature or intensity. As such, this chapter analyses major and material conflicts of interest occurring in the banking, insurance and securities segments of the financial sector.

## Section I

## Conflicts of interest in the Indian context

The closely held structures in the Indian financial market, in a significant manner, come in the way of benchmarking the prevalent corporate governance practices to international standards, which are vital for mitigating / minimising conflicts of interest situations.

The prevailing structures and the significant implications for corporate governance practices and thereby for conflicts of interests are briefly analysed below.

### 1 Structure of Public Sector Units and conflicts of interest

In India, public sector units control about seventy five per cent of banking and insurance (both life and non-life) business. Hence, an analysis of the conflicts of interests in the public sector financial units assumes added significance.

Conflicts of interest situations are particularly tricky and complex, in the corporate governance of these Public Sector Enterprises (PSEs). The range of PSEs is vast and

government's control varies depending upon whether it is a statutory company at the Central or State level (eg., the erstwhile Unit Trust of India and State Financial Corporations); a public sector bank (e.g., State Bank of India, which is created by law), etc.

The structures of public sector units and their effect on corporate governance practices including multiplicity of conflicts of interest situations have been examined, in a generic manner, by the Commonwealth Association for Corporate Governance in a series of reports since 1999. The same with specific reference to the Indian context was examined, to a large extent, by The Yaga Reports of 1997 and 2001; besides the Advisory Group on Corporate Governance in 2000 formed by the Standards Committee of RBI on International Financial Standards and Codes. The observations in this regard, to a certain extent, have been derived from these reports.

Multiple layering of `principal-agent' chains in the case of government owned entities has important consequences for the corporate governance mechanisms that will be adopted in them. Often, the accountability chain is very weak in public sector units. Such multiple layering in agency relationship arises due to the inherent conflict of roles of the Government – as regulator, owner, adjudicator and executive. This conflict gets compounded when the state uses public enterprises as agents of public / political policy than let them function as autonomous legal and economic entities.

There is a virtual stranglehold by a multitude of agencies of the government / the concerned administrative ministry, its officials, planning commission, Comptroller & Auditor General, Central Bureau of Investigation, Central Vigilance Commission over the working of the PSEs. These over arching controls over the PSEs and their boards, arise from the view that the PSEs are indeed government and that the boards are needed only for compliance purposes of the company law. It is often perceived that executive chairmen are subordinate in stature to the ministry representatives on the board, who often exercise, de-facto veto powers.

The Chief Executive Officers (CEOs) and board members in PSEs are appointed by the Government, while their primary duty, being in the public sector, lies in safeguarding the interests of all the stakeholders, as also managing in a way which would promote social good. However, there is a possibility that the incentives are such that they may be more sincere to Government - being their appointing authority, holding office at their pleasure and not the other stakeholders, leading to sub-optimal performance of the units.

Further, cross-holdings among PSEs create situations of conflicts of interest. An apt example of conflicts of interest in PSEs involves the one relating to IDBI and UTI. The Joint Parliamentary Committee (JPC) reports have mentioned about IDBI dominating the affairs of UTI despite the obvious conflict of interest, since IDBI had started its own mutual fund in 1994. IDBI should have taken the initiative to withdraw itself from control of UTI and its presence on the Board of Trustees of UTI at that stage.

Now, the UTI's Asset Management Company (UTI II) has four sponsors viz. Life Insurance Corporation (LIC), State Bank of India (SBI), Bank of Baroda (BoB) and Punjab National Bank (PNB), all having their own mutual funds and three of them are listed on stock exchanges, obviously leading to conflicts of interest. These three sponsors are important banking sector stocks, which no fund worth its name can ignore if it wants a well-rounded portfolio. If UTI- II decides to aggressively purchase stocks like SBI, PNB or BoB, the conflicts of interest aspect would be too apparent as the market would view that UTI Mutual is supporting its sponsors' scrips. There is another possibility of conflict of interest whereby an aggressive investment by UTI Mutual in stocks of blue chip companies will boost the asset value of such stocks held by all the four sponsors in their

own investment account as well as in the mutual funds run by them. Anticipating this, the JPC has, commented that the institutions chosen to sponsor UTI "should be those that have not sponsored their own mutual funds". It has even said that in case this is not found feasible, the government should spell out in detail both through legislation and through policy guidelines as to how it proposes to insulate UTI-II from the inherent conflict of interest as regards these institutions

One of the adverse features repeatedly pointed out in the context of PSEs is that the institutional directors are not generally pro-active. Literature provides us with three different hypotheses, which may explain the relationship between institutions and their incentives to intervene in corporate governance – the efficient monitoring hypothesis, the conflict of interest hypothesis and the strategic alignment hypothesis. The efficient monitoring hypothesis suggests that institutional shareholders are more informed and able to monitor management at lower cost than small shareholders. Alternatively, the strategic alignment hypothesis suggests that institutional shareholders and the board may find it mutually advantageous to cooperate on certain issues. In a similar vein, the conflict of interest hypothesis suggests that institutional shareholders may have current or potential business relationships with the firm, which make them less willing to actively curb management discretion. In this context, it should be ensured that the conflict of interest hypothesis adverted to, is not the reason for which institutional directors are not that active. Managements of such institutions should introspect for themselves and take effective corrective action, if conflicts of interest were the reasons behind their nominee directors' relative non-performance. The substitution of conflicts of interest situations with that of efficient monitoring and strategic alignment situations would augur well for improving corporate governance of the concerned financial institutions having such institutional directors.

Of late, with many of the PSEs becoming listed entities, the expectations of employees and general public are increasing, thereby increasing the pressure on these units and thereby the Government to improve their corporate governance practices.

**2. Structure of private sector units and conflicts of interest**

Traditionally, corporate governance practices are classified as \`Insider' and \`Outsider' models, depending on the extent of separation between ownership and management. The predominant form in India's corporate sector is much closer to the East Asian \`insider' model where the promoters dominate governance in every possible way. Indian corporates, which reflect the pure \`outsider' model with widely dispersed shareholdings and professional management control, are still relatively small in number. An important feature of the Indian scene is the implicit acceptance that corporate entities belong to the \`founding families,' (similar to the behaviour of Governments as owners of PSEs) though not necessarily as their private properties. Even today, the concept of industrial house popularised some time ago by the Dutt Committee and the Monopolies and Restrictive Trade Practices Act (MRTP) continues to be the commonly accepted reference point in most of the discussions on ownership patterns of industrial / business units.

Family business groups still dominate the private sector firmament in India. The business structures are still relatively opaque with a maze of cross-holdings spread across several structures, aimed basically to retain ownership and control over the companies. They are essentially pyramid like structures. In a pyramid, an ultimate owner uses indirect ownership to maintain control over a large group of companies.

In many countries, controlling shareholders are accused of tunneling / diversion, i.e., transferring resources from companies where they have few cash flow rights to ones

where they have more cash flow rights. In a very interesting piece of research, in working paper 7952 of National Bureau of Economic Research, (NBER of USA) titled: "Ferreting out tunneling; an application to Indian business groups," the extent of tunneling / diversion in India was investigated based on a fairly general empirical methodology, relying on data available in the public domain over the period 1989 to 1999.

The research suggests a significant amount of tunneling / diversion between firms in business groups. The tunneling / diversion followed the lines of ownership, flowing from firms near the bottom of the pyramid (where the ultimate owner's cash flow rights are weak) to firms near the top of the pyramid (where the ultimate owner's cash flow rights are strong). Much of this diversion occurred on non-operating components of profits.

Such tunneling / diversion / squirreling represents an exploitation of material pecuniary conflicts of interest, since they deprive the minority or other outside shareholders (i.e., outside the business family circuit), of their otherwise due share in the profits of the listed entities in the group.

## Section II

## Conflicts of Interest in case of Information Gatekeepers

There are several types of agents like auditors, lawyers, investment analysts, rating agencies, brokers, agents, etc., who have privileged access to proprietary information. Information flows through them to the market and hence from an information paradigm point of view are known as 'information gate-keepers.' The gradient of access to top proprietary information reflects the ability of agents to discover the true financial condition and performance of their client firms.

There are three important areas of financial service activities that have the greatest potential for conflicts of interest and thereby an overriding influence on the flow of information in financial markets. They are discussed below:

### 1 Underwriting and research in investment banking

Investment bankers blatantly abused privileged information and misled clients on new-share sales – Initial Public Offerings (IPOs) during the dot-com bubble in the stock market, especially in USA. The two famous star analysts quoted in this context are Hency Blodget of Merrill Lynch and Jack Grubman of Citi group.

The information synergies from underwriting, research, and market making provide a rationale for combining these distinct financial services. This combination of activities leads to conflicts of interest, however. The conflict of interest that raises the greatest concern occurs between underwriting and brokerage, where investment banks are serving two client groups - issuing firms and investors. Issuers benefit from optimistic research, while investors desire unbiased research. If the incentives for these two activities are not appropriately aligned, there will be a temptation for employees on one side of the firm to distort information to the advantage of their clients and the profit of their department. When the potential revenues from underwriting greatly exceed brokerage commissions, there will be a strong incentive to favour issuers over investors or risk losing the former to competitors. As a result, analysts in investment banks might distort their research to please issuers, and the information they produce on securities will not be as reliable, thereby diminishing the efficiency of securities markets.

The role of stock analysts comes under scrutiny. These analysts working for investment banks have the task of providing investors with advice and issue research reports on stocks along with recommendations to buy, hold, or sell the stocks. But, if the bank is more interested in gaining the business for its corporate finance activities than safeguarding the investors' interests, this may influence the analyst's assessment. A fact worth noting is that very few stock analysts issue sell recommendations during a bear market. Curiously, even after Enron executives admitted to accounting fraud, most stock analysts kept a buy recommendation on Enron stock. A nexus may be nurtured and developed between financial analysts, bankers, merchant bankers, fund managers, economists, rating agencies, consultants, stock and currency traders, and funding agencies aligned with one another through common consultancy or accounting firms.

Seeking out conflicts of interest in investment banking is like peeling an onion. It could go on and on until there is little or nothing left. Take for example equity trading. It does not require much digging to unearth potential conflicts of interest at firms with even the purest (that is, the simplest) business. Even that singular man, the so-called specialist on the stock exchange, trades both for himself and on behalf of clients. Hence, conflicts of interest, especially in this case cannot be legislated or wished away. The best course is to realize their existence and take effective steps for mitigating / minimizing them, as discussed in the next chapter.

### 2 Auditing and consulting in accounting firms

The traditional role of an auditor has been to act as an efficient monitor of the quality of information produced by firms so as to reduce the inevitable information asymmetry between the firm's managers and stakeholders, especially its suppliers of capital. Audit fulfils a critical quasi-public statutory function that merits maximum protection. In auditing, threats to truthful reporting arise from several potential conflicts of interest that can lead to biased outcomes. The conflict that has received the most attention lately occurs when an accounting firm provides auditing as well as non-audit consulting services - tax advice, accounting, or management information systems, and strategic advice, commonly referred to as management advisory services. These multiple services enjoy economies of scale and scope, but create two potential sources of conflict of interest. The most commonly discussed conflict is the potential to pressurise auditors to bias their judgments and opinions to limit any loss of fees in the "other" services. The second more subtle conflict is that auditors often evaluate systems or structuring (tax and financial) advice that were put in place by their non-audit counterparts within the firm. Both conflicts may lead to biased audits, with the result that less information is available in financial markets, which will make it harder for them to efficiently allocate capital.

In fact, auditing and consulting are two different businesses with two conflicting interests. While auditing has to deal with investor protection, transparency and reliability; consulting is aligned towards ensuring the operational success of the company they are serving. In this context, another conflict of interest arises since the companies hire and pay the auditors to whom they naturally tend to be obliged.

The issues relating to accounting and audit come to the fore with every reported case of irregularity, bankruptcy, liquidation or regulatory action which is taken to avert liquidation. The need for accounting and auditing transparency has been amply felt and the conduct of internal accounting procedures and auditing firms have come under scanner in the wake of recent corporate collapses such as Enron and WorldCom. Arthur Andersen became a victim of exploitation of such conflicts of interest and had to go out of business. In India, it has been observed, in case of Global Trust Bank where some variances were observed in assessment as between the auditors and the regulators.

### 3 Credit assessment and consulting in rating agencies

Rating agencies act as powerful quasi-official regulators of public debt markets. Ratings are widely used by investors as a guide to the creditworthiness of the issuers of debt, and in financial covenants. As such, they play a major role in the pricing of debt securities and in the regulatory process. For instance, in US alone, more than a dozen financial regulations depend for their effectiveness upon the notion of credit ratings.

Conflicts of interest can arise from the fact that there are multiple users of ratings; and, at least in the short term, their interests can diverge. The investor and regulators are interested in a well-researched, impartial assessment of credit quality; the issuer in a favourable rating. Because issuers pay to have their securities rated, there is a fear that credit agencies may bias their ratings upwards in order to attract more business. A more serious concern is that rating agencies have begun to provide ancillary consulting services in recent years. Rating agencies are increasingly asked to advise on the structuring of debt issues, usually to help secure a favourable rating. In this case, the credit rating agency would be in the position of "auditing its own work," raising conflicts of interest similar to those in accounting firms when they provide both auditing and consulting services. Furthermore, providing consulting services creates additional incentives for the rating agencies to deliver more favourable ratings in order to further their consulting business. The possible reduction in the quality of credit assessment by rating agencies could then increase asymmetric information in financial markets, thereby reducing their ability to allocate credit.

## Section III

### A. Pan-sectoral conflicts of interest

Many of the situations of conflicting interests are common, with a slight variation therein, for all the three segments of the financial markets (including information gatekeepers, to a large extent). However, some of the more important conflicts of interest situations which are prevalent across the financial sector – in securities, banking and insurance segments, are described hereunder.

#### Dealings involving insiders

Dealings with persons or entities connected with the financial intermediary in a way that might affect its judgment represent a potential conflict of interest or self-dealing activity. Such dealings may include investing in securities held by insiders (including bank officers, directors, and employees) or their related interests, assuming their obligations, acquiring their property, selling them properties, or lending funds to them.

A multifunctional financial firm may act as trading counterparty for its own fiduciary clients, as when the firm's asset management unit sells or buys securities for a fiduciary client, while its affiliated broker-dealer is on the other side of the trade.

**Tying**

A financial intermediary, who tries to sell a product / service along with some others offered by either him or some others – a case of tying, may act in ways which are detrimental to the interests of the customers. The concerned staff may not dispense 'dispassionate' advice to clients, possibly to the disadvantage of the customer.

For instance, a financial intermediary may use its lending power to influence a client to use its securities or advisory services as well – or the reverse, denying credit to clients that refuse to use other (more profitable) services.

Costs are imposed on the client in the form of higher-priced or lower-quality services in an exercise of market power. This differs from cross-subsidization, in which a financial institution (possibly pressured by clients) engages in lending on concessionary terms in order to be considered for securities or advisory services. There may be good economic reasons for such cross-selling initiatives, whose costs are borne by the bank's own shareholders. The line between tying and cross-selling is often blurred, and its effectiveness is debatable.

**Misuse of fiduciary role**

All financial intermediaries fundamentally are functioning in a fiduciary (trust agents) capacity vis-à-vis their customers / clients. They are privy to sensitive financial and non-financial information about them. In all circumstances where the customers depend on their trust in the intermediary, the latter are supposed to act in the best interests of the customer. If they act contrary thereto, it constitutes a case of misuse of his fiduciary capacity and tantamounts to exploitation of conflicts of interest.

The complete and efficient use of internal information is central to the operation of financial services firms, including such functions as cross-selling and risk assessment. This may impinge on client privacy concerns or regulatory constraints on misuse of personal information, and raises conflict-of-interest issues that tend to be increasingly serious as the activity-lines of a particular firm become broader.

For example, banks which obtain personal information from their clients, if they tend to misuse the same for other purposes, tantamounts to misuse of fiduciary capacity.

**Churning**

A financial intermediary (a bank, brokerage firm, fund managers, etc.,) that is managing assets for clients – whether retail or wholesale, may exploit its agency relationship by engaging in excessive trading, which creates higher costs and may lead to portfolio sub-optimization. Commission-based compensation for the intermediaries is the usual cause of churning.

## B. Conflicts of interests in the securities markets

### 1. Conflicts of interest in demutualised stock exchanges

The report of working Group on Capital Markets Development of the Federation of Euro-Asian Stock Exchanges (2001), notes a host of problems, in the capital markets, including abuses in privatization programs in transition economies, lack of investor protection standards (especially minority shareholder rights), inadequate disclosure

standards, and entrenched cultures of self-dealing, that contribute to the obstacles. Even where adequate rules and regulations exist, lack of effective enforcement is often a major problem, for a range of reasons.

The conflicts of interest in a broker-dealer ownership of an exchange are well-known. Demutualisation and corporatisation are usually thought to be the way out of such conflicts.

However, the majority of regulators world over, today, believe that conflicts are likely to be exacerbated in 'for-profit' exchanges. It is apprehended the SRO functions of exchanges as the first regulator may be undermined by the business interests of 'for-profit' exchanges. Some of the other major conflicts of interest in the case of corporatised exchanges relate to administration of operating rules, regulating competitors, self-listing and in discharging various regulatory functions relating to listing rules, market surveillance, member regulation, etc. The creation of Conflicts Committees to address any conflicts between the listed exchange and listed companies that it regulates appears to be an emerging best practice. Such committees are in place in Hong Kong, Singapore and Toronto.

BSE has been recently corporatised, but has not yet gone public. Though it is too premature to judge the working in the revised structure, care should be taken to ensure that it does not lead to a situation where one set of conflicts of interests are replaced by another; while carrying forward the unfinished agenda of corporatising the various regional stock exchanges in the country.

**2. Conflicts of Interest in wholesale securities financial markets**

In wholesale financial markets (government or corporate debt or equities) involving professional transaction counterparties, corporations and sophisticated institutional investors, the asymmetric information and competitive conditions necessary for conflicts of interest to be exploited are arguably of relatively limited importance. Caveat emptor and limited fiduciary obligations rule in a game that all parties fully understand. Nevertheless, several types of conflicts of interest seem to arise.

**Principal transactions**

A financial intermediary may be involved as a principal with a stake in a transaction in which it is also serving as adviser, lender or underwriter, creating an incentive to put its own interest ahead of those of its clients or trading counterparties. Further, the firm may engage in misrepresentation beyond the ability of even highly capable clients to uncover.

**Board interlocks**

The presence of bankers on boards of directors of non-financial companies may cause various bank functions such as underwriting or equity research to differ from arms-length practice. This displacement may impose costs on the bank's shareholders or on clients. Although constrained by legal liability issues, director interlocks can compound other potential sources of conflict, such as simultaneous lending, advisory and fiduciary relationships.

**Spinning**

Securities firms involved in initial public offerings may allocate shares to preferred investors on the understanding of obtaining future business, creating a transfer

of wealth to those individuals at the expense of other investors. In India, SEBI, in the recent past, has taken measures for avoidance of such situations.

Merrill Lynch, J.P.Morgan, Citi have been indicted for spinning during the dotcom induced stock market boom in the US in early 2000.

**Investor loans**

In order to ensure that an underwriting goes well, a bank may make below-market loans to third-party investors on condition that the proceeds are used to purchase securities underwritten by its securities unit.

**Front-running**

Financial firms may exploit institutional, corporate or other wholesale clients by executing proprietary trades in advance of client trades that may move the market.

All of the foregoing represents exploitation of Type 1 conflicts, which set the firm's own interest against those of its clients in wholesale, inter-professional transactions.

Type 2 conflicts dealing with differences in the interests of multiple wholesale clients seem to centre predominantly on two issues:

**Misuse of private information**

As a lender, a bank may obtain certain private information about a client. Such proprietary information may be used in ways that harm the interests of the client. For instance, it may be used by the bank's investment banking unit in pricing and distributing securities for another client, or in advising another client in a contested acquisition.

**Client interest incompatibility**

A financial firm may have a relationship with two or more clients who are themselves in conflict. For example, a firm may be asked to represent the bondholders of a distressed company and subsequently be offered a mandate to represent a prospective acquirer of that corporation. The firms may indulge in under pricing IPOs to the detriment of a corporate client in order to create gains for institutional investor clients from whom they hope to obtain future business.

## 3. Conflicts of Interest in retail securities financial markets

Asymmetric information is intuitively a much more important driver of conflict-of-interest exploitation in retail financial services than in inter-professional wholesale financial markets. Retail issues all appear to involve Type 1 conflicts, setting the interests of the financial firm against those of its clients.

**Inappropriate margin lending**

Clients may be encouraged to leverage their investment positions through margin loans from the firm, exposing them to potentially unsuitable levels of market risk and high credit costs. Broker incentives tied to stock margining usually underlie exploitation of this conflict of interest.

**Failure to execute**

Financial firms may fail to follow client instructions on market transactions if doing so benefits the firm.

**Misleading disclosure and reporting**

Financial firms may be reluctant to report unfavorable investment performance to clients if doing so threatens to induce outflows of assets under management. Whereas a certain degree of puffery in asset management performance reviews is common, there is undoubtedly a "break-point" where it becomes exploitative if not fraudulent.

**4. Wholesale-Retail Conflicts in securities markets**

Conflicts of interest between the wholesale and retail domains – characterized by very different information asymmetries – can be either Type 1 or Type 2, and sometimes both at the same time.

**Suitability**

A classic domain-transition conflict of interest exists between a firm's "promotional role" in raising capital for clients in the financial markets and its obligation to provide suitable investments for retail clients. Since the bulk of a firm's earnings usually come from capital-raising side, and given the information asymmetries that exist, exploiting such conflicts can have adverse consequences for retail investors.

**Stuffing**

A financial firm that is acting as an underwriter and is unable to place the securities in a public offering may seek to ameliorate its exposure to loss by allocating unwanted securities to accounts over which it has discretionary authority. This conflict of interest is unlikely to be exploited in the case of closely-monitored institutional portfolios in the wholesale domain. But in the absence of effective legal and regulatory safeguards, it could be a problem in the case of virtual discretionary accounts in the retail domain, maintained on trust basis.

**Market-timing and late-trading**

Important clients tend to receive better service than others, in the financial services sector as in most others. When such discrimination materially damages one client segment to benefit another, however, a conflict of interest threshold may be breached and the financial firm's actions may be considered unethical or possibly illegal, with potentially serious consequences for the value of its franchise. Such cases came to light in 2003, involving both criminal fraud charges and civil settlements regarding "late trading" and "market timing" by hedge funds in USA in the shares of mutual funds, shifting returns from ordinary investors to the hedge funds in exchange for other business solicited by the mutual fund managers involved.

**Laddering**

Investment banks involved in initial public offerings may allocate shares to institutional investors who agree to purchase additional shares in the secondary market, thereby promoting artificial prices intended to attract additional (usually retail) buyers who are unaware of these private commitments. A related conflict involves providing bank loans to support the price of a security in the aftermarket. SEBI, in the recent past, has issued instructions to address the issue.

**Shifting bankruptcy risk**

A bank with credit exposure to a client whose bankruptcy risk has increased, to the private knowledge of the banker, may have an incentive to assist the corporation in issuing bonds or equities to the general public, with the proceeds used to pay-down the bank debt.

## Section IV

## Conflicts of interests in the banking markets

### 1. Conflicts of interest in Universal Banking

The concept of 'universal banks' is gaining ground in the country. In general it refers to the combination of commercial banking and investment banking, i.e., issuing, underwriting, investing and trading in securities. In a very broad sense, however, the term 'universal banks' refers to those banks that offer a wide range of financial services, beyond commercial banking and investment banking, such as, insurance, mutual fund products, provide venture capital, etc. In the spectrum of banking, specialised banking is on the one end and the universal banking on the other.

The potential for conflicts of interest is more in universal banking, and runs across the various types of activities the bank engages. For example -

- **Stuffing fiduciary accounts**: When a bank acting as an underwriter is unable to place the securities in a public offering, it is thereby exposed to a potential underwriting loss. In such cases, there would be 'Conflict of Interest' when it may seek to ameliorate this loss by stuffing unwanted securities into accounts managed by its investment department over which the bank has discretionary authority.

- **Risk transfer in the cases involving Bankruptcy / Non-Performing Assets (NPAs)** - A bank with a loan outstanding to a corporate, whose bankruptcy/non performing risk has increased, to the private knowledge of the banker, may have an incentive to induce the firm to issue bonds or equities - underwritten by its Merchant Banking unit - to an unsuspecting public. The proceeds of such an issue could then be used to pay-down the bank loan. In this case the bank has transferred debt-related risk from itself to outside investors, while it simultaneously earns a fee and/or spread on the underwriting. This is a situation of 'Conflict of Interest' against society.

It is widely believed that conflicts of interest at major banks may have played a role in Enron's collapse. J.P.Morgan and Citigroup, as well as Bank of America and several other non-American banks, such as Deutsche Bank and Switzerland's UBS, are alleged to have made loans at a loss in order to win more lucrative investment banking business; thus allowing the company to become over-leveraged. These banks avoided disclosing this, at least in the short term, thanks to favourable accounting rules that do not require commercial banks to mark their loan portfolios to markets. However, the banks concerned have denied such practices.

Nonetheless, certain fundamental questions beg an answer. Did being both a creditor of Enron and an adviser create acute conflicts of interest as the company approached bankruptcy? As creditors, the banks may have had an interest in preserving whatever value Enron had left to maximise their chance of being repaid. As advisers, they may have had reason to promote riskier strategies in a bid to keep Enron alive and stop its shareholder being wiped out. The crucial point is that it

would be unethical to place oneself deliberately in a position which would result in conflicting interests and hence, as far as possible, it would be prudent to avoid placing oneself in such compromising situations.

### 1.1 Intra-group transactions and exposures (ITEs)

Intra-group transactions and exposures can facilitate the synergies within different parts of the conglomerate and thereby lead to healthy cost efficiencies and profit maximisation, improvements to risk management, and more effective control of capital and funding. At the same time, material ITEs represent avenues of contagion within the conglomerate and potentially complicate the resolution of failures. There could be many sources of potential conflicts of interest in ITEs in form of capital or income being inappropriately transferred from the regulated entity; terms or circumstances under which parties are operating do not allow arm's length relationship and thus be disadvantageous to a regulated entity; the cross dealings within the group may adversely affect the solvency, the liquidity and the profitability of individual entities within a group; the synergies are used as a means of supervisory arbitrage, thereby evading capital or other regulatory requirements

### 1.2 Conflicted research

Analysts working for multifunctional financial firms wear several hats and are subject to multiple conflicts of interest. In such firms, the researcher may be required to: (1) Provide unbiased information and interpretation to investors, both directly and through retail brokers and institutional sales force; (2) Assist in raising capital for clients in the securities origination and distribution process; (3) Help in soliciting and supporting financial and strategic advisory activities centred in corporate finance departments; and (4) Support various management and proprietary functions of the firm. These diverse roles are fundamentally incompatible, and raise intractable agency problems at the level of the individual analyst, the research function, the business unit, and the financial firm as a whole. Researchers cannot serve the interests of buyers and sellers at the same time. No matter how strong the firewalls, as long as research is not profitable purely on the basis of the buy-side (e.g., by subscription or pay-per-view), the conflict can only be constrained but never eliminated as long as sell-side functions are carried out by the same organization. And even if research is purchased from independent organizations, those organizations could face the same inherent conflicts if they expect to develop further business commissioned by their financial intermediary clients.

## 2. Conflicts of interest in traditional banks and financial institutions

Conflicts of interest situations, being ubiquitous in nature, are also present in standalone banks / financial institutions as opposed to universal banks, perhaps in lesser number, degree and intensity. The conflicts of interest discussed in these stand-alone banks are also present in the universal banks, perhaps in greater numbers, degree and intensity. For ease of presentation the more important of them are discussed below.

### *2.1 Conflicts in lending function*

In the Indian context, its political economy and relationship-based society lead to certain unique conflicting situations like behest lending, nepotism / favouritism,

dilution of lending norms, etc., which have a debilitating effect on the financial intermediaries in the long run, by way of accretion to NPAs.

Grant of loans, advances and contracts to (a) directors of the bank (b) relatives of directors of the bank, (c) directors of other banks and their relatives, (d) directors of subsidiaries and their relatives, and (e) relatives of senior officials of the bank could lead to conflicts of interest. Even issuing guarantees on behalf of directors or accepting guarantees from directors could lead to Conflict of Interest.

While legal provisions are available to take care of majority of these conflicts; there is no such provision for preventing lending to large shareholders, which is a particularly significant problem in India, given the structure of private sector undertakings, as already discussed.

### *2.2 Conflicts in Investment Banking & Asset Management Services*

Banks providing various investment services for clients may be required to manage a variety of actual or potential conflicts of interest. Conflicts of Interest and self-dealing transactions normally arise whenever the bank's ability to act exclusively in the best interest of account beneficiaries or clients is impaired. A fiduciary is required to put the interests of account beneficiaries before the interests of the bank. The fiduciary owes its beneficiaries undivided loyalty and must administer each trust for the exclusive benefit of account beneficiaries and the purposes for which the account was created.

Conflicts of Interest are not limited to instances in which the bank is acting in a fiduciary capacity. In fact, as the trust business increasingly becomes an asset management business with opening up of pension funds and provident funds etc., the opportunities for a bank to find itself in a conflict of interest will increase. Asset management - the management of third-party assets for a fee or commission - includes fiduciary services, investment advisory services, retail sales of non-deposit investment products, and agency arrangements including custody of assets. When a bank provides these services, the best interests of the client and the bank are not always the same.

### *2.3 Conflicts in Risk Management*

Risk management activities, by their very nature, offer fertile ground for conflicting interests. There could be potential conflicts of interest, if the roles of the individuals and / or committees responsible for risk management are not clearly defined, there is no proper separation of duties in key elements of the risk management process and the risk measurement, monitoring and control functions are not sufficiently independent from position-taking functions of the bank.

Consequently, the internal control guidelines in all aspects of risk management are fairly well developed in comparison to the other areas of a financial institution's functioning.

#### 2.3.1. Treasury activities

The treasurers in particular, wield tremendous power in committing the financial institutions for large amounts, in a matter of seconds. Several major financial institutions, the world over, have come to considerable grief, in particular, due to exploitation of conflicts of interest by treasury personnel. Barings, Stan Chart, ABN-Amro are among the several such examples.

In most of such scandals, it is observed that the cultivation of 'star' status among treasurers or for that matter among staff at any level, paved the way for exploitation of conflicting interests. The stars are held in awe and whatever actions they indulge in are believed to be highly profitable, based on previous institutional experience. As a corollary, questioning their actions is thought of to be highly unbecoming of a profitable institution. Consequently, institutions lower the guard in monitoring the activities of such stars, on the ill-logical belief that such stars would continue to always act in the best interests of the institution, though not necessarily in the short run; which provide added incentives to them for exploiting conflicts of interests. 'Fit and proper' criteria should be applied to all treasury personnel, at its absolute broadest, on an enduring and on-going basis.

#### 2.3.2 Empanelling Stock Brokers

Banks empanel stock brokers for their security and shares investment trading. There could be possible conflict of interest, if the stockbrokers or their close relatives are appointed as independent directors on the Boards of banks or in any other capacity they/ their relatives involve themselves in any manner with the Investment Committee or in the decisions in regard to making investments in shares, etc., or granting advances against shares. This apart, bank directors also may try to get their relatives appointed as stock brokers.

### *2.4 Conflicts in Internal control functions*

#### 2.4.1 Audit work

Classic conflicts of interest arise especially when the internal audit function is not independent from the internal control process and when the internal auditors are asked to undertake other non-auditing work like accounting and operational functions. Another serious conflict arises when the auditors have to report to the people who are their administrative bosses.

### *2.5 Conflicts in merchant banking activities*

A bank's merchant banking division or merchant banking subsidiary may solicit merchant banking business from corporates and may simultaneously agree for funding credit requirements of the corporation as a quid-pro-quo. There may be deficiencies in the appraisal of credit proposals. High projections of the borrowing company may not be critically analysed by the sanctioning authorities. With the result, the borrowers' credit requirements may not be properly assessed.

Another conflicting interest arises when banks sanction credit limits to corporates on the basis of appraisal made by their merchant banking division or subsidiary for the purpose of public issue. The bank's credit department relies on such appraisals and no separate / independent assessment for credit risk is done leading to possibility of loans turning into non-performing assets.

The merchant banking division / subsidiary arranges finance through public issue for a corporate for a fee income. It has a fiduciary relationship with its client and it has to do best for the client. If it presents a rosier picture of its client than what is warranted there may be a conflict of Interest with public at large, as the public may look at the standing and credibility of the Merchant Banker and invest in the public issue.

Reliance by the bank's credit department on such appraisal leading to lending decisions may obviously be fraught with risks.

## Section V

## Conflicts of interest in the insurance markets

### 1. Conflicts of interest in General insurance

The general insurance industry contains numerous instances wherein conflicts of interest situation. We analyse the more important of them and give solutions how best these can be managed given the inherent nature of the activities.

#### 1.1 Underwriting of risks – Premium chargeable/cross-subsidization

A general insurance company operates in a competitive environment and the underwriter is exposed to various pulls and pressures. While the marketing person exerts pressure to have his proposal accepted at the most favourable terms and conditions, the underwriter has to use his judgement to ensure that the risk is worthy of being underwritten at the technical rate. There exists a potential conflict of interest position if the underwriter is also made responsible for the marketing functions in the insurance company.

The way forward to avoid conflict of interest is by separating the two positions and making them independent.

#### 1.2 Role of Surveyor and Loss Assessor in settlement of claims

Every loss which is more than Rs. 20,000/- has to be compulsorily surveyed and assessed by an independent surveyor and loss assessor licensed by IRDA. The insurance company pays the fees (except in marine cargo insurance) for the loss assessment report submitted by the surveyor and loss assessor. The amount of loss suffered by the policyholder in an accident is determined by the surveyor. The surveyor and loss assessor are in a conflict of interest situation as they are paid fees by the insurance company, while they have also an important duty to perform vis-à-vis the policyholder. The surveyor and loss assessor may, therefore, be more prone to listening to the advice of the insurance company, being their employers, thus potentially hurting the policyholders' interests.

#### 1.3 Claims settlements

The reputation and character of the insurance company is determined by the claims settlement ability. The timely action on part of the insurance company goes a long way in mitigating the distress which falls on the insurance policyholder. The claims manager has to play a delicate role in balancing the expectation of the insurance policyholder as he expects to be paid in full the loss and the interests of the insurance company by whom he is employed. The claim settlement has to be effected by him under the terms and conditions of the policy issued by the company without compromising the expectations of the policyholder or the interests of the insurer. The position becomes more acute when he is required to do the claims settlement in respect of a claims belonging to him or his close relative. To that extent the claims manager is in a conflict of interest position.

## 2. **Conflicts of interest in Life Insurance**

The policyholder entrusts his savings to the life insurance companies in the belief that in case of an unfortunate death / accident, the life insurance company would compensate him or his family members. It is therefore more imperative for the life insurance companies to manage conflicts of interest situations. The following illustrates some of the activities of the life insurance company.

### Appointed Actuary System

In India, the Appointed Actuary System has been adopted, whereby the Appointed Actuary acts as the ears and eyes of the Authority in the life insurance company. He is appointed in a life insurance company with the prior approval of the Authority and cannot be removed from his position without the consent of the Authority.

He is responsible for rendering actuarial advice to the management of the insurer, in particular in the areas of product design and pricing, insurance contract wording, investments and reinsurance; ensuring the solvency of the insurer at all times; complying with the provisions of the section 64V of the Insurance Act, 1938 in regard to certification of the assets and liabilities that have been valued in the manner required under the said section; complying with the provisions of the section 64 VA of the Act in regard to maintenance of required solvency margin in the manner required under the said section, drawing the attention of management of the insurer, to any matter on which he or she thinks that action is required to be taken by the insurer to avoid –

(i) any contravention of the Act; or

(ii) prejudice to the interests of policyholders;

and complying with the Authority's directions from time to time, etc.

All these place onerous responsibility upon him to discharge his duties with fairness and equity. The position of appointed actuary is therefore in a conflict of interest position as he has to balance the interests of the customer with that of the insurance company.

### 2.2 Actuarial valuation of liabilities and distribution of surplus

The actuarial valuation of liabilities is of key importance as it based on these valuations that the insurance company declares the bonus for distribution to the policyholders. This is akin to reserving in case of general insurance business. The actuarial valuation of liabilities can have an impact on the benefits to be passed on to the policyholders. Hence the chief executive officer because of the competitive pressures may try to influence the actuary to declare a higher bonus based on the valuation exercise done by him. Here again the actuary has to ensure that the conflict of interest position that he is in is minimised and is able to satisfy the demands of the policyholders without compromising the interests of the insurer.

*The issue relating to influencing the actuary to declare a higher bonus, has been addressed in a number of countries by having a system of Actuarial Audit and of Peer Review. In India, the Authority has appointed an actuarial panel with eminent Actuaries. This actuarial panel would review the reports of the Actuary and also the reports of the insurer to examine the reasonableness of the assumptions made by the Actuary and also the growth of determination of bonus. Besides, the Actuarial Society of India has subjected the Appointed Actuaries to*

*have their reports reviewed by a peer actuary. This also ensures the system of Appointed Actuary to act in the interest of policyholders.*

### 3. Intermediaries in Insurance Markets

#### 3.1 Appointment of Surveyors & Loss assessors & Third Party Administrators (TPAs)

One of the important functions of a general insurance company is to appoint an independent surveyor and loss assessor licensed by the Authority in case of all claims over Rs. 20,000/-. An employee performing this task is in a potential conflict of interest position as he has to watch the interest of the company, give immediate attention and proper service to the customer and appoint a competent surveyor to carry out his job.

In order to insulate the position of the person who does the surveyor and loss assessor's appointment, clear limits for survey appointment should be fixed by the company. Secondly the company should have a panel of surveyors and they should be given work on rotational basis so as to reduce the potential conflicts.

#### 3.2 Empanelling of insurance brokers, insurance agents and corporate agents

An agent represents the insurance companies while the brokers represent the policy holders. However, the brokers are paid brokerage by the insurance company. Hence, they are in a conflict of interest situation as their loyalties are divided between the person paying them fees for the services rendered to the policy holder.

Every insurance company utilizes different channels of distribution for selling insurance policies. In such cases conflicts of interest arise when the agent/ broker/ producer sells a policy to the prospect based not on his needs or requirements but on the commission that he gets from the insurance company on the type of policy sold. Hence agents may give advice to the customer to buy a endowment policy where the commissions are high vis-à-vis the term insurance where the commissions are low even though the prospect needs term insurance. The agents/ brokers are therefore in a conflict of interest situation.

Aon, the world's second largest broking company was indicted for 'steering' business to companies which paid the highest commission.

## Section VI

## Conflicts of interests in the other areas

### 1. Self Regulatory Organisations

Self Regulatory Organisation (SRO) is a trade body / pressure group representing a certain class of persons/ organizations having a common objective which works for the interest of that group. SROs are creatures of law, which are expected to operate as quasi-regulators under the auspices of the main regulator. The empowerment of the SRO's essentially involves grant of rights and responsibilities to market participants who, for their part, must be capable of ensuring effective regulation and must be able to

meet these challenges. Failure to regulate effectively will lead to a deterioration of market integrity and stability and, ultimately, to the intervention of the concerned regulators.

As the Indian markets develop, the role of the Self-Regulatory Organisations (SROs) will take on greater significance. The SROs should be the best means of self-regulation and more and more regulatory functions should get delegated to them. But, in SROs, generally conflicts of Interest arise because of the representation by the nominees of the members on the Board and Disciplinary Committee of the SROs, which would have the power to initiate action against its members. The functionaries on the Boards / Disciplinary Committees of such SROs are employees of some of the members at different management levels. Striking balance between the member's interest and market interest (delegated by regulator) becomes a major challenge for them. Any wrong action tilted in favour of the members whose representatives are on the Board / Disciplinary Committee would endanger the SROs' credibility. Inequality of the treatment among the members of the SRO may also be a potential conflict situation. On the other hand, impartial decision making and action against a particular member may invite concerned member's wrath against the nominee of that member. The way forward is to strike a healthy overall balance, so that they can function as effectively self-regulatory bodies.

Hence, the SRO's main conflict of interest situation arises due to the fact that on one hand, they have to look after the interests of the stakeholders while on the other hand, they have to act as a disciplinary authority. The SRO's are not able to take action against the erring entities and undertake the task of acting as a disciplinary authority because of the stakeholders interests in the organization.

**2. Financial Planning profession**

In India, as per trends discernible, it is observed that professions relating to wealth management / financial planning are quickly becoming the most sought after ones, given the potential therefor, considering the phenomenal growth in the number of High Networth Individuals (HNIs) and Double Income No Kids (DINKs) couples, due to rapid rise of income levels on account of enhanced economic growth. The professionals in these spheres, be it in institutions like banks or as individual practitioners, have access to all privileged information about the financial status of their clients. In such circumstances, given the overall literacy levels of Indian populace, there could be a tremendous incentive to exploit conflicts of interests in a myriad ways, to the detriment of the clients, since all HNIs may not necessarily be highly literate.

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# Chapter V

## Measures adopted for mitigating conflicts of interests in the financial sector – Nationally and Internationally

The various measures – legislative, regulatory and others, adopted in India for mitigating conflicts of interest in the banking, securities and insurance segments of the financial sector are discussed in Sections I, II and III respectively. Section IV highlights the important measures adopted in major jurisdictions internationally.

### Section I
### Measures adopted nationally

**Measures by RBI**

**1.1. Governance**

The various measures undertaken by RBI, in this regard, are detailed in Annexure IV.

It would be observed therefrom that the more important measures pertain to improving the standards of corporate governance in banks through implementation of the Ganguly Group recommendations, restrictions in related party transactions and connected lending.

The more important specific measures undertaken to raise the standard of corporate governance in respect of listed banking companies, which would reduce conflicts of interest, pertain to:

(a) increased representation for independent directors;

(b) optimum combination of executive and non-executive directors in the Board;

(c) setting up of qualified and independent audit committees, their constitution, chairmanship, power, roles, responsibilities, conduct of business, etc.;

(d) disclosures on related party transactions, accounting treatment, risk management, remuneration of directors, uses /applications of proceeds from public issues, rights issue, preferential issues etc., CEO/CFO certification;

(e) disclosure on pecuniary relationship or transactions of the non-executive directors vis-à-vis the bank;

(g) disclosures to be made by management to the Board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (for e.g. dealing in company shares, commercial dealings with bodies which have shareholding of management and their relatives etc.);

(h) remuneration of Directors (in case of private sector banks);

(i) prescribing periodicity / number of board meetings;

(j) information to shareholders regarding appointment / re-appointment of directors and display of quarterly results;

(k) maintenance of office of non-executive Chairman;

(l) the bank's board should set up a remuneration committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference, the bank's policy on specific remuneration packages for executive directors including pension rights and any compensation payment (in case of private sector banks);

(m) restricting the number of committees to ten, in which a Director can be a member or to five as Chairman, across all companies in which he is a director. Furthermore, it is a mandatory annual requirement for every director to inform the company about the committee positions he occupies in other companies and notify changes as and when they take place;

(n) prescribing a separate section on Corporate Governance in the annual reports of companies, with a detailed compliance report on Corporate Governance. Non-compliance of any mandatory recommendation with reasons thereof and the extent to which the non-mandatory recommendation has been adopted should be specifically highlighted. This will enable the shareholders and the securities market to assess for themselves the standards of corporate governance followed by a company.

(o) issue of comprehensive 'Know Your Customer' and money laundering guidelines

**1.2 Other legislative / regulatory measures**

**1.2.1 Prohibition of employment of managing agents and restrictions on certain forms of employment** – Banks are prohibited from employing or being managed by a person whose remuneration or part of whose remuneration takes the form of commission or of a share in the profit of the banking company.

**1.2.2 Prohibition of common directors** - No banking company incorporated in India shall have as director on its Board of Directors, any person who is a Director of any other banking company.

**1.2.3 Restriction on nature of subsidiary companies:** A banking company shall form a subsidiary company to undertake only business which is permissible for a banking company to undertake and with the approval of the RBI.

**1.2.4 Restrictions on loans and advances:** No banking company shall grant loans or advances to or on behalf of (i) on the security of its own shares; (ii) to any of its directors;(iii) to any firm in which any of its director is interested as partner, manager, employee or guarantor; (iii) to any company of which any of the directors of the banking company is a director, managing agent, manager, employee or guarantor or in which he holds substantial interest; or (iv) to any individual in respect of whom any of its directors is a partner or guarantor. These guidelines are applicable mutates mutandis to Directors of subsidiaries/ Trustees of mutual funds/venture capital funds set up by banks as also by other banks.

**1.2.5 Restriction on power to remit debts:** A banking company shall not remit in whole or in part any debt due to it by (a) any of its directors or (b) any firm or company in which any of its directors is interested as director, partner, managing agent or guarantor, or (c) any individual if any of its director is his partner or guarantor.

**1.2.6 Business relationship with subsidiaries:** Banks have to maintain 'arm's-length" distance vis-a-vis its subsidiaries in regard to business dealings (such as taking undue advantage in borrowing / lending funds, transferring / selling/buying of securities at rates other than market rates, giving special consideration for securities transactions, overindulgence in supporting / financing the subsidiary, financing the bank's clients when the bank itself is not able or is not permitted to do so, etc.).

**1.2.7 Stock brokers as Directors on the Boards of Banks:** Banks have been advised to ensure that the stockbrokers as Directors on the Boards of banks or in any other capacity , do not involve themselves in any manner with the Investment Committee or in the decisions in regard to making investment in shares, etc., or advance against shares.

**1.2.8 Sanctioning of credit limits:** Banks have been advised not to sanction credit limit on the basis of appraisal made by the Merchant Banking Division for the purpose of public issue.

## Section II

## Measures by SEBI

The measures undertaken by SEBI are given in Annexure V.

It would be observed therefrom that the regulations framed under the SEBI Act, 1992 are predominantly aimed at mitigating the conflicts of interest situations arising in the securities industry. The rules and regulations / instructions, framed by SEBI are quite detailed in scope and content with regard to corporate governance practices, disclosures, misuse of position or information available in professional capacity, dealings among associate / group concerns.

The respective codes of conduct framed for almost all categories of intermediaries – merchant bankers, registrars to an issue and share transfer agents, stock brokers and sub-brokers, credit rating agencies, mutual funds; contain provisions which cast an obligation on the respective intermediary to avoid / put in place mechanisms to avoid any conflict of interest and to resolve, if any, such conflicts as and when they arise and also to provide adequate disclosures regarding thereto. Apart from the above, generally codes of conduct of almost all the intermediaries contain provisions relating to maintaining high standards of integrity, promptitude and fairness in the conduct of the intermediaries business.

### Legislative/regulatory mechanisms

SEBI has built into its various regulations and directives, provisions on corporate governance, adequate disclosures and internal controls, systems and mechanisms to be put in place to avoid conflict of interest situations and to ensure good corporate governance, striving to duly serve the interests of all stakeholders. The provisions so built in have broadly been classified under the following heads:

a) Corporate Governance
b) Disclosures
c) Misuse of position or information available in professional capacity
d) Dealings with / through Associate / Group Concerns
e) Appropriate Use / Segregation of Funds / Securities / Other Business

f) Miscellaneous.

A brief synopsis of the regulatory requirements put in place to avoid conflict of interest is given below:

- **Corporate Governance**

Observance of principles of good corporate governance in letter and spirit by the various stakeholders in the capital market is of utmost importance in order to do justice to the interests of all concerned in the process. Towards this end, certain provisions have explicitly been incorporated in the various Regulations of SEBI. Such requirements, inter alia, include provision for independent directors on the Boards of Issuer Companies / Asset Management Companies of Mutual Funds and Collective Investment Schemes; obligation to ensure good corporate governance on the part of intermediaries, segregation of different activities / businesses etc.

- **Disclosures**

Adequate disclosures and proper dissemination of information by issuer companies / intermediaries about the conduct of their business are the hallmark of enabling investors to take informed investment decisions. Stringent initial and continuous disclosure requirements have been put in place for issuers. Intermediaries are also obligated to disclose their interest, if any, in the various activities that they undertake so that the investor is fully informed of conflict of interest situation, if any.

- **Misuse of position or information available in professional capacity**

Various stipulations have been put in place to prevent any misuse of position or information available to an issuer or intermediary or their employees in professional capacity. It has been made obligatory on the part of intermediaries to ensure that information pertaining to the clients is kept confidential and is not used for making any personal gains. Dealing by an insider on the basis of any unpublished price sensitive information is an offence attracting stiff penalties, both civil and criminal.

- **Dealings with / through Associate / Group Concerns**

It is quite likely that if an intermediary is allowed to deal with / through its associates / group concerns without making proper and adequate disclosures, it may tend to act in a manner detrimental to the interests of investors. It is in this light that various restrictions have been put on intermediaries dealing with / through group / associate concerns. For example, a credit rating agency cannot rate securities issued by its promoter. A merchant banker cannot manage issue of its group or associate companies. Investment restrictions are in place for dealing in the scrip of group/ associate companies by an asset management company.

- **Appropriate Use / Segregation of Funds / Securities / Other Business:**

Various compliance requirements have been put in place in the regulatory framework making it obligatory on the part of intermediary to ensure that the funds / securities belonging to clients, are adequately separated and segregated from those belonging to the intermediary in order to prevent any misuse. It has also been mandated to maintain an arms length relationship between the various activities and businesses of the intermediary concerned.

## Section III

## Measures by IRDA

The measures undertaken by IRDA are given in Annexure VI.

**Provisions contained in the Insurance Act, 1938**

**1. Non-issuance of composite license for life and general insurance -** For the purposes of eliminating the conflicts of interest amongst different insurance entities, the Insurance Act, 1938, allows for issuance of license to carry out life insurance business or general insurance business or reinsurance business. The three cannot be combined in a single license.

**2. Restrictions on name of insurer** – In order to prevent conflicts of interest, the Act prohibits registration of an insurance company whose name resembles an already registered insurer.

**3. Capital** – The capital of the company to consist of only ordinary shares each of which has a single face value and voting rights. Transfer of shares is only permitted with the prior approval of the Authority. Such checks prevent in the conflict of interest amongst different promoters.

**4. Manner of divesting of excess shareholding in certain cases** – The Act also lays down the manner in which the excess shareholding will be divested by the promoters, so that they do not come into conflict of interest situations.

**5. Separation of accounts and funds** – The Act in order to prevent mixing of funds, has specified that the funds belonging to life insurance business, fire insurance business, marine insurance business and miscellaneous insurance business shall be maintained separately.

**6. Investments** – Investments made by insurance companies will have to be made strictly in accordance with the provisions of the Act.

7. **Prohibition of loans** – No insurer is allowed to grant loans or temporary advances either on hypothecation of property or on personal security or otherwise, except on life policies issued by him within their surrender value to any director, manager, managing agent, actuary, auditor or officer of the insurer. This provision acts to prevent conflicts of interest amongst the various roles which a director, manager, managing agent, actuary, auditor or officer of the insurer have to perform.

**8.Provisions relating to Managers** – This provision of the Act provides for a number of functions which cannot to be undertaken by the manager

.

**9. Prohibition of common officers and requirements as to whole time officers** – This provision of the Act, prevents managing director or officers carrying on life insurance business to be the managing director or other officer of any other insurance company, banking company or investment company.

**10.Prohibition of payment by way of commission or otherwise for procuring business** – This Act expressly states that no person shall pay or contract to

pay remuneration or reward by way of commission or otherwise for soliciting or procuring insurance business except to agents.

**11. Other provisions** include Limitation on expenditure on commission and life insurance agents not to be directors of life insurance

**2. Regulations of IRDA**

The Authority has issued number of regulations for the effective functioning of the insurance industry in the country.

**2.1 IRDA's (Insurance Advertisements and Disclosure) Regulations, 2000** - These regulations are aimed at providing complete and correct picture to the insurance policyholder in respect of the products being offered to him by the insurance company.

**2.2 IRDA's (Licensing of Insurance Agents) Regulations, 2000** – One of the express conditions placed in the code of conduct for an agent is that he cannot become or remain a director of any insurance company.

**2.3 IRDA's (Appointed Actuary) Regulations, 2000** - The Appointed Actuary regulations specify the duties and functions of the appointed actuary and bring out the conflict of interest in the role that he plays in a life insurance company.

2.4 **IRDA's (Protection of Policyholder's Interest) Regulations, 2002** – These regulations empower the policyholder to protect himself from the different positions wherein some person may twist it to the detriment of the policyholder also equip the policyholder to demand greater attention and adequate disclosures which will minimise conflict of interest and the adverse impact on the policyholder.

## Section IV

### International Practices adopted for Mitigating the Conflicts of Interest in the Financial Sector

The outcome of various corporate malfeasances has been the foremost concern amongst regulators, professional and academicians worldwide in addressing the issue of conflicts of interest in financial sector. In last few years, various developments have taken place internationally to address this issue.

As regards the measures already in prevalence before these initiatives were undertaken, it has to be stated that they were broadly based on the same universal principles of restricting conflicting roles as far as possible, disclosure of the same in unavoidable situations, backed by strong and strict legislative / regulatory actions to secure compliance. While the substance of such measures in place has been more or less the same across all jurisdictions (including India), they were calibrated to suit the individual social realities – the nature of government control, legal / regulatory practices and the nature of society. As the extant measures in Indian context have already been discussed , the same in the international context are not again discussed to avoid repetition.

The more important measures undertaken internationally, in response to the recent corporate scandals are discussed in the ensuing paragraphs. There does not seem to be any exclusive and overarching exercise by any regulator to address the

same. For instance, Financial Services Authority UK (FSA) addresses conflict of interest in a broader perspective. The issue has been explicitly mentioned in “Principles of Business”. According to FSA, A *firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.* US have addressed this issue in several legislative reforms. Also it observed that most of the reforms are disclosure - based.

1. **Investment Banking and Role of Stock Analysts:**

There is a potential conflict of interest between investment bank’s activity in corporate finance such as issuance of securities, mergers and acquisitions and providing independent investment advice. Traditionally, there is a Chinese wall between the two functions but its efficacy is often put to test.

**US developments:**

Section 501 of The Sarbanes-Oxley Act (2002), deals with analysts’ conflicts of interest. It gives the Securities Exchange Commission (SEC) powers to make and amend its regulations, or direct securities associations and national securities exchanges to do so, to protect investors and the public interest. Separately, in February 2003 the SEC adopted Regulation Analyst Certification, (known as Regulation AC) which requires research analysts to certify truthfulness of the views they express, and to disclose whether they have received any compensation in connection with them. Further investment banks accused of corporate abuses agreed to comply with a number of additional requirements:

- the insulation of research analysts from investment banking pressure;
- disclosure of analysts’ recommendations;
- publication of ratings and price target forecasts;
- a complete ban on the spinning of IPOs;
- an obligation to fund independent research.

**European developments**

Certain recent developments aimed at providing for an EU-wide consideration of analysts conflicts of interest are given below:

- ***Market Abuse Directive:*** The Market Abuse Directive requires investment research to be “fairly presented” and relevant conflicts of interest to be disclosed. It sets out high-level disclosure requirements, together with more detailed disclosures on particular matters such as a firm’s material interest in research and recommendation.
- ***Revision of the Investment Services Directive:*** The proposed revision of the Investment Services Directive includes ‘investment research and financial analysis’ as an ancillary service. This means that where investment research is carried on in conjunction with a Directive core activity, it will be subject to regulation under the Directive.
- ***Forum Group on Financial Analysts*** **:** In November 2002, the European Commission set up a Forum Group on Financial Analysts to make recommendations on the best regulatory and market practice framework for financial analysts within an

integrated European capital market. The report sets out principles that should govern firms' actions but leaves implementing measures to the Commission to decide upon.

Further Financial Services Authority (FSA) has mandated that all regulated firms who publish research, would be required to publish a policy explaining how they manage conflicts of interests in their business. Such policies would have to meet certain core standards such as 'analysts should not be involved in any activity that could conflict with their ability to produce objective research'; 'analysts should not attend road shows or pitches' etc. Other standards include not allowing someone with conflicting responsibilities to:

- Supervise an analyst; or
- to decide on the content of research; or
- to decide the remuneration of an analyst. For example, analysts should not be remunerated from the proceeds of specific investment banking deals.

**a. Conflict of Interest in Financial Conglomerates:**

**USA: SEC Consolidated Supervised Entity rules**

One of the major conflict of interest in any financial conglomerates is the relationship between group companies. SEC has adopted rules to implement Section 17 (i) of the Securities Exchange Act of 1934, which created a new framework for supervising an Investment Bank Holding Company ("IBHC"). An IBHC that meets specified criteria may elect to become a Supervised Investment Bank Holding Company ("SIBHC") and be subject to supervision on a group-wide basis by filing a notice of intention with the SEC. Pursuant to the statute and these new rules, an IBHC is eligible to be an SIBHC if it is not affiliated with certain types of banks and has a subsidiary broker-dealer with a substantial presence in the securities markets. These rules provide an IBHC with a process to become supervised by the Commission as an SIBHC, and establish regulatory requirements for an SIBHC, including requirements regarding its group-wide internal risk management control system, record keeping, and periodic reporting (including reporting of consolidated computations of allowable capital and risk allowances) consistent with the standards published by the Basel Committee on Banking Supervision.

**European Union : *EU Financial Conglomerates Directive***

The Financial Conglomerates Directive (the Directive), enacted in European Economic Area (EEA) in Jan-05 introduced supplementary supervision of financial conglomerates on a group-wide basis. It will operate in addition to both the prudential supervision of EEA regulated entities on a standalone basis and consolidated supervision on a sectoral basis e.g. the existing consolidated supervision of banking and investment services groups, which is also supplemented by the Directive. The Directive requires the co-ordinator to exercise supplementary supervision by a variety of methods, including by:

- Supplementary supervision of the conglomerate's capital adequacy, including by requiring adequate capital resources to be available at the level of the financial conglomerate;
- monitoring and requiring the annual reporting of significant risk concentrations at the level of the financial conglomerate; and
- monitoring and requiring the annual reporting of significant intra-group transactions (those above 5 per cent of the financial conglomerate's capital requirement are presumed significant).

In addition, the requirement for management to be of sufficiently good repute and experience is extended to the management of a financial holding company with at least one regulated EEA subsidiary.

Similar rules were enacted by FSA in U.K called as '*Financial Conglomerates And Other Financial Groups Instrument 2004'.*

**3. Conflicts of Interest in Credit Rating Agencies:**

Conflicts of interest may arise in several areas within a credit rating agency. Reliance by credit rating agencies on issuer fees could lead to a conflict of interest and the potential for rating inflation.

**USA :** As registered investment advisers, the current Nationally Recognized Statistical Rating Organization (NRSRO) has a legal obligation to avoid conflicts of interest or disclose them fully to subscribers. NRSROs have implemented a number of policies and procedures designed to assure the independence and objectivity of the ratings process, such as requiring ratings decisions to be made by a ratings committee, imposing investment restrictions, and adhering to fixed fee schedules. In addition, they assert that rating analyst compensation is merit-based (*e.g.*, based on the demonstrated reliability of their ratings), and is not dependent on the level of fees paid by issuers the analyst rates.

Conflict of interest may also arise when credit rating agencies offer consulting or other advisory services to the entities they rate.

To manage these potential conflicts of interest, the Commission is considering the following approach:

- NRSRO recognition could be conditioned on a rating agency's developing and implementing procedures to address issuer influence (*e.g.*, prohibiting ratings employees from participating in the solicitation of new business or fee negotiations, and basing their compensation on factors other than business maintenance or development).

- NRSRO recognition could be conditioned on a rating agency's developing and implementing procedures to address subscriber influence (*e.g.*, restricting private contacts between employees of rating agencies and subscribers, to help prevent intentional or inadvertent disclosure of confidential issuer information and information regarding forthcoming rating changes).

- NRSRO recognition could be conditioned on a rating agency's developing and implementing procedures to address issues regarding ancillary fee-based services (*e.g.*, establishing strict firewalls between employees engaged in rating services and ancillary business development, and prohibiting compensation of employees engaged in rating services from being impacted by revenues from these services).

- NRSRO recognition could be conditioned on a rating agency's having adequate financial resources (*e.g.*, net assets of at least $100,000, or annual gross revenues of at least $1,000,000) to reduce dependence on individual issuers/subscribers.

- NRSRO recognition could be conditioned on a rating agency's deriving only a certain percentage of its revenues (*e.g.*, 3%) from a single source to help assure that the NRSRO operates independently of economic pressures from individual customers.

**IOSCO**

IOSCO has laid down detailed guidelines, 'Code of Conduct Fundamentals for Credit Rating Agencies', (2004) to avoid conflict of interest in Credit Rating Agencies (CRAs). The general rules are mentioned below:

- The CRA should not forbear or refrain from taking a rating action based on the potential effect (economic, political, or otherwise) of the action on the CRA, an issuer, an investor, or other market participant.
- The credit rating assigned to an issuer or security should not be affected by the existence of or potential for a business relationship between the CRA (or its affiliates) and the issuer (or its affiliates) or any other party, or the non-existence of such a relationship.
- The CRA should separate, operationally and legally, its credit rating business and CRA analysts from any other businesses of the CRA, including consulting businesses that may present a conflict of interest. The CRA should ensure that ancillary business operations which do not necessarily present conflicts of interest with the CRA's rating business have in place procedures and mechanisms designed to minimize the likelihood that conflicts of interest will arise.

**4. Conflict of Interest between Company and its Auditor**

The conflict of interest between company and its auditor is one of the foremost issue highlighted by Enron collapse. The conflicts of interest here are:

- Auditors are responsible for accuracy of financial information which may be compromised as the same company pays them.
- Many auditing firms are into consulting also and their audit clients may be their consulting clients also.
- The auditor's employee joins the company which they have audited.

**USA**

A new private-sector regulatory body Public Company Accounting Oversight Board (PCAOB) has been set up to oversee the accounting industry. It comprises a majority of representatives of investors and business, with a minority of members of the accounting industry, and its funding is independent of the industry. It has three main areas of oversight: ethics, competence and quality review, and would undertake a yearly review of all firms that audit more than 75 public companies each year. It has authority to monitor internal controls at accounting firms and its important task is to ensure that auditors are independent of management and report to audit committees.

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# Chapter VI

## Suggested Measures/ Actions for Mitigating conflicts of interests in the Indian Financial Sector

### Introduction

The chapter is divided into VII sections. Section I enumerates the generic guiding principles for management / mitigation of conflicts of interest. Section II dwells on the measures to be taken at the level of the individual. The measures that can be taken in the context of Indian public and private sector are analysed in Section III. The next section discusses the measures to be taken in the context of information gatekeepers – investment banks, auditing / accounting firms and credit rating agencies. Section V delineates the various steps that can be taken internally, at the institutional level. Section VI analyses the external measures that could be taken by the regulatory / supervisory agencies and the general public, as also certain other measures. The evaluation of remedies and certain useful resources are given in the last section.

A study of the subject and the extensive discussions held with the resource persons from the three segments of the financial sector viz. banking, insurance and securities market have confirmed that in view of the rapid convergence in the financial services sector, conflicts of interest in the present scenario are universal, pervading all segments of the financial sector and are neither inherently wrong nor avoidable in all cases. Situations in which real or perceived conflicting interests may exist cannot be avoided without severely impairing the desirable consequences of the convergence. The basic problem, however, caused by conflicts of interest in financial markets is the loss of trust in the quality of financial information. This loss of trust has wide ranging consequences for market efficiency. However, a complete elimination of the conflicts of interest may neither be possible nor warranted. The goal is to ensure that the integrity of the institution, information etc is not compromised or perceived to be compromised. Thus, the financial institutions need to provide credible assurance that the exploitation of conflicts has been prevented, and that their clients are aware of the potential conflicts that exist, even if in certain cases this may involve foregoing synergies that the financial entities believe are of significant benefit. Also there are dangers involved in attempting to regulate conflicts of interest in conglomerates, as it is likely to lead / contribute to compromising the synergies of information and that of scope and scale.

In India, as discussed in the previous chapter, several measures – legal, regulatory and others – are already in place in the various segments of markets, in varying degrees. Suggesting only further additional measures for the financial sector after weaning through all the existing ones, may be too laborious besides falling short of bringing forth an integrated set of initiatives, which are forward-looking for the benefit of the entire system. Keeping this viewpoint in mind, the Group has set upon the task of attempting to suggest an integrated set of initiatives – at the individual, institutional (both public and private sectors), regulatory, governmental and the societal levels (some of which may already be present in different degrees in various segments of the Indian financial sector), which are forward looking in nature. Some of the emerging areas have also been identified as a part of this exercise.

## Section I
## Guiding principles for management / mitigation of conflicts of interests

The present business milieu is one of cut-throat competition, aggressive attitude of the market players to safeguard their market position, breathtaking financial innovations, ill-effects of lack of ethical moorings in dealings of the economic agents in general and the financial intermediaries in particular, on the society, as reflected by the major corporate scandals in recent years. This situation behoves that all the economic agents and more so the financial ones, need to formulate an ethics / corporate governance framework, of which the systems, policies and procedures relating to conflicts of interest form an integral part.

The following four principles should guide and underpin the development of systems, policies and procedures to manage conflicts of interest. The principles reflect values that already exist in the ethics frameworks of progressive organisations, the world over.

### 1. Protecting the customer interest

Serving the customer interests should be the central focus of all employees. Ensuring that the customer interest is not compromised should be the overriding objective of any conflicts of interest management strategy.

In doing so, they should act within the limits of their proper roles, and focus on the merits of each case without regard for private interests, personal attitudes or opinions. In particular, decisions that apply policy to individual cases should be impartial.

In order to meet their duty obligations, all employees must not only act within the law but must also apply broader public service values such as impartiality, integrity and serving the overall public interest.

### 2. Supporting transparency and accountability

Conflicts of interest must be seen to be managed fairly and effectively. To achieve this, the processes for identifying, disclosing and managing conflicts of interest must be transparent – that is, the processes should be open to scrutiny and help maintain accountability.

Strategies such as the registration of interests, and the non-assignment of tasks or duties that involve a conflict of interest are useful in this context. Disclosure of private interests or affiliations that could compromise, or be seen to compromise, the unbiased performance of an employees work is the first step towards the effective management of the conflict.

By taking a consistent and open approach to resolving or managing conflicts, organisations will encourage staff to follow policy and procedures. If all the stakeholders are aware of the organisation's policies and procedures for managing conflicts of interest they can be more confident that the organisation and its employees will not act prejudicially or improperly.

### 3. Promoting institutional and individual responsibility and personal example

Resolving or managing conflicts of interest in favour of the customer interest demonstrates the integrity and professionalism of individuals as well as organisations.

Managing conflicts involves input from all levels of an organisation. The management of an organisation is responsible for establishing systems and policies.

Because private interests are usually known only to individuals, it is equally important for employees to take responsibility for identifying and acknowledging their own conflicts of interest.

All employees are individually responsible for arranging their private affairs as far as reasonably possible, to prevent conflicts of interest arising. Managers have an additional role in setting an example to their staff by demonstrating commitment to established policies and procedures.

### 4. Building a supportive organizational culture

Managements are also responsible for providing and implementing a policy environment that helps and encourages effective decision making when conflicts of interest arise.

Organisations can provide, implement and promote management policies, processes, and practices that create and sustain a culture of integrity and openness by:

- assisting staff with guidance and training to promote understanding of the established rules and practices, and their application to the working environment
- encouraging open communication and dialogue so that staff are comfortable disclosing and discussing conflicts of interest in the workplace
- protecting information about disclosed conflicts of interest from misuse by others
- including staff in any development or change in organisational policies and procedures, to encourage ownership and adherence.

The purpose of systems to manage conflicts of interest is to maintain the integrity of official policy and administrative decisions, and support public confidence in the financial system. Individual organisations can help to achieve this outcome by developing:

- specific standards for promoting integrity set in codes of conduct and elsewhere
- processes for identifying risk and dealing with emerging conflicts of interest
- appropriate external and internal accountability mechanisms
- management approaches (including sanctions) that aim to ensure that officials take personal responsibility for complying with both the letter and the spirit of such standards.
- Establish a whistle-blower policy

## Section II
## Measures at the individual level

In a relatively long list of measures suggested for mitigating conflicting interests, measures to be taken at the individual level are being enunciated first, to reiterate the fact that it is the primary and clinching condition; with all other measures only reinforcing and providing incentives to the ethical behaviour of a value-oriented individual. This is an universal truism applicable to all situations of conflicting interests in every field / profession, every sector – public / private / joint and is geography and country-neutral.

The foundations of the process for mitigating conflicts of interests lie primarily internally within an individual, As famously said, “the greatest conflicts are not between two people / institutions / nations, but between one person and himself.” Resolution of conflicts of interest is an exercise in resolving this greatest internal conflict, within the recesses of one’s own individual selves. The process of rekindling the

conscience – the inward monitor, which is initiated in the childhood should be carried forward into the work atmosphere through an enabling legal, regulatory and institutional environment.

Hence, an aware and value oriented individual is the best bet against exploitation of conflicts of interest. At the individual level, an insightful understanding of the overriding importance of ethics and morality in the long term success, at both the personal and professional levels needs to be appreciated. A true value oriented individual would be such that he would not exploit conflicts of interests, which may be subsisting and can have an impact thereon, even after he has left an organization.

In the ultimate analysis, the clinching condition to mitigate successfully, conflicts of interest is the value-orientation of the individual decision-makers, which will assist in making the appropriate ethical decision, when faced with conflicting interests, while within an organisation or outside it.

An ethical corporate citizen is indeed and in fact, an extension of a good human being.

## Section III

### Organisational structures, corporate governance practices in India and countering conflicts of interest

Good corporate governance practices in an organisation are a necessary pre-condition for an efficacious management of conflicting interests. As already indicated in Chapter V, the organisational structures in both the public and private sector, in a substantive measure, come in the way of putting in place robust corporate governance practices. It is in this perspective that the various measures necessary for fostering a good corporate governance climate in financial institutions – either in the public or private sector, are discussed below. In this context, it is to be stated that the implementation of Clause 49 of listing agreement of SEBI will address a number of crucial issues relating to corporate governance.

#### 1. Measures relating to public sector

Given the still predominant presence of public sector entities in the field of industry and financial sector, any steps to improve corporate governance in the Indian economy would remain effectively incomplete, without addressing the issues in PSEs.

In the Indian public sector, as indicated earlier, conflicts of interest begin at the apex level, primarily due to improper alignment of interests. The structure of the Public Sector Enterprises (PSEs), as already discussed - characterised by multiple layering of 'principal-agent' chains, accountability chain being very weak, lack of independence of the board or its members, etc., make a hotbed for conflicts of interest. These infirmities in governance architecture, in a substantial way, circumscribe the effective functioning of the PSEs.

The Advisory Group on Corporate Governance constituted by the Standing Committee in RBI on international financial standards and codes has identified a few measures in this context. The first important step to improve governance mechanism in these units is to transfer the actual governance functions from the concerned administrative ministries to the boards and also strengthen them by streamlining the appointment process of directors. The process of selecting directors should be made

highly credible by entrusting the task to a specially constituted body of eminent experts with an independent and high status like the Union Public Service Commission.

The Board should be made accountable to the ultimate owner of the government company, which is essentially the public, and conduct affairs of the company in such a way that overall social interests receive the due priority; besides taking care of the interests of all stakeholders. In other words, proper alignment of interests of all the stakeholders, which is essential for proper functioning of the units assumes paramount importance.

The Yaga Report (Reddy, 2001) provides a set of 16 first principles. These form a comprehensive list for improving corporate governance in PSEs. Four of these principles, which are crucial from the view point of mitigating conflicts of interests are discussed below.

Firstly, ownership rights of the government should be exercised by specialized agencies (trusts, SPVs, etc.) to be created for the specific purpose, to whom the government should transfer all its shares / ownership rights. The specialized agencies alone should deal with the PSEs as an owner, so as to provide a reasonable hedge between ownership and management.

Secondly, such agencies which exercise the voting rights should actively structure, create, develop and renew the governing board ensuring highest qualities of leadership, enterprise, integrity and judgment among its members.

Thirdly, each PSE has to develop a best practice manual for board processes, procedures, etc., to exercise some control over commissions of unethical / inappropriate actions, involving conflicts of interests.

Fourthly, a process for professionalisation of directors on the lines of practices being employed in UK, Australia and New Zealand, merits serious consideration.

Operationalising the above measures would require a deep understanding of how the possible conflicts of interest could be resolved in practice, as the principal-agent problems are particularly complex in the public sector, as the Board acts as an agent of the Government, which in turn represents the public. There should a set time frame within which these measures should be implemented.

**2. Measures relating to listed private sector companies**

Since most of the Indian companies belong to the `insider' model, the most important reform that should be quickly brought about is to make boards more professional and truly autonomous. They need to be restructured in such a way that majority of the directors are truly independent; to inter alia, protect interests of the minority shareholders who are particularly vulnerable.

As stated earlier, the opaque structures in India facilitate exploitation of financial conflicts of interest by the majority shareholders, by way of tunneling / diversion of funds, to the detriment of the interests of the minority shareholders. Adequate legal and regulatory steps should be taken to make all the business structures in the private sector, as transparent as possible.

**3. Corporate Governance – the unfinished legal and regulatory agenda impinging on measures relating to conflicts of interest**

The wide-ranging work of the 12 Advisory Groups, formed by RBI's Standing Committee, as part of the on-going efforts to benchmark Indian financial standards and codes to international standards; has indicated a daunting load of legislative and regulatory activity. The more important of them are discussed below.

The legal agenda, in this context, is comparatively heavy. Consolidation of the legal framework is a vital imperative for the effective functioning of the Indian financial sector. For example, banks and financial institutions are covered under several Acts of the Parliament like SBI Act, Bank Nationalisation Act, IDBI Act, Banking Regulation Act, RBI Act, and the Companies Act. Such multiple Acts affect the functioning of banks, particularly the public sector ones. Likewise, the insurance companies are regulated mostly in terms of the Companies Act, IRDA Act and Insurance Act. In the same manner, securities markets are controlled essentially through the Companies Act, SEBI Act, Securities Contract Regulation Act and Depositories Act. Early consolidation of the existing legal framework would help reduce regulatory arbitrage, gaps and over laps.

India has opted for Report on Observance of Standards and Codes assessment in the area of corporate governance on two occasions. The first assessment was completed in July 2000 and the Report was publicly disseminated the following year. The second was completed in April 2004. While taking into account the various measures initiated which have improved investor confidence, the Report, however, identifies several areas where further reform is necessary; which incidentally form some of the crucial measures to mitigate conflicts of interest situations in the Indian financial sector. These relate to : (i) tightening of related party and insider trading norms so as to make sanction and enforcement process a credible deterrent, (ii) removing the regulatory arbitrage arising from multiple regulation of listed companies by DCA, SEBI and the Stock Exchange, (iii) further strengthening of board practices, and (iv) formulation of comprehensive corporate governance policy by institutional investors, inter alia, covering voting and board representation.

The unfinished agenda in corporate governance areas has a significant impact on issues relating to conflicts of interest.

As regards the banking sector, the more important of the measures having a direct bearing on conflicts of interest relate to re-defining `substantial interest' as defined in Section 5(ne) of BR Act which is too low, defining explicitly `closely related group' and providing in law the discretion to the supervisor, in interpreting the definition, on a case by case basis; re-defining 'connected lending' in a more broad-based manner to include all types of counter parties irrespective of whether they are in the public or private sector; making prior supervisory approval mandatory for change of ownership or voting rights above a threshold, besides empowering RBI to conduct `fit and proper' tests on shareholders holding in excess of a threshold level and prohibition of loans and advances to large shareholders.

There is a gap between corporate governance in law and words and the corporate governance as it is practiced generally. While there has been improvement in both the legal framework as well as the way corporate governance is practiced in the country, the gap still remains large. For instance, there is a large number of de-listed companies which indicates that efforts on implementation of corporate governance need to be reinforced.

Continued legal support for corporate governance is important. Poor corporate governance laws encourage not only bad behaviour by management, but also activities that fall under the classification of `looting' / `tunneling.' For instance, in recent past, several companies have vanished after raising capital from the public. The investors in these companies are not able to trace the companies are not able to trace he companies to resolve their grievances. Even in companies which are traced, there is no effective resolution of investor grievances.

Particular attention is required that the control structures are consistent with the interest of the shareholders who are the owners, especially as control is often exercised through thin holdings and cross holdings through a complex pattern of subsidiaries, companies and investment companies, which now has an added dimension of investments by institutions incorporated abroad. Close monitoring of related party transactions to ensure that they are conducted at 'arms length' is also necessary. Notwithstanding the adoption of most good practices as coded in the OECD principles and adapted in domestic legislations/codes, the success of the corporate governance initiative would ultimately depend on the tone at the top supported by a conducive legal and regulatory framework. The costs, time and uncertainty in legal process in dealing with corporate cases are large. Furthermore, orders of CLB are generally followed by appeals in court.

Considering the above aspects, improved corporate governance is required in all three segments covered by the Advisory Group.

PSEs in recent past accounted for about a third of BSE's market capitalization. Corporate governance for banks is also important since, as prime lenders to the private companies and PSEs, they affect the functioning of the entire corporate sector. Considering the growing importance of PSU and bank stocks, as suggested by the Advisory Group, corporate governance in these companies should be more or less at par with private companies. RBI is implementing the recommendations of the Consultative Group of Directors of Banks and FIs (Ganguly Group) and those made by the Advisory Group that considered various aspects of corporate governance. However, there is a need for focusing more closely on implementation of these circulars in letter and spirit.

While improvement in corporate governance needs to be furthered, the course has to be carefully negotiated. Enhanced stock disclosure rules are necessary, but they have to be carefully framed keeping in view the heterogeneity (several types of public, private and joint sector companies) in the corporate sector. A good guidance point is the mixed experience with the Sarbanes-Oxley Act 2002 that has been put in place in the United States to enhance corporate governance, inter alia, through enhanced disclosures. Recent studies show that a large number of public companies have ceased filing with the US SEC by deregistering their securities, but continuing to trade in the OTC market, which in effect means a substantial decrease in disclosure and investor protection. They document a large negative abnormal return at the announcement and filing of deregistration, which is more pronounced for the firms that deregistered after the passage of the Sarbanes-Oxley Act. The studies have also shown that the US SEC's adoption of Regulation Fair Disclosure (RegFD) in October 2000 has raised costs of capital for small firms. RegFD stopped selective disclosure practice to analysts and institutional investors before public disclosures, without adequately replacing it with alternative information channels that were cost-effective for small firms. There is a lot to be learnt from experiences of other countries specially those which have progressed in this area.

The above provides a broad agenda for reforms towards improved corporate governance that could be pursued, which have a significant bearing on conflicts of interest situations in the financial sector.

### Corporate Governance framework for listed and unlisted companies

The Companies Act defines the detailed statutory framework of corporate governance. Most of the important requirements set out by the OECD principles are reasonably well defined in the Companies Act in India. These provisions have been further supplemented by SEBI recently. The SEBI guidelines will eventually apply to all listed companies.

However, unlisted companies would not be covered by these guidelines; thus it may be desirable to incorporate the requirements of good corporate governance in the Companies Act. It is also necessary to have effective penal provisions in the Companies Act so that the management of a company does not have any incentive to violate the required corporate governance norms; of which safeguards against exploitation of conflicts of interest is an integral part.

## Section IV

### Measures in the context of 'Information Gatekeepers'

There are several types of agents like auditors, lawyers, investment analysts, rating agencies, brokers, agents, etc., who have privileged access to proprietory information. Information flows through them to the market and hence from an information paradigm point of view are known as 'information gate-keepers.' The gradient of access top proprietory information should reflect the ability of agents to discover the true financial condition and performance of their client firms.

The crucial nature of their role in the functioning of markets can be gauged from the fact that OECD principles of corporate governance state that, *'the corporate governance framework should be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others, that is relevant to decisions by investors, free from material conflicts of interest that might compromise the integrity of their analysis or advice.'* If these information gatekeepers operate free from conflicts and with integrity, the company boards will be provided with adequate incentives to follow good corporate governance practices. Conflicts of interest in these agencies affect their judgement, when the provider of advice is also seeking to provide other services to the company in question, or where the provider has a direct material interest in the company or its competitors. The concern identifies a highly relevant dimension of the disclosure and transparency process that targets the professional standards of stock market research analysts, rating agencies, investment banks, etc.

Experience in other areas indicates that the preferred solution is to demand full disclosure of conflicts of interest and how the entity is choosing to manage them. Particularly important will be disclosure about how the entity is structuring the incentives of it employees in order to eliminate the potential conflict of interest. Such disclosure allows the market to judge the bias in the advice and information provided.

IOSCO has developed the statements of principles relating to addressing conflicts of interest of sell-side securities analysts and in the activities of credit rating agencies.

### 1. Investment banks

As stated in Section II of Chapter IV, seeking conflicts of interest in investment banking is like peeling an onion, which could go on and on until nothing or little is left. Hence, conflicts of interest cannot be avoided.

The more efficacious of measures would be to have Chinese walls between the various important departments like underwriting, research, market making, etc. An enabling organisational culture – which actively promotes voluntary disclosures and a code of conduct which promotes a strong ethical ethos would go a long way in mitigating conflicting situations in investment banks. The regulators should ensure that adequate safeguards are available, especially since investment banking is growing in importance in line with the maturing economy.

### 2. Auditors

Recent accounting scandals have brought to the fore three aspects. First, the distinction between rules-based and principles-based accounting. The former allows the auditor to hide behind formalities. In a society that puts a strong emphasis on litigation, rules-based accounting may be the response of the profession. Generally, till the recent past, accounting in USA was more rule-based in comparison to the more principle-based accounting obtaining in Europe. Rules may leave less room for judgement and discretion, but may encourage abiding by the letter instead of the spirit of accounting standards. A principles-based approach, on the other hand, may allow too much room for judgement. The accounting standards should strike a healthy balance between the two.

Second, the internal organization of audit firms matters. In the case of multi-national audit companies, decentralization forces local offices to accommodate local monopolists. This is akin to concentration risk in banking. Persuading auditors to certify misleading reports proved to be easy in scandalous cases such as Enron.

The last aspect is the governance of the firm-auditor relationship. This apart the provision of non-audit consulting services by audit firms is another issue.

The accounting companies should ensure avoidance of situations, which alter incentives such that a self-interested auditor is more likely to ignore, conceal or misrepresent his findings, thereby undermining his independence. An appropriate disclosure framework and a strict code of conduct are important in mitigating conflicting situations. The Institute of Chartered Accountants of India (ICAI) should ensure a high order of compliance to professional ethics and further speed up the process in deciding on cases involving professional misconduct.

Arthur Andersen is an apt example in this context because of its unique role as auditors of Enron, WorldCom, Qwest, Sunbeam and Waste Management and its subsequent demise.

Department of Company Affairs (DCA, Government of India), RBI, SEBI and ICAI need to come together to take stock of the entire gamut of such issues relating to auditors and take a view thereon, so that the standards and norms applicable are uniform, across the sector, as far as practicable.

### 3. Rating agencies

Rating agencies act as a quasi-official regulators of public debt markets. The markets seem to be progressively getting addicted to the rating agencies – Moody's, S&P

and Fitch ratings. Even regulators are increasingly using them. For instance, the new Basel Accord, due to be applied from 2006, will increase the addiction, because they propose to give ratings a role in determining how much capital banks must hold. In other words, the regulators are co-opting rating agencies as information-producing agents for regulatory purposes. This apart, rating agencies internationally are also being asked to rate exotic financial instruments like Collateralised Debt Obligations (CDOs) etc, which may be a very difficult and tricky proposition.

Less weightage should be placed on the methodology and findings of the agencies, by both investors and regulators. The best way to achieve both aims is to take agencies out of the framework of financial regulation and return them to their origins as mere servants and guides for the capital markets. The Basel negotiators need to find other way of harnessing the markets' judgement to their rule for bank capital. When ratings become not just a tool for investors but the very basis for regulation, they are likely to become distorted, and conflicts of interest risk becoming sharper.

A question which may come up in this context is whether taking credit rating firms out of regulation leave investors unprotected? The predominant view is that it hardly matters than now. There is always a risk that funds will be invested badly. Restricting the kinds of corporate or municipal bond that they buy does not stop many going into even riskier equities. Besides, higher risk is an inevitable counterpart of higher returns

Since the entry barriers are high, leading to an oligopolist situation, the incentive to maintain reputation may be less. Further, there are high barriers to entry of new firms. One way to reduce conflicts of interest situations is to enhance competitiveness in the rating industry. To do that, new entrants and new types of rating need to be encouraged. In fact, for the last decade there has been no recognised newcomer.

The Government, RBI and SEBI should have a hard look at the rating industry and consider the above as also other required measures to ensure that over-reliance on rating agencies is avoided by the market participants as also the regulators.

## Section V

## Internal measures at the institutional level

### 1. FRAMEWORK FOR MANAGING COI

The institution / profession / vocation should develop an appropriate panoply, (as discussed in Chapter V), by which a commensurate premium / discount is placed on the ethical / unethical behaviour of the individuals (or the institutions, as the case may be). In this context, the organizational culture assumes paramount importance in that it should be open and should encourage ethical deliberation among decision makers. The entire organizational ethos should be such that critical importance is placed on high standards of corporate governance and business ethics.

No single set of guidelines can address every conceivable situation because conflicts of interest arise in many different ways. The following elements have been chosen for their broad applicability, their effectiveness and their proven utility across all parts of the financial sector.

In some cases, organisations will be required by legislation to manage conflicts of interest in a particular way. Legislation generally provides a minimum standard while the suggested measures here provide examples of best practice.

The information in this section is generic and can be applied to individual agencies regardless of the legislative or regulatory requirements that bind them. Many of these suggestions go beyond most legislative provisions for managing conflicts of

interest.

When putting the guidelines into practice, it is important to recognise that in many instances, there is likely to be more than one way to effectively manage a conflict of interest. The choice should be influenced by the operating environment and legislative requirements.

There are seven basic steps, involving three major stages for developing and implementing a comprehensive conflicts of interest policy which will allow the organisation to manage conflicts of interest before severe problems arise.

**STAGE 1 – IDENTIFICATION**

1. **Identify** the different types of conflicts of interest that typically arise in the organisation.

**STAGE 2 – MANAGEMENT**

2. **Develop** an appropriate conflicts of interest policy, management strategies and responses.

3. **Educate** staff, managers and the senior executive and make available the conflicts of interest policy across the organisation.

4. **Lead** the organisation through example.

5. **Communicate** the organisation's commitment to its policy and procedures for managing conflicts of interest to all the stakeholders.

**STAGE 3 – MONITOR**

6. **Enforce** the policy.

7. **Review** the policy regularly.

In the following section, each of these steps is explained in detail.

### 1.1 IDENTIFY THE DIFFERENT AREAS OF RISK FOR CONFLICTS OF INTEREST

The first step in developing an effective organisational approach to conflicts of interest is to identify the areas of risk, and describe the kinds of conflicts of interest that are likely to occur. Conflicts of interest risks can be identified and evaluated by examining the functions of the organization, the activities performed by staff and external / personal affiliations that may pose a conflict for the staff. Most organisations have a cluster of issues that are likely to arise from the particular functions they perform. These issues should form the basis for the design of a conflicts of interest policy and accompanying management strategies.

Effective management of conflicts of interest is predicated on an organisation being able to identify specific conflicts of interest when they occur. Ideally, the aim is to be able to minimise the occurrence of *actual* or *perceived* conflicts of interest by identifying and managing them while they remain *potential* conflicts. Clearly identifying at-risk functions and the positions or organisational areas that perform them is the first step in managing the risk that conflicts of interest present.

Staff participation in this process of identification is important. Not only will staff involvement ensure better coverage of relevant conflicts of interest risks, but also ensure that they are more likely to feel they own the policy and contribute to its effective implementation if they have played a part in its development.

Some examples of private interests that could create pecuniary and non-pecuniary conflicts of interest include:

- financial and economic interests (such as debts or assets)
- family or private businesses
- affiliations with for-profit and not-for-profit organisations
- affiliations with political, trade union or professional organisations and other personal interests
- involvement in secondary employment that potentially conflicts with an employee's duties
- undertakings and relationships (such as obligations to professional, community, ethnic, family, or religious groups in a personal or professional capacity, or relationships to people living in the same household)
- enmity towards, or competition with, another person or group

Functions that are subject to close public or media scrutiny should also receive specific attention.

The process of identifying risk areas should be consistent with the definitions, principles and essential requirements of the legislation and regulations that apply to the organisation and its employees.

### 1.2 DEVELOP APPROPRIATE STRATEGIES AND RESPONSES

Once likely risk areas have been identified, strategies and practices can be developed to manage the variety of conflicts of interest that staff may face. Effective management depends on staff and managers being aware of an organisation's approach to conflicts of interest and their responsibilities within it.

Rules about what is expected of staff and management should distinguish between individual responsibilities and the responsibilities of the organisation, and ensure that staff and managers are able to:

- recognise all actual, perceived and potential conflicts of interest as they arise
- disclose conflicts of interest and clearly document the strategies implemented to manage them
- monitor the effectiveness of strategies chosen to manage identified conflicts of interest.

### 1.3 EDUCATE STAFF AND SENIOR MANAGERS

The effective implementation of a conflicts of interest policy will require the ongoing education of *all* stakeholders of the organisation, from depositors, borrowers, shareholders, debenture holders, regulators and the public at large.

All employees should have access to policies and other information that will help them to identify and disclose a conflict of interest. Managers need to know how to manage conflicts of interest effectively to help maintain the organisation's functional integrity.

Conflicts of interest education should be included in organisational induction programs, and be part of on-going education for staff and management.

As a first step, education programs should ensure all employees understand the concept of a conflict of interest. An education program is also a useful place to point out the specific conflicts of interest and high-risk areas identified in the first phase of developing the organisation's conflicts of interest policy, as well as any differences in the

way the policy applies to staff (i.e. depending on their seniority, roles and functions).

Training materials can give clear and realistic descriptions of the circumstances and relationships that can lead to conflicts of interest, and focus on practical examples of ways to resolve them. Broad corporate awareness and reinforcement of the potential for conflicts of interest to arise, and appropriate strategies for their management, will assist in ensuring compliance. Such awareness and reinforcement will also help anticipate at-risk areas where further prevention work may be necessary.

### 1. 4 LEAD BY EXAMPLE

All employees are expected to manage their private interests in a way that preserves public confidence in their own integrity and that of their organisation. However, effective implementation of a conflicts of interest strategy requires thought, effort and commitment from the top.

Top management will need to demonstrate leadership commitment to the organisation's conflicts of interest policy by modeling compliance and appropriate behaviour. This top-down approach relies on managers actively supporting the policy and associated procedures – not only by word and deed, but also by being clearly and unambiguously seen to do so by staff. Mere lip service to a narrow interpretation of an organisation's conflicts of interest policy is not generally sufficient to encourage public confidence in the integrity of an organisation or its staff.

Top management should also encourage their staff to disclose conflicts of interest and be prepared to exercise judgment to help staff resolve or manage a conflict of interest by:

• considering carefully whether a reasonable person who is in possession of the relevant facts would be likely to think that the organisation's or individual's integrity was at risk from an unresolved conflict of interest

• weighing the interests of the organisation, the individual, and the customer and public interest when determining the most appropriate solution to resolve or manage the conflict of interest

• considering and weighing other factors, which may include the level and type of position held by the staff member concerned, and the nature of the conflict of interest.

Management have the power to influence staff in how the conflicts of interest policy is implemented and how well the procedures are followed. If ethical management of conflicts of interest is considered a priority by senior management, then others in the organisation will follow this lead.

### 1.5 COMMUNICATE WITH STAKEHOLDERS

The range of stakeholders in this context is broad and includes the general community. As this document emphasises, the *perception* that a conflict of interest is not being managed properly can be very damaging – regardless of how well it is in fact being managed. This is one reason why financial sector organisations should communicate their commitment to their policies and procedures for managing conflicts of interest to all their stakeholders, including the general community.

It is important for financial organisations to inform the people they deal with about their conflicts of interest policies. Of late, internationally, many organizations, belonging to every segment of the economy have statements of business ethics that they use to communicate their ethical and accountability obligations to their business stakeholders.

Two-way communication with the stakeholders can also help to keep conflicts of

interest strategies relevant and effective. Client, stakeholder and partner organisations can play a role in developing conflicts of interest management strategies in several ways, for example by:

• being involved in jointly reviewing high-risk areas – such as the handling of privileged or commercial-in-confidence information – in order to identify and develop appropriate preventative mechanisms to protect both sides in a potential conflict

• providing feedback on a draft conflicts of interest policy

• developing and maintaining up-to-date mechanisms for identifying and resolving real or potential conflicts of interest.

Involving partners and other stakeholders in the design of new integrity measures to identify or negotiate mutually acceptable solutions, helps ensure that proposed standards reflect actual customer expectations, and encourages cooperation in the implementation process.

Above all, in creating partnerships for integrity, it is vital that the organisation ensures that, whatever the proposed activity or involvement with other bodies, decision-making procedures at all stages can be audited for integrity and transparency, and can be justified.

The choice of the means of communicating to each type of audience should be appropriate. Executive briefing, training, intranet, newsletters, bulletins etc., for internal staff and web site, annual accounts etc., for the general public as considered appropriate may be employed.

### 1.6 ENFORCE THE POLICY

It is clear that both individuals and organisations have responsibilities for implementing a conflicts of interest policy. The minimum requirement for all conflicts of interest is that they must be formally disclosed.

Individuals are responsible for supporting the policy both by their own compliance and by encouraging others' compliance – particularly those they supervise. The management of an organisation is responsible for properly enforcing the policy and the effectiveness of its related procedures.

Once the policy is in place – i.e. fully implemented with all employees made aware of the policy requirements and their personal responsibilities – it is essential to strictly enforce this policy. One of the most difficult management challenges is to ensure that policies, once finalized, do not just sit on the shelf but become part of the organisation's culture. Moreover, it must be seen by all to be enforced. To help achieve this, consequences for non-compliance, which are proportional to the seriousness of the offence, should also be clearly set out and employees made aware of these.

Non-compliance might range from a simple failure to register a relevant private interest as required, to refusal to resolve or properly manage a conflict of interest of which the employee is aware.

Depending upon the seriousness of the breach and the relevant legal and industrial relations frameworks, such sanctions may range from being at minimum a disciplinary matter, to sanctions for abuse of office or prosecution for corruption. All sanctions must be enforceable.

To complement sanctions for policy breaches, effective forms of redress can be provided through positive management. For example, such measures could include retrospective cancellation of affected decisions. These forms of redress can be very effective in discouraging those who may seek to benefit, directly or indirectly, from such breaches.

Breaches of policy can be detected through monitoring mechanisms established

for this purpose. These mechanisms will include management and internal controls as well as external oversight functions, such as independent auditors or an ombudsman. Organisations should ensure that these mechanisms and functions work together to detect and discourage non-compliance with required standards.

Effective complaint mechanisms for dealing with allegations of non-compliance should also be developed, together with clear rules and procedures for reporting violations, and sanctions for those who abuse the complaints mechanism. To encourage reporting, the organisation should ensure that those wishing to make a disclosure in accordance with correct procedures can feel confident that they will be protected by the organisation against reprisal.

### 1.7 REVIEW THE POLICY

As with all organisational policies and procedures, it is essential that a formal process is established for regularly monitoring and evaluating the effectiveness of the conflicts of interest policy.

A review should be capable of revealing how effective the policy is in terms of compliance and outcome. This can only be effective if managers and staff are consulted about their experiences in using the policy and its procedures.

The policy and associated procedures will need to be updated, adjusted or rewritten as necessary, to keep pace with a continuously evolving environment and to ensure that they remain relevant and effective in dealing with current and anticipated conflicts of interest.

This periodic system assessment should include reviewing at-risk areas within the organisation, and its activities, for potential conflicts. At the same time the organisation needs to review current assumptions and preventive measures, and to identify new measures, which deal with emerging conflicts of interest. For example, the impact of new technology (such as internet trading) may require procedures to effectively record an individual's changing pecuniary interests.

For this reason, involving staff and other interested parties in the review process can substantially contribute to the improvement of the policy and existing procedures. As users, their opinion and experience in dealing with the day-to-day implementation of the conflicts of interest policy can bring a practical aspect into the process, and help build a common understanding of the organisation's requirements.

Where appropriate, it is also useful to draw upon others' experiences of risk, such as those of clients and partner organisations. Apart from tapping into a broader set of experiences, this strategy also indicates the organisation's continuing commitment to the process of risk management and safeguarding its integrity.

An important final step in the review process is to ensure all staff receive up-to-date information about any changes to the policy or procedures, to help them understand any new principles and rules, and improve their practical decision-making skills. Support mechanisms should also be provided to help managers review and improve their skills in identifying, resolving and managing conflicts, and providing sound advice on this issue to their staff.

## 2. RESPONSIBILITIES OF THE CONSTITUENTS FOR CONFLICT MANAGEMENT

### 2.1 Organisations

The role of the organisation is to identify major areas of activity where conflicts of interest may occur, and take the action necessary to establish policies and procedures for managing conflicts when they arise. The CEO and senior executives and, in some

instances, Boards are the appropriate people to take organisational action.

Essentially, an organisation's responsibilities in this area are to:

• provide a clear and realistic description of what circumstances and relationships are likely to lead to conflicts of interest for those in the organisation

• ensure staff and managers know what is required of them in relation to identifying and declaring conflicts of interest (when, in what situations, how etc.)

• develop formal procedures to allow staff and managers to disclose their interests in a transparent manner

• provide staff and managers with relevant and effective strategies to manage conflicts of interest appropriately

• develop appropriate procedures for managing conflicts of interest.

**2.2 Managers and supervisory staff**

Managers and supervisors have a role as organisational leaders in implementing and giving effect to the policies developed by the organisation on a day-to-day basis. They are also in a position to demonstrate how a conflicts of interest policy should operate by setting an example when their own conflicts arise. As the saying goes, 'an ounce of practice is more than a pound of preaching.' Apt behaviour of an enlightened and responsible Top Management has a great 'Rub-off' / 'Demonstration effect.' It would be more efficacious than any external or internal measures for mitigating conflicts of interest.

**2.3 Individual employees**

Individuals make up the organisation and, regardless of their level, each person has a responsibility to follow organisational policy and procedural requirements established to manage conflicts of interest. Employees and managers alike are also responsible for monitoring their own interests and the possibility that such interests may conflict with their official duty.

Individual employees must:

• be aware of potential conflicts of interest that might affect them

• avoid where possible any obvious conflicts that they encounter

• promptly identify and disclose any actual or potential conflicts of interest that might affect (or might be perceived to affect) the proper performance of their work.

**3. Conflict Management Policy (CMP) and its essentials**

Internal policies on management of conflicts of interest customized to their specific needs and risks may be prescribed by each financial entity for itself. The policies may essentially define the likely sources of conflicts in an organization, expected course of action for divulging information on the existence of the conflicts and the extent to which the organization may be expected to exploit these for better results/returns. It would also develop procedures to manage or eliminate material COI. Each entity may develop and administer procedures for effective implementation of the policy. Similarly, effective internal control mechanisms and codes of conduct may be defined. This is essential to guard against the damaging perception that the customer/public interest is being compromised by undeclared or unmanaged COI and will go a long way in providing credible assurance that exploitation of the conflicts of interests is aimed to be prevented and that the necessary transparency towards client awareness on the issue is attempted.

The more important essentials of a good conflict management policy are enumerated below

### 3.1. Corporate Governance / Oversight

CMP should be a part of an overall corporate governance policy of an institution. The first line of defence for corporate governance in an organisation has to be the personal ethics of the internal watchdogs and the people being watched. Transparent fit and proper criteria have to be adopted for all the employees irrespective of their rank. Internally, a firm's board of directors and the auditing team have an onerous responsibility in this context.

Improved and adequate corporate governance principles could contribute substantially towards controlling conflicts of interest. Good corporate governance in financial sector would rely on three key building blocks viz. a) proper incentives, b) adequate transparency and c) clear accountability. Prime responsibility for managing conflicts of interest rests with the senior management of the firms. A combination of robust self-regulation norms, public understanding and public awareness on the subject, meaningful and effective oversight by independent directors on the Boards with a set of guidelines, where considered necessary, could be a useful tool for combating the menace of conflicts of interest. The senior management should tackle the issue through a combination of tight internal management controls and effective disclosures to the market as mandatory disclosures alone may not be sufficient. Large entities may be required to establish governance procedures to oversee the legitimacy and as also the legality of transactions. In this context –

(a) one of the key function of the Boards would be to monitor and manage the potential conflicts of interest of the management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions,

(b) the Board should also consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is potential conflict of interest e.g. ensuring integrity of financial and non financial reporting, review of related party transactions (role of the Audit Committee), nomination of board members and key executives (role of the Nominations Committee), and board remuneration (role of remunerations committee).

### 3.2 Disclosures and Transparency

Companies and firms in the financial sector – banking, securities and insurance segments, should be guided by the best practices enunciated in this regard by the OECD Principles of Corporate Governance. Principle V thereof deals with Disclosure and Transparency. A strong disclosure regime that promotes real transparency is a pivotal feature of market-based monitoring. The concept of materiality is important in determining the information value. Material information can be defined as information whose omission or misstatement could influence the economic decisions taken by users of information. timeliness, completeness (i.e., disclosing the 'whole picture') and adequate frequency are the hall marks of proper disclosure. The IOSCO principles for ongoing disclosure and material development reporting by listed entities enunciate the common principles for ongoing disclosure and material development, which can be used by the listed financial intermediaries.

While mandating disclosures, the regulators should keep in mind the cost of compliance. In this regard, the experience of US companies in the context of SOX as already stated above, in the para on the unfinished legal and regulatory agenda relating to corporate governance needs to be noted.

### 3.2.1 Mandatory disclosures

(i) Mandatory disclosures on conflicts of interest could be a potent tool for inhibiting the menace of information asymmetry. Selectivity in disclosures should be the byword as disclosures without responsibility could be dangerous and cause confusion in the markets. Weak disclosures and non-transparent practices can contribute to unethical behaviour and to a loss of market integrity at great cost, not just to the financial entity its shareholders but also to the economy as a whole.

Mandatory disclosures are most crucial in the case of wholesale market for bonds, derivatives and other exotic products, where few checks exist to ensure that prices are transparent and that privileged information is not abused. There is a question of perception; one person's synergy (the happy combination of abilities and information) is another person's conflict of interest (ruthless exploitation of privileged foreknowledge). What appeared to be synergy in a bull market, suddenly, in a bear market, looks more like conflict.

Mandated disclosures are most important in the case of OTC derivatives markets, which are relatively non-transparent when compared to the exchange traded markets. Counterparty Risk Management Policy Group I highlighted three levels of information transparency that are important to the smooth functioning of financial markets and more particularly the OTC markets: bilateral sharing of information between counterparties, disclosure of information in public filings and reporting by firms to their regulators and rating agencies. The financial intermediaries and associated internal control organisations should be encouraged for the purpose of adoption of best practices, as applicable, the recommendations of the Final Report of the Multidisciplinary Working Group on Enhanced Disclosure published in 2001; Enhancing Public Confidence in Financial Reporting published in 2004 by the Group of Thirty. Unfinished agenda in this context relates to public disclosure of trading and derivative activities of banks and securities firms.

Greater transparency would enable the market itself to provide plenty of sanction against wrong-doers – the loss of customers; downgrades by credit rating agencies and punishment of the share price.

Thus, it is essential that following aspects relating to disclosures are given due significance:

(a) Setting down of disclosure requirements and ensuring compliance therewith,

(b) Easily accessible and comprehensible form of disclosure. The disclosures should be in simple language, preferably in English and in the local language.

(c) Transparency in disclosures; as excessive information in fine print could only be detrimental to the interests of the consumers.

Some of the resource persons expressed reservations on the efficacy of excessive / undue disclosures and favoured selectivity so as to prevent confusion in the market. Particular attention should be taken as regards disclosures in fine print. For instance, a prospectus for an IPO is cluttered with so much data and the font is so small that it inhibits reading. Responsible disclosure is a pre-requisite for enhancing transparency, which at the minimum should have the following:

independent validation of information,

disclosures on fees being paid to auditors / consultants / rating agencies,

Transparency in interest rates /service charges

voluntary disclosures and peer monitoring in form of self-regulation,

provisions for ensuring timeliness and quality of disclosures.

Disclosure of risks and 'worst case scenario' to clients before selling products.

### 3.3 Disclosure of private interests

In view of the complexity and diversity of personal relationships and as the perception of the conflicts of interest may vary from one individual to another, an effective means of resolving the conflicts of interest is to establish a system under which employees disclose and obtain evaluation of the potential conflict. The transparency law may be based on three pillars of a) broad scope, b) openness, c) enforceability. It may also essentially lay down clear obligations and specific restrictions, for the officials/employees, need for a register of interests i.e a public, easily accessible, updated and user friendly database, creation of a special body to ensure that the law is adhered to, procedures for levying fines and penalties.

Large financial conglomerates or supermarkets may maintain a conflicts data base as a central information source for the entire organisation.

Disclosure is probably the most common solution to the various kinds of conflicting interests problems we are talking about here – and often it will also be a moral duty, insofar as concealing a conflict of interest is a way of misleading or deceiving the principal, and may cause harm to third parties. Disclosure may take various (non-mutually exclusive) forms and can be mandatory or voluntary. For instance:

? Disclosure of private interests that may conflict with the agent's professional, contractual or legal duty. For instance, officials may be required, on taking possession of his office, to submit a report detailing any personal and family interests (business interests, share ownership, etc.) that may interfere with the independence and honesty of their decisions in the future. In some countries a record of these private interests is kept in a register that is open to the public or only to certain monitoring bodies, and subject to periodic review or update.

? Disclosure of conflicts of interest to the agent's superior or to a monitoring body as soon as they arise. For example, officials may be required to declare immediately potential conflicts of interest, which may crop up in the course of discharge of their official duties, and are likely to have a material adverse impact.

Following this initial disclosure of private interests, various solutions may be adopted, such as the recusal of the agent from the decision that gives rise to the conflict, disclosure to the principal of the existence of a conflict of interest so that the principal may decide for himself whether or not the agent should recuse himself from the decision, etc.

? Disclosure of conflicts of interest to the principal. For example, a doctor may be required to explain to the patient whom he invites to join a group taking part in a research project that he receives a payment for each new patient that joins the group. It is assumed that the agent will inform the principal truthfully, clearly, and in detail about the conflict of interest, and that this will enable the principal to make an informed and voluntary decision, either to withdraw from the mutual relationship or to take other protective measures.

? The logical counterpart of the disclosure of conflicts of interest by the agent is informed and voluntary consent by the principal.

? If the conflict of interest situation is self-evident, disclosure may not be necessary. Nonetheless, even in such cases it is an advisable precaution.

**Disclosure of private interests has unquestionable advantages:**

? It saves the agent the disadvantages of having to renounce making a decision that is by office or professional qualifications, or having to renounce legitimate private interests.

? It simplifies the job of the person in power or regulator, who is released from the obligation to monitor any conflicts of interest that may arise, the responsibility falling instead on the agent.

? It helps the agent to appreciate the risk he runs and make it compatible with his interests.

? It improves the efficiency of social and market mechanisms by at least partly resolving the problem of asymmetric information.

? It is particularly useful in some professions – legal practice, for example.

**But it also has certain drawbacks**

? It does not eliminate the problem, it merely makes it known. Ultimately, there is nothing that can save the principal having to assess the moral quality of the agent in the particular case at hand.

? The principal will still have the problem of adapting his judgement to any information that is disclosed. For example, if a financial expert advises the principal to buy shares in a particular company and reveals that he himself owns shares in that same company, in what way and to what extent is the advice likely to be distorted as a result of the conflict of interest? How can the distortion be corrected? In other words, although disclosure removes or mitigates one of the causes of conflicts of interest – the high information costs – it cannot resolve another – the high monitoring costs.

? "Anchor effects" occur: the starting point influences the entire process, even if it is known to be irrelevant or biased. If the expert starts by recommending the shares of a particular company, that recommendation will condition all subsequent judgments, as experiments have shown. The principal will find it difficult to "forget" the information he has been given, even though he knows it to be biased, or even false. Information that is repeated earns greater confidence on the part of the principal. And information received earlier tends to acquire a higher truth status than information received later, even if it is known to be false.

? The principal tends to overestimate the role of the agent's predispositions and underestimate the circumstances of the advice, including the fact that there is a conflict of interest.

? For all these reasons, the principal is unlikely to be able to fully discount the bias caused by the conflict of interest, even if it is honestly, completely and clearly disclosed.

? The disclosure will also influence the agent. On the one hand, it may make him more honest, because he knows that the principal will be more alert to possible biases.

? But it may also have the opposite effect, whether through strategic exaggeration (increasing the bias, so that it is not neutralised by any correction the principal may make); or through "moral license" (the agent considers that having disclosed his interest, he has already fulfilled his obligation toward the principal and from now on can safely ignore the principal's interest); or because the fact of being obliged to disclose the conflict induces the agent to do so partially or incompletely.

? There is no guarantee that the disclosure will leave the principal any better placed to give his free and informed consent. For instance, if a doctor advices a patient to have treatment at a clinic in which the doctor has a financial interest and declares that interest, the patient still will not know whether the treatment is necessary, or whether the clinic that the doctor has recommended is suitable or not. And obtaining that extra information (for example, by seeking a second opinion) may be very expensive.

? Disclosure may weaken the principal's confidence in the agent, owing to the conflict of interest; but it may also strengthen it if the disclosure is interpreted as proof of the agent's honesty. This may induce the principal to commit more serious errors of judgment.

? If the disclosure of a conflict of interest is not reiterated at regular intervals, it may cease to have any effect on the principal's attitude.

? There are some conflicts of interest that cannot be resolved or mitigated by disclosure. For example, even if a researcher reveals that he has a financial interest in obtaining particular results from his work, we cannot be sure whether that interest has influenced his results (except by conducting an in-depth analysis of his work).

? In any case, if disclosure of a conflict of interest is not made out of moral conviction, there will have to be some incentive for the agent to effectively comply with the disclosure requirement, either in the form of a legal obligation (with the corresponding penalty in the event of non-compliance), or an obligation to pay compensation for harm caused (if no disclosure was made, or if the information disclosed was false or incomplete), or the threat of loss of reputation, etc.

Here again is the proof of the fact that the innate value-orientation of the individual is primary and all other legal / regulatory / institutional actions are only secondary.

### 3.4 Blogging

In organisations which promote an open and transparent culture, web blogs (or blogs for short), an ICT facilitated tool is fast becoming a rage as an ideal communication facilitator – within the organisation among all the employees and outside with the larger community of stakeholders. It has the potential to provide visibility to almost employees thereby serving as a vital motivating factor. Not surprisingly, blogging is spreading like wildfire on the internet.

A **weblog** or **blog** is a web-based publication of periodic articles (**posts**), usually presented in reverse chronological order. It is an online journal with one or many contributors. Weblogging or blogging is the practice of keeping a frequently updated on-line journal.

Blogging, either internally, externally or in management in organisations can be used to improve transparency on an on-going basis. Conceptually, it can be viewed as a reverse flow of information – the opposite of transparency, where the organisation and its management get an invaluable feed back. It would indeed be a rich source of feedback for the entire organisation because all the stakeholders – both within and outside, can effectively participate in it. However, being an extra-ordinarily powerful tool, it needs to be ensured the usage thereof is done in an appropriate and effective manner. If used properly, it has the ability to improve corporate governance enormously and perhaps make the organisation transparent and open. It is stated that the organistions who are the first movers in the blog world will fare better than the ones who don't. The realisation is slowly dawning as even now only around 3-6% of the fortune 500 companies have blogs, either internal / external or by management.

### 3.5 Separation of functions / Chinese walls

The more extreme solution of enforcing separation of financial institutions by functions may ensure that 'agents' were not placed in the position of responding to multiple 'principals' so that conflicts of interest were reduced. There may be degrees of separation and the prescription of certain combination of activities in a single financial entity could eliminate conflicts but only at the expense of foregoing the synergies that gave rise to the combination in the first place. Litigation, industry standards and supervisory oversight would be sufficient to erect the limited firewall in most cases. Further, to some extent the market forces are expected to discipline the entities that are perceived to be exploiting conflicts of interest. Clear accountability and appropriate safeguards in place with regard to information sharing would be of significance in this regard. It has also to be kept in mind that while Chinese walls afford a good opportunity for financial institutions to manage confidential information, these walls can be ineffective when designed poorly. As per the UK Law Commission report 1995, "a Chinese wall would not prevent the attribution of knowledge between the component parts of a company unless appropriate provision is made in the contract between the firm and the customer, a Chinese wall cannot in all cases be relied upon as a matter of private law, to limit the fiduciary duties the firm owes to the customer".

### 3.6 Alignment of interests

Since improper alignment of interests of the stakeholders is one of the major breeding grounds for exploitation of conflicts of interests, alignment thereof is one of the main functions of a body corporate.

Towards this end, BCBS discusses compensation of senior management in its paper "Enhancing Corporate Governance for Banking Organisations," (September 1999). The Board should approve the compensation and ensure that it is consistent with the institution's culture, objectives, strategy and control environment. It should not overly depend on short-term performance. The same principles are covered in the Insurance Core Principles issued by IAIS. Of late, equity-based remuneration (stock options, etc) is increasingly being used to motivate managers and employees. However, since a badly designed incentive system could lead to sharp increase in conflicts of interests, there is a need for a debate in our country about the appropriate use and design of such equity-based compensation.

### 3.7 Appointment and Remuneration Structures

It is considered good practice in an increasing number of countries that remuneration policy and employment contracts for board members and key executives

be handled by a special committee of the board comprising either wholly, or a majority of independent directors. There are also calls for a remuneration committee that excludes executives that serve on each others' remuneration committees, which could lead to conflicts of interest.

One crucial area of corporate governance critical to the quality of information in the financial system is thought to be auditing. The Auditors may be hired, compensated by, and report to audit committees whose responsibility is to represent stakeholders other than management.

The issue of payment of part of the commission received by the brokers and selling agents to their clients /customers needs to be examined as this enabled them to pass on policies / products not particularly suited to the needs and profiles of the customers but the ones in which the former received the maximum / highest commission. The need of the hour is to first create awareness about bad practices such as these prevalent in the market and thereafter identify/initiate remedial action. At the systemic level, a broader perspective is required in view of the uniqueness of Conflicts of interest in the Indian context given the fact that it is predominantly a relationship-based society. It is thus imperative to ensure an environment of discipline, confidentiality and professionalism. Formulation of Insiders Law in this respect and imposition of self-discipline within the organizations are the other important steps.

### 3.8 Leadership Dynamism/Organisational Ethics

Top Management, by their example, should re-orient the organizational culture for ensuring transparency on the existence of the conflicts of interest in an organization and the extent to which the latter intends to exploit the same for better returns. For this, the issue of leadership crisis in the financial institutions needs to be resolved by evolving ethical organizational culture and adequate human capital where the principles and purpose are well articulated and well understood. Managers will need to demonstrate leadership commitment to the organisation's conflict of interest policy by modelling compliance and appropriate behaviour. Managers should also encourage their staff to disclose the conflicts of interest and be prepared to exercise judgement to help staff resolve or manage a conflict of interest.

Ethics are the soft side of corporate governance. While systems and controls are necessary, they are not sufficient by themselves. Sufficiency arises only when sensitivity to ethics is institutionalised and imbibed into the organisational culture.

### 3.9 Whistle Blowing

Whistle blowing should be encouraged. All financial institutions may be required to devise a whistle blowing policy for their organizations. At the same time, prescription of obligation costs in forms of appropriate incentives or disincentives on whistle blowers may be mandatory. In the context of incentives, the question of providing suitable protection to whistle blowers needs to be adequately addressed.

Whistle blowers have been responsible for bringing to light many of the recent scandals. Sherron Watkins of Enron, Cynthia Cooper of WorldCom and Coleen Rowley of FBI were essentially insiders who first blew the whistle on the malpractices in their organisations.

## Section VI

### External Measures

The second line of defence, in the context of ensuring that conflicts of interest are not exploited and financial markets run smoothly, is the external watchdogs whose efforts run parallel to the first line of defence viz., the internal watchdogs. The external watchdogs to be effective must be known both for bark and bite. They include the regulators, the information / financial market gatekeepers – external auditors, analysts, rating agencies; standard-setting professional organizations, law enforcing agencies and the judicial system, press, academicians, researchers and the general public.

### 1. Role of the regulators

There are certain caveats regarding regulatory actions, which need to be taken care of, ex-ante. It should be ensured that the cure does not turn out to be worse than the disease and the policy response does not stifle risk-taking. Regulation should not kill off animal spirits. Transparency should be promoted by regulation and in fact, 'leaving it to the market' and 'regulating for transparency' should be combined into one strategy. The Group feels that regulation should strike a reasonable balance against future problems of conflicts of interest, while also preserving and protecting those traits of financial system, which are the source of its creative and competitive genius.

The policy response must be proper and proportionate and deal broadly with the financial entities in their entirety. The solution should be developed in association with market participants. Regulatory actions should pass the twin tests of relevance and rigour. More importantly, the regulatory regime should be based more on principles rather than on rules.

More specifically, the explicit actions which need to be taken by our national regulators are enunciated below.

#### 1.1 Revamped architecture for increasing co-ordination among regulators

The problems / issues especially in the financial sector in our country, transcend the sum of the parts, in an increasingly integrating domestic economy with the global economy and with the domestic financial sector itself making rapid strides towards greater diversification, through universal banking and establishment of financial conglomerates / supermarkets. To tackle such pan-sectoral issues, a framework for promoting effectively a collaborative mindset among the various regulators and within the regulatory institutions themselves is an absolute imperative. At present, such a framework does exist. A High Level Co-ordination Committee on Financial and Capital Markets (HLCCFCM) and the Technical Advisory Committees (TACs) are functioning with representatives from SEBI, IRDA and RBI to look into similar aspects. However, the scope and coverage thereof do not parallel the international efforts.

Harmonisation of prudential regulation and supervision across financial intermediaries, inter alia, would more effectively help in efforts to mitigate conflicts of interest which increase in number, variety and complexity due to growing financial integration. Such harmonisation, at present, remains rather limited due to the same

entities being regulated, rather exclusively, by several regulators. Poor or weak communication and co-ordination lines among the supervisory agencies as also weak accountability of the agencies will further accentuate the position resulting from conflicts of Interest. Regulatory arbitrage will also remain a potential threat in this direction.

Internationally, a Joint Forum, comprising the three organizations viz. International Association of Insurance Supervisors (IAIS), Basel Committee on Banking Supervision (BCBS) and International Organisation of Securities Commissions (IOSCO) coordinates efforts on issues of relevance to the Banking, Insurance and the securities market. The Forum functions on an on-going basis and has issued papers which are a significant step forward in addressing some of the most important supervisory issues that arise from the continuing emergence of financial conglomerates and the blurring of distinctions between the banking, securities and insurance sectors. A suitably revamped architecture among the Indian regulators, on the lines of the Joint Forum to mimic the international efforts and cooperation, may be of significant use. Considerable thought and deliberation need to go into establishing a nationally appropriate architecture.

In a slightly different form, the need for a joint forum in the Indian context was recommended by the Synthesis Report (synthesising the reports of all the 12 Advisory Groups constituted by RBI as part of initiatives taken in the context of International Financial Codes and Standards).

The Synthesis Report states: "………… (T)he reports of the (12 Advisory) Groups and action thereon cannot be a one-off affair. Nor can we make implementation into strict sequenced process. In view of this, it is desirable that we create some permanent mechanism for monitoring and evaluating follow up, responding to new developments and coordinate with Government, Regulators, SRO's and other market participants on a continual basis. Independently, a number of the Groups have recommended that High Level Group on Capital Markets be given a formal legal status. The tasks can be merged by assigning this task of evaluation and supervision also to this Group. The analogy of creating a domestic Financial Standards Forum would not be inappropriate. Further, such a group or forum would need some secretariat, which could be located in RBI, in view of the fact that it has already evolved a small professionally well-equipped group to assist the various Advisory Groups. The responsibility of this establishment would be to monitor both international and domestic developments in this regard and follow up with annual reports. Where required, similar non-official Advisory Groups involving experts to assess and evaluate change can be set up from time to time. Further, increasingly, our performance under these norms will play an important role in determining the overall risk assessment. In this context, periodic reviews by independent experts will help in providing vital inputs for improved governance. All incidental benefit of such a formal structure is in terms of promoting greater international awareness of our efforts in this critical area as well as acting as a reference and pressure group for economic reform."

This Working Group feels that the Joint Forum as suggested by it could be an umbrella body, of which the above proposed domestic Financial Standards Forum could be an integral part. The main advantage would be that the work of the Joint Forum could, inter alia, serve as a permanent monitoring and follow-up mechanism, as adverted to by the Synthesis Report. Such an effort would an omnibus one, encompassing the entire financial world; since, inter-alia, it can carry forward the broad agenda delineated by the 12 Advisory Groups, whose reports have been classified into three categories namely: Macroeconomics Policy and Data Transparency (covering Transparency in Monetary and Financial Policies, Transparency in Fiscal Policy and Data Dissemination); Institutional and Market Infrastructure (covering Bankruptcy Laws, Corporate Governance, Accounting and Auditing Standards, and Market Integrity); and Financial Regulation and Supervision (consisting of Payments and Settlement System, Banking

Supervision, Securities Market Regulation and Insurance Regulation). Such work would be benefited from the panoramic view of the entire financial sector offered by the already existing body of recommendations from the expert Advisory Groups and hence, be able to synthesise the growing interfaces and intertwining of activities of various financial intermediaries and come out with regulations, which would take care of the emerging grey areas and minimise / avoid, jurisdictional / regulatory arbitrage indulged in by the financial players.

Corroborative evidence of the growing inter-faces and inter-relationships among various players across all the segments, is offered by recent discernible trends in the Indian financial market, viz., its exponentially increasing sophistication and maturity, on a continuing basis, mainly due to the following :

- ICT enhanced institutional and networked infrastructure promoting seamless integration through tools such as Shared Payment Network Systems (SPNS), Real Time Gross Settlement System (RTGS), Core Banking Solutions(CBS), on-line trading, emergence of depositories, etc. Incidentally, India ranks 39 out of 104 countries in the Network Ratings Index (NRI), ahead of even some developed economies, according to Global Information Economy Report 2005 prepared by United Nations Conference on Trade and Development (UNCTAD). The NRI, for this report, is defined as `the degree of preparation of a nation or community to participate in and benefits from ICT developments'. This only points out to the fact that seamless integration would be a defining characteristic of the Indian financial sector, in the near future.

- Consequently, increase in the networked space in the market brings about concerns regarding money laundering. To be effective against cyber crime, which can only be expected to increase, the need for a definition of financial crime and for technology neutral legal changes are paramount. For instance, the Information Technology Act, 2002 is not technology-neutral.

In this context, the recent testimony of FBI Director Louis Freeh before the United States Senate that, “statutes need to be rendered technology neutral, so that they can be applied regardless of whether a crime is committed with pen and paper, e-mail, telephone, or geosynchronous orbit personal communication devices,” needs to be noted with the highest concern by all the regulators and the Government.

- Domestic financial conglomerates are springing up and in a majority of them, a few unregulated entities are invariably their constituents, over which none of the regulators have any jurisdiction. This raises important concerns relating to Intra-group Transactions and Exposures (ITEs) and Risk Concentrations (RCs). There is a corresponding need to look into the risk management and capital adequacy standards, on a consolidated basis.

- Increase in the number of composite products, embedding elements of securities, insurance and / banking products. For instance, co-ordination between SEBI and IRDA has to be ensured for overseeing the business of unit-linked insurance plans (ULIPs), so as to provide a level playing field between insurance companies and mutual funds, since ULIPs have elements of both insurance and securities.

- Increase in sophisticated financial instruments like various types of derivatives, securitization deals and their downstream securities, spanning across all the three segments of the financial industry.

- New regulatory institutions like Pension Fund Regulatory and Development Authority (PFRDA) coming into existence and the increasing role of Forward Markets Commission (FMC) due to exponential increase in the commodity derivatives turnover.

- Greater outsourcing by all economic agents across all segments, leading to veritable explosion in the conflicts of interest situations.

- Increasing number of private sector players in all the three segments of the market, actively spurring innovations in all aspects of financial intermediation.

- Greater degree of wealth management / financial planning services (which embed significant conflicts of interests, as already stated in Chapter IV) to take care of the increasing number of High Networth Individuals (HNIs) and Double Income No Kids (DINKs) category, due to accelerated economic growth.

- Increase in the number of areas, which are not being regulated / supervised, with due emphasis they merit, such Inter-Corporate Deposits (ICDs), un-hedged forex exposures of companies, etc.

The greatest challenge in such an environment for the regulators is to be in lock-step with the market, and deal with pan-sectoral issues, on a real time basis, as far as possible. The developments mentioned above, would increase the regulatory gaps / overlaps as also their systemic effects, in ways which would be difficult to predict.

Further, with rise in the stature of India as a global economic player and its financial stakes assuming mammoth and complex proportions, the criticality of financial sector stability occupies centre-stage.

To deal with such challenges on an urgent footing, before they go out of hand and cause financial disturbances, the proposed Joint Forum, in the Group's opinion, would be an ideal instrumentality. In the medium term, the instrumentality could be put on a legal footing with appropriate amendments to the statute.

**Supervisory oversight**

A more intrusive approach in form of supervisory oversight may be considered where mandatory disclosures are unable to fruitfully reveal and /or constrain the conflicts of interest plaguing the various financial institutions. Where banks are involved, supervisory intervention is an indispensable facet as part of the efforts towards averting / thwarting systemic impact of events and self-regulation alone may not suffice. The supervisors could also obtain proprietary information about conflicts of interest without revealing it to a financial entity's competitors for necessary action for prevention of exploitation of conflicts of interest financial firms. Excessive regulation however could be fraught with potential drawbacks. Supervisory rules might tend to be too tightly drawn, attempting to eliminate all conflicts; even those where there were positive net information benefits to the market. Also, it may lead to a culture of compliance in which letters of rule overtake significance of the spirit.

Supervisory oversight is of particular importance in the case of financial conglomerates and the regulators, in close co-ordination should ensure that they and their subsidiaries and joint ventures have adequate risk management processes covering

group-wide risk concentrations; especially in view of the fact that, at the moment, the supervisors do not have the legal authority to prohibit detrimental intra-group transactions and exposures (ITEs); which inherently involve conflicts of interest situations.

Identification and segregation of areas prone to emergence of serious and non-serious conflicts of interest and examination of the cost – benefit factor of regulation thereof need to be taken into account. A guidance note or best practices code may be a better option instead of resorting to pure guidelines as the latter may give an impression of being mandatory and not leave enough flexibility to the market participants.

**1.2 An Ethical Framework for financial services**

At present, an overarching ethical framework for financial services is not available for the financial sector in India. As a starting step, a discussion paper on an ethical framework for financial services which would provide the overall guidance to all financial intermediaries should be developed by all the regulators together and placed in public domain, on the lines of the one developed by FSA of UK. Thereafter, the same could be finalised after taking into consideration the suggestions received in this regard. Alternatively, the proposed Joint Forum could take up the assignment.

**1.3 Public awareness and education**

Improved public awareness and proper perceptions are necessary pre-conditions for control and regulation of the conflicts of interests. Latest reports indicate that a growing number of younger investors are coming into the stock market, thereby reducing the market's sophistication. The general level of lower literacy in our country behoves an active public awareness and education programmes. The regulators may require the various intermediaries to devise suitable education programmes and more particularly in local languages. Channels for the dissemination of information should provide for equal, timely and cost-efficient access to relevant information by users. Internet and ICT tools have greatly increased the opportunities for improving information dissemination.

Acute information-asymmetry, at times in certain segments of the financial sector, bring to fore the urgency involved in this regard.

**2. Role of the Government**

Delay in dispensation of justice in India is a well known issue. The fact that politico-judicial reforms have not gone hand-in-hand with economic reforms is well known. Regulatory efforts to improve corporate governance and exploitation of conflicts of interests in the financial sector leading to various scandals would not be entirely successful, unless the individuals and institutions responsible therefor, are brought to book and proper justice meted out, speedily.

An appropriate example in this context is Eliot Spitzer, the combative New York Attorney General, whose untiring efforts exposed wrong doings galore on Wall Street. The exploitation of fundamental conflicts of interests in high offices, as in case of the unduly fat pay packages of high profile individuals like Richard Grasso – Chief of New York Stock Exchange and Jack Welch of General Electric, at the expense of shareholders; were exposed. His efforts have also exposed unethical practices of well-known investment bankers like Merrill Lynch, Morgan Stanley and Salomon Brothers like inflating the price of new public issue of shares (IPOs), and also reserving scarce shares

for favoured clients. Spitzer also targeted brokers that indulged in late trading and market-timing, two dubious stock market practices. He also brought to book top insurance broking companies like Marsh and McLennan for price rigging and for offering contingent commissions that induced insurance brokers to sell unnecessary and expensive insurance policies. Aon, the world's second largest insurance broking company was charged of 'steering' business to those who paid the most commission. His actions, pretty quickly, triggered a wave of overdue corrective actions aimed at improving the governance practices in all these segments of the financial industry.

One of the important facts which should not be lost sight of, in all the above mentioned corporate misdemeanours is the speed with which justice was meted out. Almost all the firms and individuals involved have been prosecuted in good time, and / or had to pay hefty fines.

The Government should immediately take effective steps to tackle the well-known delays in dispensing justice. SEBI has taken up with the Government for constitution of designated courts for expeditious trial of prosecution cases filed by SEBI. In Delhi, one such court is constituted and has become functional since early 2005. Proposals for setting two such courts in Mumbai is under active consideration.

In this context, the 17th Law Commission, in December 2003, with a view to expedite justice in case of economic crimes has proposed constitution of Hi-tech Fast-Track Commercial Divisions in High Courts. The Commission has proposed that where the value of the subject matter is Rs.1 crore the commercial suits must go before the Commercial Division. The Law Commission has stated that such a step was imperative to instill confidence among the foreign and domestic investors. The recommendation was mooted against the background of a spate of judgments (prior to Dec 2003) of the US and UK Commercial Courts declaring that the Indian Court system has "collapsed " because there are delays upto twenty years or more,and that, therefore Indian defendants can be sued in US and UK Commercial Courts, even if there is no cause of action in those countries, provided the Indian defendant has a branch or local representative in that country or is trading in the stock exchange of that country.

The Government and the regulators should consider the above and other measures to ensure that along with speedy justice, the remedies suggested are appropriate. One particular case involving investment banks in USA has come in for special scrutiny and vehement criticism.

The case involves Jack Grubman of Citigroup and Henry Blodget of Merrill Lynch, who have been convenient scapegoats for the firms that employed them and for the rest of the industry. Wall Street's top bosses – notably Sandy Weill, the head of Citigroup, Grubman's former employer and the most heavily fined of the Wall Street firms – have suffered very little. In fact, a strong view has emerged that instead they paying for their firm's transgressions with their jobs, they have paid with a few hundred million dollars of shareholders's money. Shareholders had a double whammy – one when the conflicts of interest were exploited and another by paying fines. Steps should be taken to ensure that such classic miscarriages of justice are avoided. It's a case of the remedy being worse than the malady.

We do not have as yet a well-articulated notion of criminal activity originating in the financial sector. In other words, we do not have a definition of financial crime. The Government should enact laws and develop agencies to deal with these issues. The Reserve Bank, in 2001, set up an expert committee on Bank Frauds chaired by Professor N.L. Mitra to suggest measures for countering the problem of bank frauds. The Report contended that there was a need to define `financial fraud' as a crime and to undertake serious measures to deal with it. The definition proposed is comprehensive and will

cover a variety of financial crimes. Further, this suggestion of the Committee will bring bank / financial frauds under the ambit of money laundering and thus enhance enforcement. The Committee suggested a two-pronged approach to handle bank and financial frauds focusing on both preventive and prohibitive measures.

In the context of financial crime, Government should provide for a technology-neutral law, in view of the hastened transformation of Indian financial industry into a seamless world through enhanced networking facilitated by various ICT tools. It is generally accepted that online conduct should be treated no differently from offline conduct. Laws should be technologically neutral and based on the act rather than the technology used to commit the act.

In framing such technology neutral law, FBI Director Louis Freeh's testimony before the United States Senate could serve as a frontispiece to the Government. He testified "Statutes need to be rendered technology neutral so that they can be applied regardless of whether a crime is committed with pen and paper, e-mail, telephone, or geosynchronous orbit personal communication device".

These apart, a number of changes in various acts and laws like RBI Act, BR Act, NI Act, etc., have been proposed by the 12 Advisory Groups set up by RBI's Standing Committee on International Financial Standards and Codes. The same need to be completed in a time-bound manner. The proposed Joint Forum could act as the main instrumentality in this regard.

**3. Role of the society and general public**

Financial services is an important industry, affecting the lives of most people. Hence, it is too crucial an industry in a country's economy, the monitoring of which cannot be left solely to the respective institutions and the regulators. In this context, the financial institutions and the regulators are not the exclusive conscience keepers of the financial services sector. They are a part of the collective conscience viz., the society at large. An enlightened public who are aware of their rights and obligations are the best safeguard for ensuring non-exploitation of conflicts of interest by the financial intermediaries. The government, regulators, individual financial players, the academia, researchers and the press have a joint responsibility in educating the public in this regard.

These measures constitute important deterrents for misbehaviours at the community level. It would send a strong message that pro-consumer behaviour would be rewarded, while anti-consumer behaviour would be appropriately punished, in good time. Society at large should debate on these issues and the press, considering the crucial role of the financial industry in the country's scheme of things, needs to play an important supportive and enabling role in ensuring that these issues are brought to the mainstream of public discourse.

The management of the regulated entities and the regulators - government, supervisors and the press have an obligation to keep an eagle's eye to diagnose early, situations which may potentially lead to misalignment of interests of the stakeholders in a company or an industry, before they are exploited leading to avoidable scandals.

One of the most important measures against exploitation of conflicts of interest are "caveat emptor." After all, one's money is one's own responsibility, no matter what the regulators or rating agencies profess.

**4 Self-Regulatory Organisations (SROs)**

Appropriate and strong internal self-regulation mechanisms as also formation of advisory bodies for self-regulation could be crucial to tackling / preventing emergence of

conflicts of interest. Stronger intervention / contribution by legally authorized SROs in this regard is suggested. A step in this direction could be formulation of a committee to study how SROs could be equipped / geared up to function in the interest of the industry and at the same time educate the market participants. In the market discernment, conflict of interest issues were accepted as normal and there is a need to build proper insight in this regard. SROs could play positive role in this direction.

Self-regulatory organisations are particularly useful when there is a diverse universe of the concerned business entities. However, one of the major conflicting interests to which an SRO is subjected is that it might dilly-dally in taking due and prompt actions against its own members, who also form a part of its management.

Nonetheless, the Government and regulators should actively promote SROs as the first line of regulation, so as to leave them with sufficient time for the more important tasks of policy framing and strategic thinking. Further, as an industry grows in maturity, actions of SROs would be willingly accepted, due primarily to peer pressure, emanating from the strong survival instincts of the constituent entities.

IRDA should encourage Insurance Councils for life and general insurance, to develop into SROs. In money and government securities markets, RBI is engaging the emerging SROs – Fixed Income Money Market and Derivatives Association of India (FIMMDA) and Primary Dealers Association of India (PDAI) – in a consultative process to facilitate their emergence as full-fledged SROs; this process needs to be further intensified. On their part, to promote integrity of the markets, SROs need to establish a comprehensive code of conduct and best practices in securities transactions and also have a mechanism to enforce such codes.

**5 Code of Ethics of professions**

Professions, companies and organizations that are particularly prone to conflicts of interest must have rules / codes, designed specifically to identify conflicts and the risks they entail, so that they may be avoided or, if necessary, resolved in the best manner possible. Codes of conduct **/** ethics are essentially policy statements that define ethical standards for their conduct**.**

These rules / codes may be imposed by law, by regulations drawn up by an official regulator, or by individual industry, market or company codes of conduct / ethics, etc. They will include prohibitions; internal and external accountability mechanisms; management policies and systems, processes and practices designed to ensure that the interested parties accept their responsibility to comply with the letter and the spirit of the rules; auditing systems (both internal and external) to detect possible non-compliance; penalties; measures to protect disclosure and declaration of information by agents affected by conflicts of interest; guides and tools for communicating and publicising the rules, and training in applying them, etc.

Fundamentally, a code of conduct / ethics depends on its *credibility*: the extent to which it is taken seriously by industry, unions, consumers and governments. Credibility, in turn, depends on *monitoring, enforcement* and *transparency* in terms of all the stakeholders are aware of the code's existence and meaning.

A code can be made transparent through its posting and dissemination and through training regarding its provisions. Monitoring can be internal (e.g. through a committee, ombudsman, regular reporting obligation, field visits, or hot lines) or external (e.g. through an NGO, outside auditor, or consultant). *Responses to violations* by

employees, subsidiaries, vendors or business associates can include: monetary fines or penalties, demands for corrective action, providing education to the violator, and severance of the employment or business relationship. Positive reinforcement of respect for the requirements of a code of conduct includes crafting appropriate incentives to employees who act ethically.

## Section VII

## Classification of Strategies / Remedial Measures

Depending upon their nature, all remedial measures – whether internal or external can be classified as non-intrusive or intrusive, along a continuum.

Generally, market solutions or voluntary measures are least intrusive; while non market solutions are most intrusive.

Market solutions generally rest on the rigor of market discipline, whereby financial intermediaries which are less efficient are penalized while rewarding efficient ones. By definition, market solutions are least intrusive.

All other measures can be categorized as non-market solutions which are intrusive in nature ranging from the least intrusive to the most intrusive viz., corporate governance, leadership dynamism / organisational ethics, voluntary disclosures, self regulation, mandatory disclosures, supervisory oversight, whistle-blowing, separation by function / Chinese walls, alignment of interests of all the stakeholders through appropriate remuneration and incentive structures and socialization of information.

### 1. Evaluation of remedies

Andrew Crockett, *et al* in their book "Conflicts of Interest in the Financial Services Industry : What Should We Do About Them?," have suggested that answer to the following two questions would help in evaluating the effectiveness of the remedies:

1. Do markets have the information and incentives to control conflicts of interest?

2. Even if the incentives to exploit a conflict of interest are strong, would a policy that eliminates the conflict of interest destroy economies of scope, thereby reducing information flows?

If the answer is 'yes' to either question, then the case for a policy to remedy a particular conflict of interest is substantially weakened. Putting the remedy into practice would be likely to reduce the overall information in the market place, thus doing more harm than good.

The choice of an appropriate remedial measure should be such that the trade-off between the synergies of scope and scale and the need for regulation are balanced. In this context, they expound five generic approaches to remedying conflicts of interest, starting from least intrusive to the most intrusive:

1. market discipline;
2. mandatory disclosure for increased transparency;
3. supervisory oversight;

4. separation by function;
5. socialization of information.

They argue in favour of less intrusive measures than the more intrusive ones on the reasons of effectiveness against the framework of the answers to the two questions put forth.

### 2. Useful resources

There are tool kits available in the internet detailing at great length as to the various steps to be undertaken to operationalise an appropriate CMP for any organisation. They provide tools to practically develop and implement an effective conflicts of interest policy. The tools have generic application – they can assist any organisation on a step-by-step basis to develop and implement a policy that is specific and customised to that organisation, and can assist any official in identifying, managing and monitoring any conflict of interest that may arise.

As regards information on blogging Toby Bloomberg of Diva Marketing Blog, has compiled a list of company blogging guidelines, and Fredrik Wackå's CorporateBlogging site provides a guide to corporate blogging.

CINet has published an FAQ about blogging on the job. Workplace Fairness provides a detailed overview of rights under labor law, as does the Legal Aid Society-Employment Law Centre. For the corporate audience, the law firm Howard Rice published a newsletter article, Corporate Blogging - Seize the Opportunity, But Control the Risks.

In 2005 the Electronic Frontier Foundation (EFF) published the guide *How to Blog Safely (About Work or Anything Else)*.

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## Chapter VII

## Concluding Remarks

On going through the myriad variety of conflicts of interest situations detailed in the report and the number of measures suggested for mitigation thereof, the feeling that conflicts of interest weave a web (reality) of complexity in the financial sector begins to dawn on us. This gives rise to an apparent paradox. Namely, at first look, it would appear that such complexity gives rise to the need for ever more detailed “Rules of the Road” in order to manage and control the conflicts of interest situations, which are inherent in functioning of the various financial intermediaries. However, while the above given principles / measures are central to the mitigation of conflicts of interest situations, they are by no means substitutes for the overriding importance of the time-honoured basics of managerial competence, sound judgement, common sense and the presence of a highly-disciplined system of corporate governance, of which, mitigation of conflicts of interests is but an integral part.

To sum up, agency theory offers a valuable lens for assessing important governance and regulatory issues, including conflicts of interest in the financial sector. All financial intermediaries invariably play a dual role, both as a principal and as an agent, during the discharge of their functions. Consequently, financial intermediaries jointly act as an agent of the customer when they provide the diagnosis to their finance related problems and consider the best remedial action therefor, besides, acting as a principal in executing with the customer the prescribed action. This inherent dual capacity, common to most professional services, naturally gives rise to conflicts of interest in cases where the professional acting as an agent, prescribes actions which he knows are to his own benefit as principal, rather than to the customers. There is nothing special about financial services in this respect. In the case of universal banks and financial conglomerates / supermarkets, the dual role of being a principal and an agent gets magnified many times over in a multi-functional set-up than in a stand-alone mode, since activities relating to banking, securities and insurance are performed by a single intermediary, leading to possible increase in the number, variety and complexity of conflicts of interest. Hence, regulation may be comparatively more focused on universal banks and financial conglomerates / supermarkets, in the context of corporate governance in general and conflicts of interest in particular.

Financial services come jointly under the category of ‘experience goods’ and ‘credence goods;’ wherein, information is obtained by the consumers only during / after the services have been purchased or perhaps, may not be able to obtain the same even after purchasing. In other words, the consumers will find it that much more difficult in obtaining information about the quality of financial services offered by the intermediaries, due to the inherent nature of the services. As such, ‘information asymmetry’ leading to adverse selection and moral hazard becomes an acute problem impinging adversely on the information-generation activity, which is the main function of markets. Further, the financial intermediaries and more particularly the banks will not be able to fulfill their task of being ‘delegated monitors,’ in monitoring the economic activities of the various economic agents in the system. The Right to Information Act recently put in place, must be put to effective use in this context, though it has an important limitation in that the private sector is out of its ambit.

In such circumstances, exploitation of conflicts of interest by financial intermediaries due to the classic `principal-agent' conflict, away from the public glare, could lead to loss of trust in the financial market. As Walter Bagehot put it so elegantly, “One terra incognita seen to be faulty; every other terra incognita will be suspected.” The inevitable financial market contagion will catch on.

The foundations of the process for mitigating conflicts of interests lie primarily within an individual. As famously said, “the greatest conflicts are not between two people / institutions / nations, but between one person and himself.” Resolution of conflicts of interest is an exercise in resolving this greatest internal conflict, within the recesses of one’s own individual selves. This effort should be sustained and fostered in the work atmosphere through an enabling legal, regulatory and institutional environment.

Moral and ethical deficit in society has to be bridged through enabling environment both in the overall system and the individual institutions, role setting by the leaders / top management and above all self-regulation. Odd and impulse-driven tactile interventions would do no good. Hence, there should be a well thought out, constructive and sustained confluence of appropriate personal, institutional, regulatory, governmental and societal actions to mitigate conflicts of interest, in the financial sector on an enduring basis.

The enabling legal environment is best achieved by expeditiously defining `financial/economic crime' and by framing suitable ‘technology-neutral’ laws, which would ensure timely and deterrent punishments to those who exploit conflicts of interest, either on-line or off-line, alike. This merits considerable debate and active intervention in our country of all segments of the society – the government, the public and the media.

The regulatory regime should create systems for ensuring transparency through appropriate disclosures to reduce the problem of endemic asymmetric information. There should be strong disincentives, to deter unethical behaviour among the economic agents.

The institution / profession / vocation should develop an appropriate panoply, (as discussed in Chapter VI), by which a commensurate discount is placed on the unethical behaviour of the individuals (or the institutions, as the case may be). In this context, the organizational culture assumes paramount importance in that it should be open and encourage ethical deliberation amongst decision makers. The entire organizational ethos should be such that critical importance is placed on high standards of corporate governance and business ethics. It should promote value-based professionalism among all employees, by appropriately crafted incentives for disclosures and by placing a premium on honesty and fair play. Apt behaviour of a responsible Top management, is paramount since it has a great ‘Demonstration effect’. As the saying goes ‘an ounce of practice is more than a pound of preaching.’ Setting an ideal example in managing the conflicts of interest, as and when faced by the Top Management, would speak much louder and accomplish much more than any external or internal measures in an organization.

Clearly, corporate governance alone is not enough to prevent frauds or mitigate conflicts of interest. The elements of good governance, namely transparent disclosures of financial information, systems of checks and balances, independent oversight in corporate affairs, and the deterrent of accountability, are good systemic tools to conduct the operations of a corporate entity. However, there is still a huge dependence on the management and staff of corporate entity to adhere to good behaviour.

Conflicts of interest which represent ethical dilemmas - `Dharma Sankats,' are best mitigated by individuals, upholding ethical values in the best traditions of human nature. The legal, regulatory / supervisory, speedy dispensation of justice, market discipline and all other measures play a supporting role. This fact is convincingly proved by the fact that Refco has happened in the post ‘SOX clean’ corporate environment.

In conclusion, it has to be stated that the source-code emanating from the discussions in the report, for scandal-proofing the financial system from exploitation of conflicts of interest situations or for that matter from any form of unethical acts, points out

to building the primary infrastructure by way of value-orientation of individuals; and simultaneously, providing supporting infrastructure through appropriate measures by the government, the regulators, media and the society at large. This is so due to the fact that the measures to be taken / implemented by the governmental, legal, regulatory and the public are necessary conditions; but the clinching condition is the value-orientation of the individual decision-makers. In other words, the framework for mitigating conflicting interests should be constructed inside-out, from the core point of an individual's value-oriented personality to an outer layer of enabling environment, through all possible means available to the society.

The Group looks at the principles / measures enunciated as forward-looking and as an integrated set of initiatives, since it realises that conflict management situations seldom involve straightforward and easy solutions. The underlying philosophy to which the Group subscribes to is that effective conflict management calls for a better balance between principles and rules. The Group strongly feels that as in all endeavours, the conflict mitigation process, at its absolute broadest, should strike a reasonable balance that helps guard against future problems of conflicts of interest, while also preserving and protecting those traits of financial system which are the source of its creative and competitive genius.

As regards regulation, in the long run, it is felt that principles-based regulation over rule-based one; supervisory regime over enforcement approaches would be more efficacious.

Towards this end, the road ahead, is long and not necessarily smooth, while the unfinished agenda is rather heavy.

In this context, to facilitate hastening the process, it is our hope that this report would trigger a wider debate on the subject, among all the stakeholders including regulators and supervisors, academia and more importantly the general public.

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# Annexures

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## Annexure I

## The Terms of Reference of the Working Group

(a) to identify the sources and nature of potential conflicts of interest in the financial sector in India;

(b) to survey the international practices adopted for mitigating the conflicts of interest in the financial sector;

(c) to enumerate the legislative, regulatory and other mechanisms already in place in the Indian context for addressing the issue of conflict of interest;

(d)to make recommendations for further measures/actions to be taken for mitigating conflicts of interest in the Indian financial services industry; and

(e)any other issue that may be considered germane to the task assigned to the Working Group.

## List of Members

1. Shri D M Satwalekar, MD&CEO, HDFC Standard Life Insurance Company Ltd. - Chairman
2. Shri Randip Singh Jagpal, Deputy Director, IRDA – (IRDA Representative)
3. Smt. Usha Narayanan, Chief General Manager, SEBI - Member
4. Shri K V Subba Rao, Chief General Manager, DBS, RBI – Member
5. Shri D S Nagi, Chief General Manager, DNBS, RBI – Member
6. Shri P Vijaya Bhaskar, Chief General Manager, DBOD, RBI –Convenor

## Annexure II

## List of resource persons

**Special Invitees**

1. Shri S.S.Tarapore, Former Dy. Gov, RBI
2. Shri Prashant Saran, Chief General Manager In-Charge, DBOD, RBI
3. Shri Amarendra Mohan, Chief General Manager, DBOD, RBI
4. Prof T.T Ram Mohan, IIM, Ahmedabad,
5. Smt. Veena Mishra, IGIDR

**Banking Sector**

1. Mr. Sudhir Joshi, Treasurer, HDFC Bank Ltd.
2. Shri Pradeep Patil, Head-Audit, IDBI Bank Ltd.
3. Charan Rawat, Associate Director, Compliance, Barclays Bank
4. Shri Shivprasad Laxman Chhatre, Sr.Vice President, Kotak Mahindra Bank Ltd.
5. Shri V G Kannan, DGM, SBI
6. Shri Rajesh Khanna, Warburg Pincus
7. Shri R I S Siddhu General Manager, Zonal Office, Punjab National Bank
8. Shri Jayaram Shetty, General Manager, Vijaya Bank
9. Shri Kotak, MD, Kotak Mahindra Bank Ltd.

**Insurance sector**

1. Shri T V Vujayan,MD,LIC
2. Smt. Shikha Sharma, MD, ICICI Prudential Life Insurance Co.
3. Shri Nani Javeri, MD, Birla Sunlife Insurance Co.

**Capital Markets**

1. Dr. R.H Patil, Chairman, CCIL
2. Shri. V K Singhania, Association of NSE Members of India (ANMI)
3. Shri Mohan Vijan, BSE – Broker Forum
4. Shri. A.P. Kurian, Association of Mutual Funds in India (AMFI)
5. Shri M V Ram Narain, Registrars Association of India (RAIN)
6. Shri. T R Ramaswami, Association Merchant Bankers of India (AMBI)
7. Shri Arun Panickkar, CRISIL
8. Shri Amit Tandon, FITCH
9. Shri Viraj Kulkarni, Citibank N.A.,
10. Shri Narayan S.A., Kotak Securities Ltd.
11. Prof. Sethu, UTI institute of capital Markets
12. Shri Nimesh Kampani, CMD, J.P Morgan Pvt Ltd.,

## Annexure III

## Discussion paper circulated to resource persons

## Conflicts of Interest in the Financial Sector – A write-up

In the context of latest developments internationally, interest on the subject of conflicts of interest in the financial sector – the banking, insurance and securities segments - has been growing steadily. A brief write-up thereon is given below:

### 1. Introduction

The on-going integration of financial markets the world over has created variety of new players, products and delivery channels. With growing financial openness, globalisation and liberalization, financial stability issues assume significance. Stability and orderliness in the financial sector is achieved by free flow of information, improved corporate governance and increased supervisory oversight.

(ii) Synergies or economies of scope are driving single financial services provider to meet diverse set of customers of varied interests through multiple products and delivery channels to reap substantial benefits, which also create potential costs in the forms of conflicts of interests. Consequently, while serving different set of clients, a single financial provider may not be willing to provide necessary information to all / part of stakeholders for making decision / effective functioning of financial markets. This information asymmetry may lead to regulatory arbitrage and situations where the other stakeholders may be forced to make less than optimal financial decisions.

(iii) Conflict of interests, thus, poses a threat to stability and orderliness in the financial sector.

### 2. Conflicts of interest – the concept

Conflict of Interests is ubiquitous in every aspect of human life. It represents a human dilemma – 'Dharma sankat.' It has been there all down human and financial history.

(ii) However, of late, interest on Conflict of Interests and the corresponding weak governance structures of public corporations has grown dramatically following events of corporate malfeasance, market volatility, inadequate disclosure and conflicts of interest that are injurious to the public besides undermining confidence in the market place, involving high profile companies like Enron, WorldCom, Tyco in USA; Parmalat, Ahold in Europe; Citi bank's activities in Europe and Japan, etc.

(iii) The untiring efforts of Eliot Spitzer, the combative New York Attorney General exposed the exploitation of fundamental conflicts of interests in high offices, as in case of the unduly fat pay packages of high profile individuals like Richard Grasso – Chief of New York Stock Exchange and Jack Welch of General Electric, at the expense of shareholders. Further, a series of investigations by the New York Attorney General exposed the unethical practices involving exploitation of conflicts of interest at investment banks (for instance, Merrill Lynch gave biased investment advice driven by the desire to aid the firm's investment banking business reflecting breakdown of the walls between its two important wings), mutual funds (improper trading and other market abuses;) and insurance companies (for instance, Aon, the world's second largest insurance broking company was charged of 'steering' business to those who paid the most commission); triggering a wave of overdue corrective actions aimed at improving the governance practices in all these industries.

**3. Conflict of Interest - A few definitions**

**3.1** Conflict of interest is generally thought as any situation involving hidden 'self-dealing,' ' related third-party transactions,' 'non-arms length relationships' or 'serving two masters' that results in gain to one party at
the expense of another. A structured definition of the concept of conflict of interest, as given by Mark R. Simmons is:

- the convergence between an individual's private interests, obligations, relationships in his / her professional obligations to the organization
- such that an independent observer might reasonably question the motive, actions and outcome regarding decisions made or actions taken by the individual as a director, officer or employee

- the individual, the individual's immediate family or a third party or organization in which the individual or the individual's immediate family has a business interest or association receiving any "thing of value" as a result of decisions made or actions taken by the individual as a director, officer or employee of the organization.

**3.1.1 What are "things of value?"**

"Things of value" include, but are not limited to : salaries / direct commission; finder fees; raises, bonuses, or promotion (other than those received as an employee of the organization); receipt of automobiles, boats or any gifts than those of nominal value; receipt of paid vacations and trips; payment of credit card bills or of any other personal expenses; receipt of stocks, bonds, annuities or other investments; insurance policies paid for by a third party; an offer or promise of

employment; realization of business profits or increased business value; realization of an unfair competitive advantage; or any other means of compensation or reward other than those provided by the organization to its directors, officers and employees.

**3.2** Conflicts of interest exist whenever one agent serves more than one principal. Acting in the interests of one principal may run counter to the interests of others. Defined this way conflicts are endemic in virtually all aspects of economic life. Conflicts can arise between an individual and the firm for which he or she works; between the interests of a firm and those of its clients; and between the interests of various categories of clients (Andrew Crockett, Former General Manager, Bank for International Settlements, Basel)

**3.3** Conflicts of interest arise when a financial service provider, or an agent within such a service provider, has multiple interests which create incentives to act in such a way as to misuse or conceal information needed for the effective functioning of financial markets (Frederic S Mishkin Graduate School of Business, Columbia University).

**3.4** Conflict of interest is "a situation in which a person, such as a public official, an employee, or a professional, has a private or personal interest sufficient to appear to influence the objective exercise of his or her official duties (Michael McDonald of the W. Maurice Young Centre for Applied Ethics, the University of British Columbia).

## 4. Characteristics

An analysis of the characteristics of Conflicts of Interest would help in understanding the concept better and thereby the consequences thereof:

### 4.1. Ubiquitous

Conflicts of Interests are ubiquitous as can be seen from Annexure IA, both at international and national level institutions and across various levels in the organizations. They cannot be fully avoided, only mitigated.

### 4.2 Tend to be more in universal banks or financial conglomerates

Due to bundling of services and delivery channels, the areas of potential conflicts of interest tend to increase in universal banks and financial conglomerates.

### 4.3. Represents Governance issue in Operational Risk

It's a corporate governance issue representing an operational risk. Hence, conflicts of interest are unique in each organization and the criticality of similar nature of conflicts of interest, may be

different in different organizations depending on specific individual factors, notably the organizational culture.

### 4.4. Information Asymmetry

Conflicts of interest are the cause of information asymmetry, with all its negative impact. As earlier stated, this is the single most important factor which is of special interest to regulators in the context of smooth functioning of financial markets.

## 5. Reasons for regulators to care about conflicts of interests

Well-functioning financial markets serve the basic economic function of channeling funds from those who lack productive investment opportunities to those that have such opportunities. By increasing the level and improving the allocation of investment, well-functioning markets perform a vital role in increasing society's material well being. Reliable information is the key to financial markets performing this function. The efficient mobilization and allocation of financial resources can be impeded by the absence of such information, leading to an information asymmetry, a situation in which one party to a contract has better information about the true nature of the contract than the other. It's a classic case of pricing of lemons as highlighted by George Akerlof in his seminal paper "The Market for Lemons; Quality Uncertainty and the Market Mechanism." Those who cannot be sure if a contract's terms are fair are likely to hold back from committing funds leading to fall in level of investment and overall growth of the economy. Hence, the basic reason why regulators should care about conflicts of interest, therefore, is that they damage the information generating function that is at the core of the contribution the financial system makes to economic welfare. This would lead to adverse selection and moral hazard problems.

(ii) Conflicts of interests essentially generate fiduciary, strategic and reputational risks. The appearance of a conflict of interest is always a red flag of warning that official acts may have occurred that are not in the best interests of the institution, and in fact may not be within the law. Organisation officials have a fiduciary duty, and, where public funds are involved, a legal responsibility, to minimise the risks associated with conflicts of interest; and to fully resolve legitimate allegations of impropriety or illegal acts that are the result of conflicting interests.

## 6. Indian Scenario

A study of the conflicts of interest in the financial world, are of crucial importance in the Indian context, at the present juncture due to:

### 6.1. Emergence of financial conglomerates and universal banks

In the Indian context, the concept of a single financial service provider having multiple interests, although may not be as prominent as in developed nations, is gaining prominence. The financial

landscape is increasingly witnessing (i) entry of some of the bigger banks into other financial segments like merchant banking, insurance, etc., which have made them financial conglomerates; and (ii)emergence of several new players with diversified presence across major segments.

In the last few years, due to liberalization measures, home grown and foreign financial conglomerates have emerged in India. The various group entities are controlled by a number of regulators – RBI, SEBI, IRDA, NABARD, NHB, etc. Conflicts of interest tend to be more in such entities due to bundling of various activities.

**6.2. Co-existence of public, private and foreign players**

Public, private and foreign players co-exist in the banking (27 banks in the public sector while others are in the private and foreign segments); insurance (in life insurance – LIC in public sector is the biggest player with others being in private and foreign segments, while in non-life insurance GIC with its four subsidiaries in the public exist co-exists with other private and foreign players); and mutual fund (UTI – the biggest player is in the public sector while the others are in private and foreign segments) industries. This apart, UTI Bank and IDBI Bank are in the private sector but floated by public sector companies.

**6.3. Different phases of market development**

Banking, insurance and securities markets are at various stages of market development and are in the midst of far reaching cataclysmic changes.

**6.4. Large scale outsourcing**

Of late, one of the important emerging feature of financial, insurance and securities institutions in India is their resort to large scale outsourcing, to reap the benefits of low cost and economies of scope / scale. Reportedly, ICICI Bank has outsourced almost half its balance sheet and has employed around 6,000 agents in the process.

**6.5. Relationship based society**

Conflicts of interests tend to be accentuated due to the fact that Indian society is predominantly relationship based, when compared to the Western ones. This brings in the problems of nepotism, favouritism, corruption etc., in its wake.
GTB, Madhavpura cases etc

**6.6. Functions performed by market players**

The functions performed by many of the financial agents in the different segments of the market are not as neatly well diversified as in the West. For instance, many of the audit firms, rating

agencies or investment analysts perform simple fee-based activities and do not have functions which hold significant risks by way of conflicts of interest like performance of auditing and consultancy, rating and consulting or underwriting and consultancy activities respectively.

Due to the above rather unique factors obtained in the Indian context, the received wisdom in the West on the subject of ' conflicts of interest,' may not applicable in toto; due primarily to vast divergence in the structures and processes of governance structures across the spectrum leading to multiple issues of conflict of interest.

## 7. Mitigating Mechanisms

Conflicts of interest can be mitigated through both external and internal mechanisms.

### 7.1. External

The legislative and regulatory provisions of RBI and SEBI as also measures to strengthen the Self-Regulating Organisations (SROs). Model code of ethics may be formulated by SROs of banking, insurance and security industries, which may be adapted by individual players with suitable modifications.

### 7.2. Internal

Good governance in financial institutions relies on three key building blocks; ***proper incentives, adequate transparency and clear accountability.***

- Policy for mitigation of conflicts of interest. Every organization should have a comprehensive policy identifying the major and potential conflicts of interests and the mitigating mechanisms therefor.
- Whistle blower policy – The role of whistle blowers as conscience keepers has come into sharp focus since they were responsible for making public the misdeeds of major corporates, especially in the US. In India, Satyendra Dubey' case has triggered a wide debate in the country.
- Transparency via more disclosures – Full and meaningful disclosure will always be crucial for limiting the ability of companies to pursue their own interest at the expense of investors.. Indeed, many of the problems uncovered at mutual funds and in the corporate world can be traced to relationships or transactions that were hidden from view. Greater transparency will provide the foundation for more effective corporate governance in the future.
- Clear accountability – acts as a deterrent for exploitation of conflicts of interests.

Andrew Crockett and others have given nine recommendations starting from the least to the most intrusive. They favour the least intrusive measures to the more intrusive ones, since they opine that they are more likely to do far more harm than good. The nine recommendations are:

- Increased disclosure requirements.
- Improving corporate governance.
- Increased supervisory oversight.
- Provision of adequate resources to supervisors to monitor conflicts of interest.
- Establish best practice codes of conduct, devised by industry and supervisors in co-operation.
- Enhance competitiveness in the rating agency industry.
- Prevent co-option of private information producing agents by regulators and supervisors.
- Avoid the forced separation of financial service activities except in unusual circumstances.
- Avoid the socialization of information in the financial service industry in most circumstances.

## 8. Challenges to the Regulators

One of the major challenges to regulators and more so to RBI as a lead regulator is to encourage the evolution of corporate governance within organizations that keeps pace with changing business strategies and evolving business practices.

## 9. Legal regulatory safeguards

### 9.1 International scenario

#### 9.1.1 Underwriter/analyst conflict of interest

In the US, a global settlement was reached by the Securities Exchange Commission (SEC), The New York Attorney General, industry bodies, New York Stock Exchange (NYSE) and state regulators on appropriate mixture of disclosure, separation and prudential supervision for the investment banks.

#### 9.1.2 Auditor/consultant conflict of interest

In regard to conflicts of Interest in Auditing and consulting and in view of failure of American Institute of Certified Public Accountants (AICPA) in controlling the spate of business and audit

failures the Sarbanes-Oxley Act of 2002 established the Public Company Accounting Oversight Board (PCAOB). Under the SEC's oversight, the PCAOB will register public accounting firms, and establish rules for auditing, quality control, ethics, independence and other standards. In addition, it will conduct inspections of accounting firms and when needed carry out investigations and disciplinary proceedings and impose sanctions. The PCAOB has indicated its intention to take over the rule making authority for auditing standards, while leaving accounting rules in the hands of the FASB (Financial Accounting Standards Board), at least for now.

### 9.1.3 Credit assessment/consulting conflict of interest

The US Congressional Committee investigating the collapse of Enron found that the rating agencies had displayed 'a disappointing lack of diligence in their coverage and assessment of ….' Enron(US Congress, 2002). As a result, the Sarbanes-Oxley Act mandated the SEC to prepare a report on 'The Role and functioning of Credit Rating Agencies in the Operation of the Securities Markets'. First part of the report of the report is mainly descriptive, outlining some of the potential sources of concern about the agencies, reviewing earlier enquiries into their activities and discussing aspects of functioning of the industry. The second part is likely to suggest possible remedies.

The first part of the SEC's report raised the following important questions:

1. Should more information be released by rating agencies about their decisions, and should more information by issuers be disclosed?
2. Should improved procedures be introduced to avoid or manage potential conflicts of interest?
3. Is there any basis to allegations of anticompetitive behaviour in the industry, and if so, what should be done about it?
4. How, if at all, should rating agencies be recognized for regulatory purposes?
5. Should oversight of rating agencies be changed?

### 9.1.4 Conflict of interest in universal banking

Given the multiple services provided by a universal bank, there are multiple opportunities for departments or individuals to benefit from the conflicts of interest. While other countries had long permitted some form of universal banking, the United States only recently re-opened the doors. Breaking down the barriers imposed by the Glass-Steagall Act, the Gramm-Leach-Bliley Financial Services Modernization Act of 1999 permits banks, securities firm, and insurance companies to affiliate within a new structure – the financial holding company (FHC). While it is too early for any judgment about the effects of the 1999 Act, banks have moved to take advantage of the law presumably to gain potential complementarities.

## 9.2 Indian scenario

**9.2.1**. Indian financial sector consists of the following financial intermediaries and service providers: banks, developmental financial institutions, primary dealers, non-banking financial companies, mutual funds, housing finance companies, venture capital funds, insurance companies (both life as well as non-life), rating agencies, accounting firms, brokers, depositories, asset reconstruction companies, trustees etc. offering financial services to one or more categories of customers simultaneously. The above service providers are regulated by RBI, SEBI, IRDA, NABARD, NHB etc.

**9.2.2** Already various legislative and regulatory provisions exist and further steps have been taken in recent times to minimise and handle *Conflicts of Interest* situations in the Indian financial sector. Provisions have been made in the following Acts for effective containment and minimisation of conflicts of interest in the Indian financial sector: (i) The Banking Regulation Act, 1949, (ii) The Securities and Exchange Board of India Act, 1992, (iii) The Insurance Regulatory and Development Authority Act, 1999, (iv) The Depositories Act, 1996, (v) The Securities Contract (Regulations) Act, 1956, (vi) The Companies Act, 1956, and (vii) The Insurance Act, 1938.

**9.2.3** The statutory and regulatory provisions, inter alia:

(i) prohibit banks from employing a person whose remuneration takes the form of commission or of a share in the profit of the bank;

(ii) prohibit banks from having as director in its Board of Directors any person who is a director of any other banking company and provides 'Fit and proper' criteria for directors of banks;

(iii) permit a bank to form a subsidiary to undertake only business which is permissible for a bank to undertake and with the approval of the RBI;

(iv) prohibit banks from granting loans or advances or on behalf of (i) on the security of its own shares; (ii) any of its directors ;(iii) any firm/company in which any of its director is interested as partner, manager, employee or guarantor, director, managing agent or in which he holds substantial interest; or(iv) any individual in respect of whom any of its directors is a partner or guarantor;

(v) prohibit a bank from remitting in whole or in part any debt due to it by (a) any of its directors or (b) any firm or company in which any of its directors is interested as director, partner, managing agent or guarantor, or(c) any individual if any of its director is his partner or guarantor;

(v) prohibit direct or indirect engagement in insider trading by regulated entities;

(vi) provide that banks have to maintain 'arm's length" distance from its subsidiaries in regard to business parameters(such as taking undue advantage in borrowing/lending funds, transferring/selling/buying of securities at rates other than market rates, giving special consideration for securities transactions, overindulgence in supporting/financing the subsidiary, financing the bank's clients when the bank itself is not able or is not permitted to do so, etc.);

(vii) require that the following measures, inter alia, to be taken in respect of listed companies to promote and raise the standard of corporate Governance:

- increased representation for independent directors
- setting up of qualified and independent audit committee
- disclosures on related party transactions, accounting treatment, risk management, remuneration of directors, uses /applications of proceeds from public issues, rights issue, preferential issues etc., CEO/CFO certification;

(viii) lay down elaborate guidelines on investment/trading in securities by employees of asset management companies and mutual fund trustee companies to ensure that all personal securities transactions are conducted in such manner as to avoid any actual or potential conflict of interest or any abuse of an individual's position of trust and responsibility; and

(ix) the stock exchanges and its members shall not disclose information pertaining to client to any person/entity except as required under the law.

**Items for discussion with the resource persons**

(i) Identify the sources and nature of potential conflicts of interest in the financial sector in India.

(ii) Possible measures/actions to be taken for mitigating conflicts of interest in the Indian financial sector.

| ***Type of institution*** | ***Areas having a high potential for ‘Conflict of interest’*** |
|---|---|
| International Financial Institutions like IMF, World Bank and BIS | The Club theory stated that a small group of developed countries bear disproportionate cost and derive disproportionate benefits due to critical majority shareholding, which goes against the principle of having an international financial architecture based on democracy for all the members. This apart, the borrowers themselves are represented on the boards of IMF and World Bank. Further, these international institutions, notably the IMF acts as economic adviser, standard setter, credit analyst, lender, auditor and crisis manager – which is too much for any institution, even with the best of intentions and without safeguards that are monitored and tested to protect shareholders. It is an important practical design hurdle. |
| Investment banks | ***Underwriting and research***. Research is for investment advice to prospective investors, whereas underwriting is for the issuing companies. In case the underwriting commission is more profitable, there is a tendency to recommend not so worthy investments as good ones. |
| Rating agencies | ***Credit assessment and consulting.*** There is a chance for compromising on the former, if the agency feels it would lose an otherwise profitable consulting business of the client. |
| Accounting firms | ***Auditing and consulting***. Classic example is that of Arthur Andersen, who were both the auditors and consultants for Enron. Consequently, they turned a blind eye to the misdeeds of the company, for fear of losing the consulting business. |

## Annexure IV

## RBI paper (including legal/regulatory mechanisms undertaken for mitigating conflicts of interest)

**Conflicts of Interest in the Banking Industry**

1. **Introduction**

1.1. *Conflict of Interest* has become a matter of great importance. Recent years have witnessed a lot being said, written and legislated on *Corporate Governance* in the corporate sector and the financial sector. *Corporate governance* issues are receiving greater attention in both developed and developing countries as a result of the increasing recognition that a firm's corporate governance affects both its economic performance and its ability to access long-term, low-cost investment capital.

1.2. Besides, the need for *Corporate Governance* has also arisen in the wake of several developments across the universe. There have been two major scams in the Indian stock market, a number of international corporate scandals, mergers of financial institutions and their banking subsidiaries to form universal banks, amalgamation of subsidiaries with parent banks and mergers of banks. Besides, there are other issues like, ownership and governance in private sector banks, need for greater autonomy in public sector banks, banks clamouring for handling investment banking activities, marketing mutual funds and insurance products and many other such activities where the main issue involved is *conflict of interest*.

2. **What is *Conflict of Interest*?**

2.1. As per a dictionary definition, *'Conflict of Interest'* refers to a situation when someone has competing professional or personal obligations or personal or financial interests that would make it difficult to fulfill his duties fairly.

2.2. In other words, the term "*Conflict of Interest*" or *"Conflicts of Interest"* refers to situations in which financial, business or other personal considerations may compromise, or have the appearance of compromising, a person's professional judgment in administration, management, instruction and other professional activities.

2.3. A *Conflict of Interest* may also exist when an individual's/organisation's loyalty to another individual/organization or a client becomes questionable due to conflicting personal interests.

2.4. This calls for thorough discussion on and threadbare analysis of *Conflicts of Interest* in the financial sector and particularly in the banking industry.

## 3. Nature and Sources of Potential *Conflicts of Interest*

### 3.1. General

3.1.1. Increasingly complex financial services, products, corporate organizations, affiliations, and arrangements with service providers may give rise to relationships that can result in *Conflicts of Interest*. The *Conflicts of Interest* and self-dealing activities may result from dealings involving insiders, the banks benefiting inappropriately, the bank's conflicting roles with a client, an employee's unethical conduct, or even personal involvement/ interest of directors or senior management.

### 3.2. Stakeholders

3.2.1. Since stakeholders have different expectations, naturally there will be a *Conflict of Interest*. This *Conflict of Interest* could be amongst the shareholders group, current owners, management, institutions, small shareholders etc. *Conflict of Interest* can also arise between owners and creditors and between owners and Government, owners and institutions, etc.

### 3.3. Dealings Involving Insiders

3.3.1. Dealings with persons or entities connected with the bank in a way that might affect its judgment represent a potential *Conflict of Interest* or self-dealing activity. Such dealings may include investing in securities held by insiders (including bank officers, directors, and employees) or their related interests, assuming their obligations, acquiring their property, selling them properties, or lending funds to them.

### 3.4. Investment Banking & Asset Management Services

3.4.1. Banks providing various investment services for clients may be required to manage a variety of actual or potential *Conflicts of Interest*. *Conflicts of Interest* and self-dealing transactions normally arise whenever the bank's ability to act exclusively in the best interest of account beneficiaries or clients is impaired. A fiduciary is required to put the interests of account beneficiaries before the interests of the bank. The fiduciary owes its beneficiaries undivided loyalty and must administer each trust for the exclusive benefit of account beneficiaries and the purposes for which the account was created.

3.4.2. *Conflicts of Interest* are not limited to instances in which the bank is acting as a fiduciary. In fact, as the trust business increasingly becomes an asset management business with opening up of pension funds and provident funds, etc., the opportunities for a bank to find itself in a conflict of will interest increase. Asset management - the management of third-party assets for a fee or commission - includes fiduciary services (personal, employee benefits, and corporate), investment advisory services, the retail sales of non-deposit investment products, and agency arrangements including custody of assets. When a bank provides these services, the best interests of the client and the bank are not always the same.

3.4.3. The role of stock analysts comes under scrutiny. These analysts working for investment banks have the task of providing investors with advice and issue research reports on stocks along with recommendations to buy, hold, or sell the stocks. But, if the bank is more interested in gaining the business for its corporate finance activities than safeguarding the investors' interests, this may influence the analyst's assessment. A fact worth noting is that very few stock analysts issue sell recommendations during the bear market. A nexus may be nurtured and developed between financial analysts, bankers, merchant bankers, fund managers, economists, rating agencies, consultants, stock and currency traders, and multilateral funding agencies aligned with one another through common multinational consultancy or accounting firms.

3.4.4. Curiously, even after Enron executives admitted to accounting fraud, most stock analysts kept a buy recommendation on Enron stock.

### 3.5. Loans & Contracts to Directors, Relatives, Senior Officers' Relatives

3.5.1. Grant of Loans, Advances and Contracts to (a) Directors of the Bank (b) Relatives of Directors of the Bank, (c) Directors of other banks and their relatives, (d) Directors of subsidiaries and their relatives, and (e) Relatives of Senior Officials of the Bank could lead to *Conflicts of Interest.* Even issuing guarantees on behalf of directors or accepting guarantees from directors could lead to *Conflict of Interest*.

### 3.6. Interest Rate Risk Management

3.6.1. There could be potential *Conflict of Interest*, if the individuals and/or committees responsible for managing interest rate risk are not clearly defined, there is no proper separation of duties in key elements of the risk management process and the risk measurement, monitoring and control functions are not sufficiently independent from position-taking functions of the bank.

### 3.7. Internal Audit Department

3.7.1. There could be *Conflict of Interest*, if the Internal Audit Department is not independent from the internal control process or performs other accounting and operational functions or is not given an appropriate standing within the bank to carry out its assignments independently.

### 3.8. Empanelling Stock Brokers

3.8.1. Banks empanel Stock Brokers for their security and shares investment trading. There could be possible *Conflict of Interest*, if the stockbrokers or their close relatives are appointed as independent directors on the Boards of banks or in any other capacity they/their relatives involve themselves in any manner with the Investment Committee or in the decisions in regard to making investments in shares, etc., or granting advances against shares.

### 3.9. Merchant Banking Activities

3.9.1. There were deficiencies in the appraisal of credit proposals. High projections of the borrowing company were not critically analysed by the sanctioning authorities. With the result, the borrowers' credit requirements were not properly assessed.

3.9.2. Many banks sanction credit limits to corporates on the basis of appraisal made by their Merchant Banking Division or Subsidiary for the purpose of public issue. The bank's Credit Department relies on such appraisals and no separate/independent assessment for credit risk is done leading to loans turning into non-performing assets. This is mainly due to the existence of a *Conflict of Interest,* which is not always appreciated.

3.9.3. The Merchant Banking Division/Subsidiary arranges finance through public issue for a corporate for a fee income. It has a fiduciary relationship with its client and it has to do best for the client. Its job is to present a rosy picture of its client even if there may be another *Conflict of Interest* with public at large, which may look at the standing and credibility of the Merchant Banker and invest in the public issue.

3.9.4. Bank's credit department's reliance on such appraisal and lending decisions may obviously be fraught with grave risk, unless the fundamentals of the corporate concerned are very strong.

3.10. **Outsourcing Activities**

3.10.1. Recent increase in outsourcing several activities in the banking sector may increase the potential for *Conflicts of Interest* in very many ways to the detriment of banks using outsourcing agencies.

3.10.2. For example, banks utilising Direct Sales Agencies for marketing their various products like home loans, credit cards, consumer loans, personal loans, auto loans, etc. get exposed to the risk of building up sub-standard assets as most of these agencies are non-regulated entities, generally proprietary concerns or partnerships and each promoter or group of promoters or partners float several agencies and take sales rights from different banks in different names. Their client base is same and they try to get the loans for the same client from several banks, or even in worst scenario at least from one or other bank. This leads to increased risk of non-performing and sub-standard assets. Similarly, banks may enrol large numbers of customers for their credit cards and pay hefty commissions to their direct sales agents but, the card utilisation per customer diminishes as each customers is loaded with multiple credit cards by the same agency.

3.11. **Self Regulatory Organisations**

3.11.1. Self-Regulatory Organisations (SROs) are created by industry participants, which are expected to operate as quasi-regulators under the auspices of the main regulator. In the banking industry, there are SROs like, Indian Banks Association (IBA), Foreign Exchange Dealers Association (FEDAI), Association of Mutual Funds of India (AMFI), Fixed Income Money Market and Derivatives Association (FIMMDA), etc.

3.11.2. The SROs should be the best means of self-regulation and more and more regulatory functions should get delegated to them. But, in SROs, generally *Conflict of Interest* arises because of the representation by the nominees of the members on the Board and Disciplinary Committee of the SROs, which would have the power to initiate the action against the members. The functionaries on the Boards/Disciplinary Committees of such SRO are employees of some of the members at different management levels. Striking balance between the member's interest and market interest (delegated by regulator) becomes a major challenge for them. Any wrong action tilted in favour of the members whose representatives are on the Board/Disciplinary Committee would endanger the SROs' credibility. Inequality of the treatment among the members of the SRO may also be a potential conflict situation. On the other hand, impartial decision making and action against a particular member bank may invite concerned member bank's wrath against the nominee of that bank. This is a reason, why hardly any powers have been delegated to these SROs.

3.12. **Universal Banking**

3.12.1. The concept of 'universal banks' is gaining ground in the country. In general it refers to the combination of commercial banking and investment banking, i.e., issuing, underwriting, investing and trading in securities. In a very broad sense, however, the term 'universal banks' refers to those banks that offer a wide range of financial services, beyond commercial banking and investment banking, such as, insurance, mutual fund products, provide venture capital, etc. In the spectrum of banking, specialised banking is on the one end and the universal banking on the other.

3.12.2. The potential for *Conflicts of Interest* is endemic in universal banking, and runs across the various types of activities in which the bank gets engaged. For example -

(i) Salesman's Stake: When banks undertake sell of affiliates' products, which may in some way clash with the bank's own products as in the case of insurance products or mutual fund products, there would be possibilities of *Conflicts of Interest*, and executives may not dispense 'dispassionate' advice to clients, possibly to the disadvantage of the customer or at times to the disadvantage of the bank itself.

(ii) Stuffing fiduciary accounts: When a bank acting as an underwriter is unable to place the securities in a public offering, it is thereby exposed to a potential underwriting loss. In such cases, there would be '*Conflict of Interest*' when it may seek to ameliorate this loss by stuffing unwanted securities into accounts managed by its investment department over which the bank has discretionary authority.

(iii) Bankruptcy/Non-Performing - Risk transfer: A bank with a loan outstanding to a corporate whose bankruptcy/non-performing risk has increased, to the private knowledge of the banker, may have an incentive to induce the firm to issue bonds or equities - underwritten by its Merchant Banking unit - to an unsuspecting public. The proceeds of such an issue could then be used to pay-down the bank loan. In this case the bank has transferred debt-related risk from itself to outside investors, while it simultaneously earns a fee and/or spread on the underwriting. This is a situation of '*Conflict of Interest*' against the society.

(iv) Loans against IPOs/Debenture Issues: To ensure that an underwriting goes well or the issues managed by the bank as Merchant Banker or as Bankers to Issue get oversubscribed, the bank may make aggressive lending to investors specifically for such IPOs/ Debenture issues. This is also a situation of '*Conflict of Interest*' against the society.

### 3.13. Other Areas

3.13.1. The Joint Parliamentary Committee (JPC), in its report, talked about IDBI dominating the affairs of UTI despite the obvious *Conflict of Interest*, since IDBI had started its own mutual fund in 1994. IDBI should have taken the initiative to withdraw itself from control of UTI and its presence on the Board of Trustees of UTI at that stage.

3.13.2. Now, the UTI's Asset Management Company has four sponsors viz. Life Insurance Corporation (LIC), State Bank of India (SBI), Bank of Baroda (BoB) and Punjab National Bank (PNB), all having their own mutual funds and three of them are listed on stock exchanges, obviously leading to *Conflict of Interest*. These three sponsors are important banking sector stocks, which no fund worth its name can ignore if it wants a well-rounded portfolio. If UTI Mutual decides to aggressively purchase stocks like SBI, PNB or BoB, the *Conflict of Interest* aspect would be too apparent as the market would view that UTI Mutual is supporting its sponsors' scrips. The is another possibility of *Conflict of Interest* whereby an aggressive investment by UTI Mutual in stocks of blue chip companies will boost the asset value of such stocks held by all the four sponsors in their own investment account as well as in the mutual funds run by them. Anticipating this, the JPC has, commenting that the institutions chosen to sponsor UTI "should be those that have not sponsored their own mutual funds". It has even said that in case this is not found feasible, the government should spell out in detail both through legislation and through policy guidelines as to how it proposes to insulate UTI-II from the inherent *Conflict of Interest* as regards these institutions.

## 4. Legislative and Regulatory Provisions

4.1. Already various legislative and regulatory provisions exist or have been taken in recent months/years to minimise and handle *Conflicts of Interest* situations in the financial sector and banking sector. Following Table details existing legislative and regulatory provisions:

4.2. Yet, the concern with the governance structure of public sector banks, private sector banks and co-operative banks has been growing dramatically following events of corporate malfeasance (Global Trust Bank, several co-operative banks), market volatility, inadequate disclosure and *Conflicts of Interest* that are injurious to the public (depositors as well as share holders in the case of listed banks and co-operative banks) and undermine confidence in the marketplace.

4.3. The challenge to investor confidence in listed organisations caused by recent events in the international capital markets has brought corporate governance issues under the spotlight, both in the international markets and in India. Serious financial manipulations in the corporate

arena have intensified the focus on how businesses are managed. Indian world is changing and forces are influencing corporations to compete globally for customers, suppliers, alliances, employees, assets, capital and shareholders. This makes it all the more important that organisations follow the corporate governance route to building market confidence.

4.4. The growing attention being paid to Corporate Governance is thus an example of how the regulators and the governmental authorities are trying to find solutions to various *Conflicts of Interest*. Corporate governance is the mechanism by which values, principles, management policies and procedures of corporate and financial sectors are made manifest in the real world. It refers to the entire system by which an organisation is managed and monitored, its corporate principles and guidelines and the system of internal and external controls and supervision to which the organisation's operations are subjected. Good transparent corporate governance ensures that the organisation is managed and monitored in a responsible manner geared to value creation. Corporate governance is concerned with both the internal aspects of the organisation, such as internal controls, and the external aspects such as the organisation's relationship with its shareholders and other stakeholders. Transparency and accountability are the fundamental principles to good corporate governance.

4.5. In a practical sense, corporate governance provides a structure through which the means of achieving an organisation's set objectives and monitoring performance is determined. It involves a cohesive set of relationships among an organisation's Board of Directors, its management, its shareholders and other stakeholders. The Board of Directors represents the interests of the organisation's shareholders, the owners of the organisation, in optimising long-term value by providing the guidance and strategic vision on the shareholders' behalf. The Board is also responsible for ensuring that the organisation's management and employees operate with the highest degree of ethical standards.

4.6. But, the issue remains "Are these measures sufficient to ensure complete elimination of *Conflicts of Interest*?"

## 5. Recommendations

### 5.1. Risk Management

#### 5.1.1. Evaluation of Risks

(i) A bank that does not properly manage *Conflicts of Interest* and self-dealing may be exposed to heightened *compliance, reputation*, and *strategic* risk. Therefore, banks should immediately evaluate the risk management practices in place to control *Conflicts of*

*Interest* and self-dealing, including their effectiveness in identifying, measuring, controlling and monitoring risks.

5.1.2. **Risks and Controls Associated with *Conflicts of Interest***

(ii) **Employees' Unethical Conduct**

(a) Employees' unethical conduct can undermine the fiduciary's ability to fulfill its duty of loyalty to account beneficiaries. A bank that promulgates a *Code of Ethics* for employees that clearly communicates the bank's expectations may reduce the risk of unethical conduct.

(b) Bank managements should have monitoring systems in place to detect employee conduct that conflicts with the bank's responsibilities as a fiduciary. Systems should be sufficient to alert the bank when a bank employee serves as co-fiduciary with the bank for a fee, competes with the bank, receives loans from fiduciary clients, accepts gifts or bequests from fiduciary clients, receives goods and services from vendors, or executes personal securities transactions that are counter to the best interests of account beneficiaries.

(iii) **Compliance Risk**

(a) Compliance risk is the risk to earnings or capital arising from violations or nonconformance with laws, rules, regulations, prescribed practices, or ethical standards. The risk also arises in situations where the laws or rules governing certain bank products or activities of the bank's clients may be ambiguous or untested. Compliance risk exposes the institution to fines, civil money penalties, payment of damages, and the voiding of contracts. Compliance risk can lead to a diminished reputation, reduced franchise value, limited business opportunities, lessened expansion potential, and lack of contract enforceability.

(b) The rules, regulations, and laws governing fiduciary activities are voluminous and complex. To minimize the risk of noncompliance, banks must create strong risk management systems to avoid even the appearance of *Conflicts of Interest*. *Conflicts of Interest* or self-dealing may result in costly, highly publicized litigation. Regardless of its outcome, a long legal battle can jeopardize a bank's present and future earnings. Fines, judgments, and settlements to avoid litigation can further deplete earnings.

(iv) **Reputation Risk**

(c) Reputation risk is the risk to earnings or capital arising from negative public opinion. This affects the institution's ability to establish new relationships or services, or continue servicing existing relationships. This risk can expose the institution to litigation, financial loss, or damage to its reputation. Reputation risk exposure is present throughout the organization and is why banks

have the responsibility to exercise an abundance of caution in dealing with their customers and community. This risk is present in such activities as asset management and agency transactions.

(d) Actual or implied *Conflicts of Interest* and self-dealing transactions can affect a bank's reputation negatively by jeopardizing a client's trust. Loss of client trust because of a bank's questionable loyalty may threaten to erode its customer base. Deposit accounts, loan relationships, corporate clients, and other banking relationships may be lost as a result.

(v) **Strategic Risk**

(e) Strategic risk is the risk to earnings or capital arising from adverse business decisions or improper implementation of those decisions. This risk is a function of the compatibility between an organization's strategic goals, the business strategies developed to achieve those goals, the resources deployed against these goals, and the quality of implementation. The resources needed to carry out business strategies are both tangible and intangible. They include communication channels, operating systems, delivery networks, and managerial capacities and capabilities.
Banks are relying increasingly on fee-based activities as a stable, consistent source of revenue. If a bank is unable to realize its fiduciary goals, its overall strategic plan and direction may be affected negatively. A bank's ability to realize its strategic goals may depend upon its success in cultivating and maintaining a satisfied, loyal customer base. A bank, because of unauthorized *Conflicts of Interest* and self-dealing, may threaten the stability of its fiduciary client base and be unable to fund businesses or attain growth projections and goals.

5.2. **Internal Controls**

5.2.1. To manage the risks associated with *Conflicts of Interest* and self-dealing, the banks must have systems in place that first identify actual or potential conflicts. Policies reflecting the bank's willingness to accept the associated risks should be established and followed. Because of the importance of a sound reputation in the asset management business, many banks take steps to prevent actual *Conflicts of Interest* and also to minimize the appearance of *Conflicts of Interests*. Some common controls include:

(vi) Assessment of business lines and activities to identify all potential *Conflicts of Interest* and self-dealing.

(vii) Identification of all insiders and their related interests.

(viii) Development of written policies and procedures appropriate to the size and complexity of the bank's business. Policies and procedures should establish an ethics policy,

identify prohibited activities, and offer guidelines for avoiding or managing *Conflicts of Interest* and self-dealing.

(ix) Dissemination of information on *Conflicts of Interest* and self-dealing to enable supervisory committees and officers to:

(f) Identify existing or potential problems when an account is considered for acceptance as well as when one already on the books is reviewed.

(g) Recognize the legality of certain conflicts or potential conflicts.

(h) Monitor potential *Conflicts of Interest* and self-dealing.

(i) Evaluate the level of risk to the bank.

(x) A risk control process, including audit, compliance, and training programs, that emphasizes the importance of avoiding *Conflicts of Interest* and self-dealing.

## 5.3. Strengthening Self-Regulatory Organisations

### 5.3.1. Decision Making Authorities

(xi) Authority for the decision making is a critical forum at the SROs level. It is believed that a properly structured decision making authority can help resolve this issue. Following views may be considered in respect of the decision making authorities in the SROs:

(j) Composition of board of SROs may be made more independent to ensure the prudent and impartial decision making by SROs. For that, Board of SROs must have more than 50% independent members. Chairman of the SROs should essentially be an independent board member. Further, for quorum in board meetings, the presence of SROs' members may not be counted. In addition to this, in all the board meetings, SROs may ensure that the representation of the independent board members is more than 50%.

(k) Similarly, to perform the credible function of the various committees, their composition should be such as to provide for majority (more than 50%) of independent members. This may be applicable to all types of committees viz Disciplinary Committee, Screening Committee etc. Indeed, one view on the subject is that the disciplinary committee should have all the independent members.

#### 5.3.2. **Confidentiality**

(xii) SROs should follow similar professional standards of behaviour on matters such as confidentiality and procedural fairness as would be expected from a regulator. There should be a “Chinese wall”.

### 5.4. **Public Disclosures**

5.4.1. Banks must disclose the information on *Conflicts of Interest* and make it public. Regulations concerning greater insight into various persons’ incentives may limit the effects of different *Conflicts of Interest.*

5.4.2. In fact, Indian Bank’s Association should formulate a **Model Code of Ethics for *Conflicts of Interest*** and advise member banks to implement the same with modifications, if any, felt necessary with their Board approval and display the same on their Websites and Notice Boards.

| TABLE showing existing Legislative and Regulatory Provisions | | |
|---|---|---|
| **No.** | **Subject Matter** | **Reference** |
| **Reserve Bank of India - Instructions** | | |
| 1 | Deficiencies Found in Sanctioning of Loans and Monitoring of borrowal Accounts by Banks / Financial Institutions | DBS.FrMC.No.BC.1/23.04.01 D/2004-05 dated 07.08.04 |
| 2 | Risk-based Internal Audit | DBS.CO.PP.BC.10/11.01.005/ 2002-03 dated 27.12.02 |
| 3 | Guidance Notes on Management of Credit Risk and Market Risk | DBOD.No.BP.520/21.04.103/ 2002-03 dated 12.10.02 |
| 4 | Report of the Consultative Group of Directors of Banks/Financial Institutions (Dr. Ganguly Group) – Implementation of Recommendations | DBOD.No.BC.116/08.139.001 /2001-02 dated 20.06.02 |
| 5 | SEBI Committee on Corporate Governance - Guidelines to Indian Commercial Banks Listed in Stock Exchanges | DBOD.No.BC.112/08.138.001 /2001-02 dated 04.06.02 |
| 6 | Bank Financing of Equities and Investments in Shares - Revised Guidelines | DBOD.BP.BC.119/21.04.137/ 2000-2001 dated 11.05.01 |
| 7 | Guidelines in regard to Grant of Loans and Advances and Award of Contracts to Directors of Banks and their Relatives | DBOD.No.GC.BC.34/C.408C (59)S-84 dated 12.04.84 |
| 8 | Directors/Trustees of Subsidiaries/Mutual Funds of Banks - Borrowing Arrangements with Sponsor Banks | DBOD.No.BC.28/24.01.001/9 4 dated 09.03.1994<br>DBOD.No.BC.28/24.01.001/9 4 dated 09.03.84 |
| **Securities & Exchange Board of India - Instructions** | | |
| 9 | Guidelines for Fair Practices/ Code of Conduct for Public Representative and SEBI Nominee Directors | SEBI/SMD/SEAD/Cir-29/2003/03/07 dated 03.07.03 |
| 10 | Corporatisation and Demutualisation of Stock Exchanges | SEBI/SMD/POLICY/Cir -3/03 dated 30.01.03 |
| 11 | Investment/Trading in Securities by Employees of Asset Management Companies and Mutual Fund Trustee Companies | SEBI/MFD/CIR No.4/216/2001 dated 08.05.01 |
| 12 | Corporate Governance | SEBI/SMDRP/POLICY/CIR-10/2000 dated 21.02.00 |
| 13 | SEBI (Mutual Funds) Regulations, 1996 | SEBI/MFD/CIR/09/014/2000 dated 05.01.00 |
| **Acts, Rules and Regulations** | | |
| 14 | Restrictions on granting/remitting loans and advances to or on behalf of any directors, firms/company in which a director is interested | Section 20 of the Banking Regulation Act, 1949 |
| 15 | Restrictions on appointment of directors | Section 10 of the Banking Regulation Act, 1949 |

## Annexure V

## SEBI paper (including legal/regulatory mechanisms undertaken for mitigating conflicts of interest)

## Conflict of Interest in Financial Sector

Potential conflicts of interest are a fact of life in financial intermediation. Under perfect competition and in the absence of asymmetric information, exploitation of conflicts of interest cannot rationally take place. Consequently, the necessary and sufficient conditions for agency costs associated with conflict of interest exploitation center on market and information imperfections. Arguably, the bigger and broader the financial intermediaries, the greater the agency problems associated with conflict-of-interest exploitation. **It follows that efforts to address the issue through improved transparency and market discipline are central to creating viable solutions to a problem that repeatedly seems to shake public confidence in financial markets.**

In recent years, the role of banks, securities firms, insurance companies and asset managers in alleged conflict-of-interest-exploitation – involving a broad array of abusive retail market practices, in acting simultaneously as principals and intermediaries, in facilitating various corporate abuses, and in misusing private information – suggests that the underlying market imperfections are present even in highly developed financial systems. Moreover, recent evidence suggests that the collective decision process in the management of major financial firms impairs pinpointing responsible individuals, and that criminal indictment of entire firms runs the risk of adverse systemic effects. Monetary penalties and negotiated settlements neither admitting nor denying guilt seem to have emerged as the principal external mechanisms to address conflict of interest exploitation. Market discipline operating through the share price may, under appropriate corporate governance, represent an important additional line of defense.

- **A Conflict of Interest Taxonomy**

Conflicts of interest are essentially two-dimensional – either between the interests of the firm and those of its client (Type 1), or between clients in conflict with one another (Type 2). They can also be multidimensional, however, spanning a number of different stakeholders and conflicts at the same time.

- **Type 1 -** Conflicts between a firm's own economic interests and the interests of its clients. In addition to direct firm-client conflicts, indirect conflicts of interest could involve collusion between the firm and a fiduciary acting as agent for the ultimate clients.

- **Type 2 -** Conflicts of interest between a firm's clients, or between types of clients, which place the firm in a position of favoring one at the expense of another. They may arise either in inter-professional activities carried out in wholesale financial markets or in activities involving retail clients. The distinction between these two market "domains" is important because of the key role of information and transactions costs, which differ dramatically between the two broad types of market participants. Their vulnerability to conflict-exploitation differs accordingly, and measures designed to remedy the problem in one domain may be inappropriate in the other.

The broader the activity-range of financial firms in the presence of imperfect information, the greater the likelihood that the firm will encounter potential conflicts of interest and the more difficult and costly will be the internal and external safeguards necessary to prevent conflict exploitation.

In the following sections, the principal conflicts of interest encountered in financial services firms arranged by type and by domain are enumerated:

- **Conflicts of Interest in Wholesale Financial Markets**

In wholesale financial markets involving professional transaction counterparties, corporations and sophisticated institutional investors, the asymmetric information and competitive conditions necessary for conflicts of interest to be exploited are arguably of relatively limited importance. Caveat emptor and limited fiduciary obligations rule in a game that all parties fully understand. Nevertheless, several types of conflicts of interest seem to arise.

- **Principal transactions*:*** A financial intermediary may be involved as a principal with a stake in a transaction in which it is also serving as adviser, lender or underwriter, creating an incentive to put its own interest ahead of those of its clients or trading counterparties. Or the firm may engage in misrepresentation beyond the ability of even highly capable clients to uncover.

- **Tying**

  A financial intermediary may use its lending power to influence a client to use its securities or advisory services as well – or the reverse, denying credit to clients that refuse to use other (more profitable) services.

  Costs are imposed on the client in the form of higher-priced or lower-quality services in an exercise of market power. This differs from cross-subsidization, in which a bank (possibly pressured by clients) engages in lending on concessionary terms in order to be considered for securities or advisory services. There may be good economic reasons for such cross-selling initiatives, whose costs are borne by the bank's own shareholders. The line between tying and cross-selling is often blurred, and its effectiveness debatable.

- **Misuse of fiduciary role**

  Mutual fund managers who are also competing for pension fund mandates from corporations may be hesitant to vote fiduciary shares against the management of those companies, to the possible detriment of their own unitholders. Or the asset management unit of a financial institution may be pressured by a corporate banking client into voting in that company for management's position in a contested corporate action such as a proxy battle. The potential gain (or avoidance of loss) in banking business comes at the potential cost of inferior investment performance for the firm's fiduciary clients, and violates its duty of loyalty.

- **Board interlocks**

  The presence of bankers on boards of directors of non-financial companies may cause various bank functions such as underwriting or equity research to differ from arms-length practice. This displacement may impose costs on the bank's shareholders or on clients. Although constrained by legal liability issues, director interlocks can compound other potential sources of conflict, such as simultaneous lending, advisory and fiduciary relationships.

- **Spinning**

  Securities firms involved in initial public offerings may allocate shares to officers or directors of client firms on the understanding of obtaining future business, creating a transfer of wealth to those individuals at the expense of other investors.

- **Investor loans**

  In order to ensure that an underwriting goes well, a bank may make below-market loans to third-party investors on condition that the proceeds are used to purchase securities underwritten by its securities unit.

- **Self-dealing**

  A multifunctional financial firm may act as trading counterparty for its own fiduciary clients, as when the firm's asset management unit sells or buys securities for a fiduciary client while its affiliated broker-dealer is on the other side of the trade.

- **Front-running**

  Financial firms may exploit institutional, corporate or other wholesale clients by executing proprietary trades in advance of client trades that may move the market.

All of the foregoing represents exploitation of Type 1 conflicts, which set the firm's own interest against those of its clients in wholesale, inter-professional transactions.

Type 2 conflicts dealing with differences in the interests of multiple wholesale clients seem to center predominantly on two issues:

- **Misuse of private information**

  As a lender, a bank may obtain certain private information about a client. Such proprietary information may be used in ways that harm the interests of the client. For instance, it may be used by the bank's investment banking unit in pricing and distributing securities for another client, or in advising another client in a contested acquisition.

- **Client interest incompatibility**

  A financial firm may have a relationship with two or more clients who are themselves in conflict. For example, a firm may be asked to represent the bondholders of a distressed company and subsequently be offered a mandate to represent a prospective acquirer of that corporation. Or firms may under price IPOs to the detriment of a corporate client in order to create gains for institutional investor clients from whom they hope to obtain future business.

- **Conflicts of Interest in Retail Financial Services**

  Asymmetric information is intuitively a much more important driver of conflict-of-interest exploitation in retail financial services than in inter-professional wholesale financial markets. Retail issues all appear to involve Type 1 conflicts, setting the interests of the financial firm against those of its clients.

  - **Churning**

    A financial firm that is managing assets for retail or private clients may exploit its agency relationship by engaging in excessive trading, which creates higher costs and may lead to portfolio sub-optimization. Commission-based compensation is the usual cause of churning, which can also arise in institutional portfolios.

  - **Inappropriate margin lending**

    Clients may be encouraged to leverage their investment positions through margin loans from the firm, exposing them to potentially unsuitable levels of market risk and high credit costs. Broker incentives tied to stock margining usually underlie exploitation of this conflict of interest.

  - **Failure to execute**

    Financial firms may fail to follow client instructions on market transactions if doing so benefits the firm. Or payments may be delayed to increase the float.

  - **Misleading disclosure and reporting**

    Financial firms may be reluctant to report unfavorable investment performance to clients if doing so threatens to induce outflows of assets under management. Whereas a certain degree of puffery in asset management performance reviews is normal and expected, there is undoubtedly a “break-point” where it becomes exploitive if not fraudulent.

  - **Violation of privacy**

    The complete and efficient use of internal information is central to the operation of financial services firms, including such functions as cross-selling and risk assessment. This may impinge on client privacy concerns or regulatory constraints on misuse of personal information, and raises conflict-of-interest issues that tend to be increasingly serious as the activity-lines of a particular firm become broader.

**Wholesale-Retail Conflicts**

Conflicts of interest between the wholesale and retail domains – characterized by very different information asymmetries – can be either Type 1 or Type 2, and sometimes both at the same time.

- **Suitability**

  A classic domain-transition conflict of interest exists between a firm's "promotional role" in raising capital for clients in the financial markets and its obligation to provide suitable investments for retail clients. Since the bulk of a firm's earnings usually come from capital-raising side, and given the information asymmetries that exist, exploiting such conflicts can have adverse consequences for retail investors.

- **Stuffing**

  A financial firm that is acting as an underwriter and is unable to place the securities in a public offering may seek to ameliorate its exposure to loss by allocating unwanted securities to accounts over which it has discretionary authority. This conflict of interest is unlikely to be exploited in the case of closely-monitored institutional portfolios in the wholesale domain. But in the absence of effective legal and regulatory safeguards, it could be a problem in the case of discretionary trust accounts in the retail domain.

- **Conflicted research**

  Analysts working for multifunctional financial firms wear several hats and are subject to multiple conflicts of interest. In such firms, the researcher may be required to: (1) Provide unbiased information and interpretation to investors, both directly and through retail brokers and institutional sales forces; (2) Assist in raising capital for clients in the securities origination and distribution process; (3) Help in soliciting and supporting financial and strategic advisory activities centered in corporate finance departments; and (4) Support various management and proprietary functions of the firm. These diverse roles are fundamentally incompatible, and raise intractable agency problems at the level of the individual analyst, the research function, the business unit, and the financial firm as a whole. Researchers cannot serve the interests of buyers and sellers at the same time. No matter how strong the firewalls, as long as research is not profitable purely on the basis of the buy-side (e.g., by subscription or pay-per-view), the conflict can only be constrained but never eliminated as long as sell-side functions are carried out by the same organization. And even if research is purchased from independent organizations, those organizations could face the same inherent conflicts

if they expect to develop further business commissioned by their financial intermediary clients.

- **Market-timing and late-trading**

  Important clients tend to receive better service than others, in the financial services sector as in most others. When such discrimination materially damages one client segment to benefit another, however, a conflict of interest threshold may be breached and the financial firm's actions may be considered unethical or possibly illegal, with potentially serious consequences for the value of its franchise. Such cases came to light in 2003, involving both criminal fraud charges and civil settlements regarding "late trading" and "market timing" by hedge funds in the shares of mutual funds, shifting returns from ordinary investors to the hedge funds in exchange for other business solicited by the mutual fund managers involved.

- **Laddering**

  Investment banks involved in initial public offerings may allocate shares to institutional investors who agree to purchase additional shares in the secondary market, thereby promoting artificial prices intended to attract additional (usually retail) buyers who are unaware of these private commitments. A related conflict involves providing bank loans to support the price of a security in the aftermarket.

- **Shifting bankruptcy risk**

  A bank with credit exposure to a client whose bankruptcy risk has increased, to the private knowledge of the banker, may have an incentive to assist the corporation in issuing bonds or equities to the general public, with the proceeds used to pay-down the bank debt.

From a regulatory and public policy perspective, efforts to address exploitation of conflicts of interest in the financial services sector should logically focus on improving market efficiency and transparency.

Nonetheless, market imperfections and information asymmetries, even under intense competition and regulatory oversight, appears to allow plenty of scope for persistent conflict exploitation on the part of financial intermediaries. It suggests a continuing role for external control through firm-specific regulation and market discipline and internal control through improved corporate governance, incentive structures, and compliance initiatives.

**Potential Conflict of Interest Situations - Indian Context**

The foregoing paragraphs give a general overview on the types of conflict of interest in financial sector as also the various possible areas of such conflict. In the following pages, their relevance in the Indian context in so far as the various intermediaries operating in the securities market are concerned, identification of areas of potential conflicts of interest intermediary-wise and measures put in place to mitigate the same is discussed.

- **Mutual Funds**

There may be situations where the Asset Management Company (AMC) may not act in the best interest of investors but may act in the interest of the sponsor or its group companies. E.g. by investing in excess in group companies of the sponsor, subscribing to securities issued by group company of sponsor (such investments not being supported by the company's fundamentals) , giving higher commission and brokerages to brokers (who belong to the same group) etc. An AMC may also favor some valued clients/ its associates at the cost of other clients through acceptance of applications beyond cut off time at preferred prices etc.

- **Brokers, Depository participants (DPs), Portfolio managers, Underwriters and Merchant Bankers**

As per SEBI Regulations, the same entity can be registered as a Broker, DP, Portfolio Manager, Underwriter and Merchant Banker. It is also possible that the broker is part of a larger group, some of whose companies are listed on a stock exchange. Some of the possible areas of conflict in such a scenario are summarized as under:

a) A broker who also deals in his proprietary account may not deal fairly with his clients. He may put in his own trade before punching in a large order from the client and thus seek to profit from the price difference, if any, that is likely to be caused due to the large order of the client (also known as front running).
b) In case the broker is also a DP, under certain circumstances, he may misuse the securities of his client to fulfill his own obligation or obligation of some other favoured clients (possibly a relative or related entity registered as client). He may also likewise with regard to funds of clients.
c) As a portfolio manager, the broker may recommend stocks to his clients which are of little value but which he is holding in his proprietary books that he may want to disinvest. The

broker may (in case, he is a discretionary portfolio manager) actually buy such stocks for his clients and thus ridding himself of such stocks from his proprietary portfolio.

d) Similarly, as an underwriter, in case of devolvement, he as portfolio manager may invest in those stocks on behalf of his clients.

e) A broker belonging to a group, also acting as discretionary portfolio manager, may recommend or invest in stocks of group companies, even if such investments are not supported by the company's fundamentals.

f) A broker, whose group companies are listed or to be listed on a stock exchange may indulge in price manipulation and other such fraudulent trading practices in order to create an artificial market in the securities of his group companies.

- **Stockmarket analysts**

Analysts are often employed to conduct research on companies and make recommendations to clients. An analyst in the employment of an underwriter/merchant banker may doctor a research report purely targeting the clients, though he may not really believe in recommendations contained in such research reports.

- **Self Regulatory Organisations(SRO)**

In India, historically, stock exchanges have been self regulatory organizations. However, in an SRO, there is often an inherent conflict of interest between the interest of the member vis-à-vis market interest. This conflict may influence the decisions of the governing board or the disciplinary committee. Further, if the head of the stock exchange is also a trading member having proprietary trading interests, he may seek trading data from the Surveillance Department of the Exchange to further his own trading interests.

- **Credit Rating Agencies**

Many credit rating agencies are promoted by banks and financial institutions. When a credit rating agency rates a borrower or an associate of a promoter, situation of conflict of interest can arise. For example, a credit rating agency may give a higher rating to a borrower of his promoter so as to facilitate the borrower to raise money from the market and repay his debts to in order that the dues of promoter of CRA gets repaid. Similarly, a credit rating agency may also compromise on credit rating if it is also engaged in a profitable consulting business to the same client.

- **<u>Audit firms employed by the regulator</u>**

A regulator often uses audit firms for inspection of the intermediaries whom it regulates. If such firms or their partners have a business/personal relationship with the firm whom it has to inspect, there may arise a situation of conflict of interest.

- **<u>Issuer</u>**

An issuer may generally want to price its securities as high as possible while accessing the market. Further, top employees of the issuer companies might have been granted stock options and therefore they may take a keen interest in the share prices of their company. In such a situation, a company may issue misleading statements or omit to state material facts. The company may also try to present a false or misleading picture of its financial statements. It may also grant money in the form of loans to its subsidiaries to be siphoned off or used for purposes other than the purpose for which money was raised or for the purposes of shoring up the price of the scrip of the company.

- **<u>Employees of intermediaries/issuer/regulator</u>**

Sometimes, the interests of employees of intermediaries / issuer, who are having a fiduciary responsibility, may be in conflict with the interests of the employer company or the other stakeholders in the employer company. For example, the top management of a company may know certain inside information and may wish to cash in on it, which may be detrimental to the interests of other stakeholders. Similarly, a dealer or employee vested with both front office and back office functions may try to obfuscate facts from his own employer to further his own interests at the cost of clients of the employer.

An employee of a regulator too may often come across certain price-sensitive information in the course of his duty and may be placed in a situation of conflict of interest. Similarly, it is also possible that the employee of a regulator may be placed in a situation of conflict of interest in case a job or any other position is offered to him or her by any intermediary in lieu of any favor bestowed upon such intermediary.

- **<u>Legislative/regulatory mechanism in place to address issues of conflict of interest</u>**

SEBI has built into its various regulations and directives, provisions on corporate governance, adequate disclosures and internal controls, systems and mechanisms to be put in place to

avoid conflict of interest situations and to ensure good corporate governance, striving to duly serve the interests of all stakeholders. The provisions so built in have broadly been classified under the following heads:

a) Corporate Governance
b) Disclosures
c) Misuse of position or information available in professional capacity
d) Dealings with / through Associate / Group Concerns
e) Appropriate Use / Segregation of Funds / Securities / Other Business
f) Miscellaneous.

A brief synopsis of the regulatory requirements put in place to avoid conflict of interest is given below:

➢ **Corporate Governance**

Observance of principles of good corporate governance in letter and spirit by the various stakeholders in the capital market is of utmost importance in order to do justice to the interests of all concerned in the process. Towards this end, certain provisions have explicitly been incorporated in the various Regulations of SEBI. Such requirements interalia include provision for independent directors on the Boards of Issuer Companies/Asset Management Companies of Mutual Funds and Collective Investment Schemes; obligation to ensure good corporate governance on the part of intermediaries, segregation of different activities / businesses etc.

➢ **Disclosures**

Adequate disclosures and proper dissemination of information by issuer companies / intermediaries about the conduct of their business are the hallmark of enabling investors to take informed investment decisions. Stringent initial and continuous disclosure requirements have been put in place for issuers. Intermediaries are also obligated to disclose their interest, if any, in the various activities that they undertake so that the investor is fully informed of conflict of interest situation, if any.

➢ **Misuse of position or information available in professional capacity**

Various stipulations have been put in place to prevent any misuse of position or information available to an issuer or intermediary or their employees in professional capacity. It has been made obligatory on the part of intermediaries to ensure that information pertaining to the clients is kept confidential and is not used for making any personal gains. Dealing by an

insider on the basis of any unpublished price sensitive information is an offence attracting stiff penalties, both civil and criminal.

- **Dealings with / through Associate / Group Concerns**

It is quite likely that if an intermediary is allowed to deal with / through its associates / group concerns without making proper and adequate disclosures, it may tend to act in a manner detrimental to the interests of investors. It is in this light that various restrictions have been put on intermediaries dealing with / through group / associate concerns. For example, a credit rating agency cannot rate securities issued by its promoter. A merchant banker cannot manage issue of its group or associate companies. Investment restrictions are in place for dealing in the scrip of group/ associate companies by an asset management company.

- **Appropriate Use / Segregation of Funds / Securities / Other Business:**

Various compliance requirements have been put in place in the regulatory framework making it obligatory on the part of intermediary to ensure that the funds / securities belonging to clients are adequately separated and segregated from those belonging to the intermediary in order to prevent any misuse. It has also been mandated to maintain an arms length relationship between the various activities and businesses of the intermediary concerned.

A detailed table giving the provisions incorporated in various SEBI regulations to take care of conflict of interest situations is given in Table 1.

- **Conclusion:**

When different types of financial services shade into each other, when on- and off-balance sheet activities are involved, when some of the regulated firms are multifunctional financial conglomerates, and when business is conducted across national and functional regulatory regimes, the conglomerates may exploit “fault lines” between them.

Regulators continuously face the possibility that “inadequate” regulation will result in costly failures on the one hand, and on the other, the possibility that “overregulation” will create opportunity costs in the form of financial efficiencies not achieved (which by definition cannot be measured). In effect, regulators face the daunting task of balancing the unmeasurable against the unknowable.

The principal tools that regulators have at their disposal include (1) “Fitness and properness” criteria, under which a financial institution are chartered and allowed to operate, (2) Frequency

and speed of financial reporting, (3) Line-of-business regulation as to what types activities financial institutions may engage in, (4) Adequacy of capital and liquidity, (5) Limits on various types of exposures, and (6) Rules governing valuation of assets and liabilities.

The more complex the financial services organization – perhaps most dramatically in the case of global financial services conglomerates, where comprehensive regulatory insight is implausible – the greater the challenge of sensible conflict-of-interest regulation, suggesting greater reliance on the role of market discipline.

## Table 1

## Provisions to address Conflict of Interest in SEBI Act and Rules and Regulations made there under:

**1. Corporate Governance:**

**(a) Specific Provisions:**

| Sl. No. | Act/Regulation/Circular | Provision | Particulars |
|---|---|---|---|
| 1. | SEBI Act, 1992 | Sec. 11AA (2) (iv) | CIS Investors not to have control over day to day operations of the Scheme. |
| 2. | SEBI (Collective Investment Schemes) Regulations, 1999 | Reg. 9(g) | At least 50% of the directors of CIS AMC to be independent not having any direct or indirect association with the persons having control over AMC. |
| 3. | SEBI (Collective Investment Schemes) Regulations, 1999 | Proviso to Reg. 18(1) | Trustee to the scheme not to be associated with persons having control over CIS AMC. |
| 4. | SEBI (Collective Investment Schemes) Regulations, 1999 | Code of Conduct (Clause 1) | Interests of all classes of unit holders to be protected. |
| 5. | SEBI (Merchant Bankers) Regulations, 1992 | Code of Conduct (Clause 9) | Merchant Banker not to discriminate amongst its clients except on ethical and commercial considerations. |
| 6. | SEBI (Merchant Bankers) Regulations, 1992 | Code of Conduct (Clause 24) | Clear demarcation of duties of intermediaries appointed by merchant banker to avoid conflict of interest. |
| 7. | SEBI (Registrars to an Issue and Share Transfer Agents) Regulations, 1993 | Code of Conduct (Clause 14) | Registrar not to discriminate amongst its clients except on ethical and commercial considerations. |

| Sl. No. | Act/Regulation/Circular | Provision | Particulars |
|---|---|---|---|
| 8. | SEBI (Self Regulatory Organizations) Regulations, 2003 | Reg. 12 | Relating to composition of Board of Directors to ensure independence in the functioning of the Board. |
| 9. | SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992 | Reg. 15A | No director of a stock broker to be a sub-broker to the same stock broker. |
| 10. | Securities Contracts (Regulation) Act, 1956 | Sec. 4A | Corporatisation and demutualization of stock exchanges. |
| 11. | SEBI Circular | SMD/SED/69/1993 dated April 20, 1993 | Composition of Governing Board and other committee of the Stock Exchanges to ensure independence and to avoid conflict of interest. |
| 12. | SEBI Circular | SMD/SEAD/Cir-29/2003/03/07 dated | SEBI Nominee directors to avoid any interest which is in conflict |

| Sl. No. | Act/Regulation/Circular | Provision | Particulars |
|---|---|---|---|
| | | February 3, 2003 | with the conduct of his official duties in an independent manner. |
| 13. | SEBI (Credit Rating Agencies) Regulations, 1999 | Code of Conduct (Clause 10) | Credit Rating Agency to make adequate disclosure of potential areas of conflict. |
| 14. | SEBI (Mutual Funds) Regulations, 1996 | Reg. 16 and Contents of Trust Deed (Reg. 15(1) | Disqualifications from being appointed as Trustee in order to ensure independence in their functioning. |
| 15. | SEBI (Mutual Funds) Regulations, 1996 | Reg. 18(20) | Trustees to ensure that there is no conflict of interest in the manner of deployment of net worth of AMC and the interests of its unit holders. |
| 16. | SEBI (Mutual Funds) Regulations, 1996 | Reg. 21(d) | At least 51% independent directors on the Board of AMC. |
| 17. | SEBI (Mutual Funds) Regulations, 1996 | Reg. 21(e) | Chairman of AMC not to be Trustee of MF. |
| 18. | SEBI (Mutual Funds) Regulations, 1996 | Reg. 24(1) | AMC not to act as trustee of any mutual fund. |
| 19. | SEBI Circular | MFD/CIR/09/014/2000 dated January 5, 2000 | Compliance report to be submitted by Trustee that there is no conflict of interest. |
| 20. | SEBI Circular | MFD/CIR/04/216/2001 dated May 8, 2001 | Restriction on investments in securities by employees of AMCs and Trustee Companies. |
| 21. | SEBI Circular | MFD/CIR/010/02/2000 dated January 17, 2000 | Formation of Audit Committee by the Board of Trustees / Directors of Trustee Company. |
| 22. | Listing Agreement | Clause 49 | Composition of Board of Directors, Formation of Audit and Other Committees, Report on Corporate Governance etc. |

**(b) Common Provisions:**

1. In case of most of the intermediaries, it is provided in the respective Code of Conduct that these intermediaries should ensure that good corporate governance is put in place.
2. Code of Conduct for intermediaries contains provisions casting an obligation on the respective intermediary to avoid, put in place mechanisms to avoid any conflict of interest and to resolve, if any such conflict arises and also to make adequate disclosure of its interests and potential areas of conflict of interest.
3. Apart from the above, generally Code of Conduct of almost all the intermediaries contains provisions relating to maintaining high standards of integrity, promptitude and fairness in the conduct of the intermediaries business.

**2. Disclosures:**

**(a) Specific Provisions:**

| Sl. No. | Act/Regulation/Circular | Provision | Particulars |
|---|---|---|---|
| 1. | SEBI (Collective Investment Schemes) Regulations, 1999 | Reg. 13(d) | CIS AMC not to invest in its own schemes without disclosing its intention of doing the same in offer document. Also CIS AMC not to charge any fee on its investment in such scheme. |

| Sl. No. | Act/Regulation/Circular | Provision | Particulars |
|---|---|---|---|
| 2. | SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992 | Code of Conduct for Stock Brokers [Clause B(6)] | Stock Broker to disclose to the client whether he is dealing as a principal or an agent. |
| 3. | SEBI Circular | SEBI Circular No. SMD/MDP/CIR/043/96 dated August 5, 1996. | Brokerage to be shown separately in the contract note issued to the clients. |
| 4. | SEBI Circular | SEBI/MRD/SE/Cir- 42 /2003 November 19, 2003 | Disclosure of proprietary trading by stock broker to its clients. |
| 5. | SEBI (Disclosure and Investor Protection) Guidelines, 2000 | Chapter VI | Disclosures to be made in the offer document. |
| 6. | SEBI (Prohibition of Insider Trading) Regulations, 1992 | Reg. 13 | Initial and continuous disclosures of interest or holding by directors and officers and substantial shareholders in listed companies. |
| 7. | SEBI (Mutual Funds) Regulations, 1996 | Reg. 48 | NAV to be published in at least two daily newspapers. |
| 8. | SEBI (Mutual Funds) Regulations, 1996 | Code of Conduct. (Clause 2) | Dissemination of timely information to unitholders including assets allocation. |
| 9. | Listing Agreement | Clause 32 | Disclosure of related party transactions. |

**(b) Common Provisions:**

1. In order to ensure proper disclosure and to avoid potential conflict of interest, Code of Conduct for intermediaries bars investment advice about any security by the respective intermediary or its employee in public media without disclosure of their interest.

**3. Misuse of Position or Information Available in Professional Capacity:**

| Sl. No. | Act/Regulation/Circular | Provision | Particulars |
|---|---|---|---|
| 1. | SEBI Act, 1992 | Sec. 12A (d) | Prohibition over Insider Trading by any person. |
| **Sl. No.** | **Act/Regulation/Circular** | **Provision** | **Particulars** |
| 2. | ------do------ | Sec. 12A (e) | Prohibition over dealing in securities |

| Sl. No. | Act/Regulation/Circular | Provision | Particulars |
|---|---|---|---|
| | | | while in possession of non-public material information. |
| 3. | SEBI (Buy Back of Securities) Regulations, 1998 | Reg. 4(3) | No person or insider to deal in company's securities |
| 4. | SEBI (Collective Investment Schemes) Regulations, 1999 | Reg. 14(k) | CIS AMC to ensure that its employees and officers do not make improper use of position or information to their advantage or to the detriment of the scheme. |
| 5. | SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992 | Code of Conduct for Stock Brokers and Sub-Brokers [Clause B(3)] | Stock Broker and sub-broker not to make improper use of confidential information pertaining to the client. |
| 6. | SEBI (Bankers to an Issue) Regulations, 1994 | Code of Conduct (Clause 24) | Prohibition over Insider Trading by any banker, its directors or employees. |
| 7. | SEBI (Prohibition of Insider Trading) Regulations, 1992 | Reg. 3 | Prohibition over Insider Trading by any person. |
| 8. | SEBI (Prohibition of Insider Trading) Regulations, 1992 | Reg. 12 | All listed companies and organizations associated with securities market to frame a code of internal procedures and conduct to deal with insider trading. |
| 9. | SEBI (Unfair Trade Practices) Regulations, 2003 | Reg. 4(2)(q) | No person shall indulge in front running on the basis of a substantial order by a client. |
| 10. | SEBI (Mutual Funds) Regulations, 1996 | Reg. 18(23)(b) | A certificate by Trustees as to no self-dealing or front running by any of the trustees, directors and key personnel of the AMC. |

**4. Dealings with / through Associate / Group Concerns:**

| Sl. No. | Act/Regulation/Circular | Provision | Particulars |
|---|---|---|---|
| 1. | SEBI (Collective Investment Schemes) Regulations, 1999 | Reg. 14(f) | CIS AMC not to enter into any transaction with or through its associates or their relatives relating to the scheme. In case of any such transaction entered into, report to be sent to the Trustee and to SEBI immediately. |
| 2. | SEBI (Collective Investment Schemes) Regulations, 1999 | Reg. 21(2)(h) | Trustee to ensure that associates are not given undue advantage or dealt with by CIS AMC to the detriment of CIS investors. |
| 3. | SEBI (Merchant Bankers) Regulations, 1992 | Reg. 20(2) | Lead Merchant Banker not to manage issue made by any associate body corporate. |

| Sl. No. | Act/Regulation/Circular | Provision | Particulars |
|---|---|---|---|
| 4. | SEBI (Registrars to an Issue and Share Transfer Agents) Regulations, 1993 | Reg. 13A | Registrar not to act as such registrar for issue made by any associate body corporate. |
| 5. | SEBI (Disclosure and Investor Protection) Guidelines, 2000 | Clause 5.4.1.1 | Associated person not to be appointed as lead manager to the issue. |
| 6. | SEBI (Credit Rating Agencies) Regulations, 1999 | Reg. 24(8) | Credit Rating Agency not to rate securities issued by it. |
| 7. | SEBI (Credit Rating Agencies) Regulations, 1999 | Reg. 26 & 27 | Credit Rating Agency not to rate securities issued by its promoter or a borrower or subsidiary or an associate of its promoter. |
| 8. | SEBI (Debenture Trustees) Regulations, 1993 | Reg. 13A | A Debenture trustee not to act as such for an associate. |
| 9. | SEBI (Mutual Funds) Regulations, 1996 | Reg. 18(6) | Trustee to ensure that associates are not given undue advantage or dealt with by MF AMC to the detriment of MF investors. |
| 10. | SEBI (Mutual Funds) Regulations, 1996 | Reg. 18(24) | Independent Trustee to comment on report received from AMC regarding investment in securities of group companies. |
| 11. | SEBI (Mutual Funds) Regulations, 1996 | Reg. 25(8) | AMC not to use services of sponsor or associate concern for any securities transactions. |
| 12. | SEBI (Mutual Funds) Regulations, 1996 | Schedule VII Restriction on Investments Clause (9) | No MF to make any investment in unlisted securities or privately placed securities of associate concerns or listed securities of any group concern in excess of specified % of net assets. |
| 13. | SEBI (Venture Capital Funds) Regulations, 1996 | Reg. 12(c) | Venture Capital Fund not to invest in associated companies. |

**5. Appropriate Use / Segregation of Funds / Securities / Other Business:**

**(a) Specific Provisions:**

| Sl. No. | Act/Regulation/Circular | Provision | Particulars |
|---|---|---|---|
| 1. | SEBI (Collective Investment Schemes) Regulations, 1999 | Reg. 35(a) | CIS AMC to invest funds of the scheme for stated objectives only. |
| 2. | SEBI (Collective Investment Schemes) Regulations, 1999 | Reg. 35(b) and Code of Conduct (Clause 4) | CIS AMC and Trustee to segregate the scheme assets and funds of diff. schemes. |
| 3. | SEBI (Depositaries and Participants) Regulations, 1996 | Reg. 42(1) | DP to maintain segregation between a beneficial owners' securities and own securities or securities of any other beneficial owner. |
| 4. | SEBI Circular | SMD-1/23341 dt. 18.11. 1993. | Stock Broker to maintain proper segregation between funds and securities belonging to the clients and |

| Sl. No. | Act/Regulation/Circular | Provision | Particulars |
|---|---|---|---|
| | | | own funds and securities. |
| 5. | SEBI (Foreign Institutional Investors) Regulations, 1995 | Code of Conduct (Clause 4) | Segregation of own money / securities and sub-accounts' money and securities. |
| 6. | SEBI (Mutual Funds) Regulations, 1996 | Reg. 18(8) | Trustees to ensure that AMC is managing the MF schemes independently of its other activities and that interest of investors of one scheme are not compromised with interests of investors of any other scheme. |
| 7. | SEBI (Mutual Funds) Regulations, 1996 | Reg. 24(2) | AMC not to undertake any other business activity other than those specified. |
| 8. | SEBI (Mutual Funds) Regulations, 1996 | Reg. 52(1) | All expenses to be clearly identified and appropriated in the individual schemes. |
| 9. | SEBI (Mutual Funds) Regulations, 1996 | Code of Conduct (Clause 5) | Trustee and AMC to ensure scheme wise segregation of bank accounts and securities accounts. |
| 10. | SEBI (Portfolio Managers) Regulations, 1993 | Reg. 15(2A) | Funds of all clients to be kept in a separate bank account. |
| 11. | SEBI (Portfolio Managers) Regulations, 1993 | Reg. 15(4) | Portfolio Manager not to derive any direct or indirect benefit out of the clients' funds and securities. |
| 12. | SEBI (Portfolio Managers) Regulations, 1993 | Reg. 15(5) | Portfolio Manager not to lend securities held on behalf of clients to third person. |
| 13. | SEBI (Portfolio Managers) Regulations, 1993 | Reg. 16(7) | Portfolio Manager to segregate each clients' funds and securities. |
| 14. | SEBI (Portfolio Managers) Regulations, 1993 | Reg. 20(1)(a) | Portfolio Manager to keep separate client wise accounts. |

**(b) Common Provisions:**

1. Arms length relationship is to be maintained between different activities / businesses of the intermediary.

**6. Miscellaneous:**

| Sl. No. | Act/Regulation/Circular | Provision | Particulars |
|---|---|---|---|
| 1. | SEBI (Depositaries and Participants) Regulations, 1996 | Code of Conduct (Clause 6) | DP not to increase fee / charges without advance notice. |
| 2. | SEBI (Depositaries and Participants) Regulations, 1996 | Code of Conduct (Clause 7) | DP not to indulge in unfair competition. |
| 3. | SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992 | Code of Conduct for Stock Brokers and Sub-Brokers [Clause B(1)] | Duty on the stock broker and sub-broker to faithfully execute the orders of the clients at the best available prices and on the stock broker to make prompt payment and delivery in respect of the same. |
| 4. | SEBI (Stock Brokers and Sub-Brokers) Regulations, | Code of Conduct for Stock Brokers | Stock broker and sub-broker not to encourage sales or purchase of |

| Sl. No. | Act/Regulation/Circular | Provision | Particulars |
|---|---|---|---|
| | 1992 | and Sub-Brokers [Clause B(4)] | securities merely to generate brokerage. Also not to induce clients with the aforesaid objective. |
| 5. | SEBI (Bankers to an Issue) Regulations, 1994 | Code of Conduct (Clause 5) | Banker not to act in collusion with other intermediary or the issuer. |
| 6. | SEBI (Mutual Funds) Regulations, 1996 | Reg. 18(27)(vii) & (ix) | Independent Trustee to pay special attention to the reasonableness of fee paid to sponsors, AMC and to any service contracts entered with any associate of AMC. |
| 7. | SEBI (Mutual Funds) Regulations, 1996 | Reg. 25(7)(a & b) | AMC not to purchase or sell shares through one broker in excess of 5%of the aggregate sale and purchase. |
| 8. | SEBI (Mutual Funds) Regulations, 1996 | Code of Conduct (Clause 3) | Trustee and AMC to avoid excessive concentration of business with broking firms, affiliates etc. |
| 9. | SEBI (Mutual Funds) Regulations, 1996 | Schedule VII Restriction on Investments Clause (4) | Restriction on investment by a scheme in any other scheme of the same AMC or of any other AMC, except for any Fund of Funds Scheme. |
| 10. | SEBI (Mutual Funds) Regulations, 1996 | Schedule VII Restriction on Investments Clause (5) | Restriction on initial issue expenses in relation to any scheme. |
| 11. | SEBI Employees | Office Circular | Employees of SEBI are allowed to deal in securities except units of mutual funds in order to avoid any conflict of interest. |
| 12. | SEBI Employees Regulations | - | Clearance to be obtained by an employee before joining any intermediary. |

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# Annexure VI

## IRDA paper (including legal/regulatory mechanisms undertaken for mitigating conflicts of interest)

## Description of potential conflicts of interest in the insurance sector in India.

### 1.1. General

The financial services industry as a whole is now undergoing major change. Institutions are invading each other's customer and product markets, while convergence, consolidation, globalization and new technologies are further impacting the level of change. The successful firms will be those that can develop the right strategies to meet the ever increasing competition.

Thanks to deregulation, industry barriers are tumbling down. As regulatory standards predominate, the opportunity will open up for industry consolidation. This is being spurred on by the eroding of regulatory barriers between the banking, finance, and securities services. Survivors will thrive, not only because of their basic competitive prowess, but on their ability to build up relationships among the related services.

In the long run, insurers that fail to establish effective partnerships with financial services giants will find themselves marginalized in a field increasingly dominated by financial services "supermarkets."

The markets are changing with gradual detariffing. Price fixing mechanisms are changing, away from coordinated systems; rates as well as product design, are determined by market forces. Price controls on insurance can no longer be justified on the basis of consumer protection. The existing regime is causing appreciable distortions and many insurers and customers are at a competitive disadvantage. Experience all over indicates that the customer is the final beneficiary in a competitive market rather than in a controlled market. Skills at determining appropriate price become, therefore, critical.

Competition brings in innovation not only in product design but also in product delivery. Traditionally, most insurers have sold policies through agents, either through their own networks or through independent businesses. The impact of the new intermediary channel of brokers coupled with technology and structural changes will drive insurers to reevaluate how they reach the customer and what products they sell. In many cases, changes to the insurance sector will

echo those underway in other fields. For instance, it is expected that there will be a shift towards "mass customization," where insurance coverage and financial services are configured to the needs of the end customer. Structural changes, such as eroding regulatory barriers, and technology changes, which introduce new web and enterprise application integration technologies, will enable insurers and financial supermarkets to mass customize their insurance products.

There would be substantial shifts in the distribution of insurance in India. Worldwide, insurance products move along a continuum from pure service products to pure commodity products then they could be sold through the medical shops, groceries, novelty stores etc. Recognizing this trend, the financial services industry worldwide has success-fully used remote distribution channels such as the telephone or the Internet to reach more customers, cut out intermediaries, bring down overheads and increase profitability.

This will require access and analysis of significant information from external sources, and improved tracking of existing customer relationships. The same goes with offering more individualized products, as over time, customer expectations for service increase. In the long run, insurers must cater to consumer motivations rather than simply study them. All these lead to a situation which can rise to potential conflict of interest situation.

### 1.2. Different regulatory institutions

The financial services sectors of most countries have long been much influenced by market developments. These include the removal or weakening of barriers to entry and of restrictions on diversification and on various types of ownership structure; innovation and technological progress (which has had a dramatic impact on the cost of entering some markets for financial services); greater competition; and internationalisation. These developments are interrelated and mutually reinforcing. The result has been a blurring within the financial services sector of the traditional distinctions which used to apply across types of firm, types of product and types of distribution channel, albeit to different extent and in different ways across different countries.

For financial services firms, this has been manifested as an increase in the number of institutions which cut across traditional sectoral boundaries. This growth in financial conglomerates has resulted in part from the impact of mergers and acquisitions. This also reflects the result of financial services firms extending through internal growth into new areas (for example, insurance companies setting up banks and vice-versa, insurance companies selling investment products, and banks setting up securities and fund management operations), and of new entrants to the financial services sector choosing to offer a range of financial services to their customers. In all of

these cases the resulting mix of functions undertaken by the firm has been determined primarily by anticipated profits and the scope for cross-selling products to customers, rather than by any traditional linkages between, or separations across, products.

With the growth of options, increasingly elaborate ways of unbundling, repackaging and trading risks have weakened the distinction between equity, debt and loans, and even between banking and insurance business. Equally, channels of distribution are no longer as specialised as they once were. Banks have used their branches as a sales point for an increasing range of products, while many of the new entrants to parts of the financial services sector have introduced new sales methods – such as telephone and internet channels – to a wide range of products which had previously been available only through more traditional channels.

The disappearance of a neat conjunction between a particular type of firm and a limited range of products being supplied by that firm means that it is difficult to regulate on a functional basis, since the traditional functional approach no longer matches the structure of either firms or markets. The emergence of financial conglomerates has challenged traditional demarcations between regulatory agencies and the boundaries between regulators simply no longer reflect the economic reality of the industry.

There is a clear need for regulatory oversight of a financial conglomerate as a whole, since there may be risks arising within the group that are not adequately addressed by any of the specialist prudential supervisory agencies that undertake their work on a solo basis. Many of the threats to the solvency of the institution can be assessed adequately only on a group-wide basis. This includes the assessment not only of whether the group as a whole has adequate capital, but also of the quality of its systems and controls for managing risks, and the calibre of its senior management. Indeed, the importance of systems and controls and of senior management to the standards of compliance achieved by a firm against both the prudential and the conduct of business standards and requirements set by financial services regulators means that it is not possible to draw a clear dividing line between prudential and conduct of business regulation, since, in this respect, both types of regulation have an interest in the same aspects of a firm's business. Moreover, there needs to be an effective exchange of information and a co-ordination of regulatory requirements across the regulators responsible for different parts of a conglomerate's business, as well as mechanisms for coordinated action when problems arise in a conglomerate.

A single regulator need not necessarily deliver these advantages. Specialist divisions/areas will exist even within a single agency, thus creating potential problems in communication, information

sharing, co-ordination and consistency. A single regulator in other words could potentially become an over-mighty bully, a bureaucratic leviathan divorced from the industry it regulates.

There remain, and will remain for the foreseeable future, major differences between banks, securities firms and insurance companies in the nature of their business, the type of contracts they issue, and hence the nature and form of asset transformation. Firms in all sub-sectors have diversified, but almost invariably their core business remains dominant. The natures of the risks are sufficiently different to warrant a differentiated approach to prudential regulation. The rationale for this approach (or for other possible objective-based models with more than one regulator) is attractive – giving regulators clear mandates and ensuring appropriate differentiation in the regulation of different types of activity.

But even if there is a strong case for an institution-wide overview of a financial conglomerate, is it necessary for this to be undertaken by a "lead" regulator (or "coordinator") appointed from among the "solo" regulators responsible for specialised aspects of the institution. This lead regulator would be responsible for taking a consolidated view of the capital adequacy and liquidity of the institution as a whole; taking a similarly group-wide view of more qualitative factors such as the calibre of senior management and the high-level systems and controls of the financial conglomerate; and coordinating and encouraging the exchange of information among the relevant regulatory bodies, both routinely and in the event of an emergency. Most countries still follow the lead regulator approach.

Regulatory Arbitrage: Conflict resolution

It must also be recognised that in practice governments have been slow and ineffective in resolving conflicts of interest between different objectives and responsibilities between multiple specialist regulators. These problems arise because they either do not have clear objectives and responsibilities or because these were set at different times and are inconsistent with each other. Thus even if all specialist regulators are focused effectively on delivering their own specific mandates, the sum of the parts need to add up to a coherent and consistent overall outcome. Governments may lack the necessary information and experience to take decisions here, and may also be reluctant to do so if it brings them too close to the regulation of individual financial institutions.

Appropriated differentiation

Multiple regulators however ought to be able to avoid the unjustifiable differences in supervisory approaches and the competitive inequalities imposed on regulated firms through inconsistent rules. However, this does not mean adoption of a "one size fits all" approach. What is required is

harmonisation, consolidation and rationalization of the various principles, rules and guidance in the regulatory material issued by the specialist regulators – so that similar risks are treated similarly irrespective of where they arise – and the need to create and to preserve appropriate differentiation to reflect the different degrees of protection required by different types of consumers.

### 1.3. 1.3. Within regulatory institutions

The existing legislative enactments do not bestow adequate powers on the regulator to make rules, to interpret rules, to investigate breaches of rules, to fine people for breaches of rules, and to keep and retain the fines in all areas which they are supposed to supervise. The essence of having an independent regulator within the flexibility to rule by regulation making ensures that matters which previously could be changed only with the consent of Parliament will be capable of being changed merely by a decision of the respective financial supervisory authority. There is quite properly a very lively debate about this. On the one hand there is much to be said for a flexible system. Legislation can never foresee all eventualities and, furthermore, legislation can never be perfect. Legislation in many cases cannot also be quick enough to correct market aberrations. In many areas sensible actions have been thwarted by faulty legislation. Often industry and regulators combine to try to get round unintended effects of legislation. Surely, according to this argument, it is far preferable if the regulation is as flexible as possible allowing regulators to take account of changing circumstances. Moreover, it is argued, one has to work with and trust the regulators and, if they cannot be trusted, then really it does not matter what sort of legislation one has.

But there is a contrary argument. No one doubts the motives, competence and qualities of the people at the top of the regulatory set up, but that can change. Moreover, sometimes major decisions can be taken some way down a regulatory body where perhaps the staff concerned does not have the broadminded approach of people at the top.

Normally regulatory bodies are accountable by being subject to parliamentary approval for key variables, for example fees and levies, and they are also subject to a ministerial power of direction - ministers themselves being accountable to Parliament, or perhaps more nowadays to the media.

At one time, regulation was believed to be the cure-all for various forms of "market failure" inherent in many industries, such as natural monopolies, externalities and information asymmetries. However, years of regulatory experience in many developed countries reveal that regulations, like markets, can also "fail."

Regulatory failure may occur for two reasons. The first is associated with the "capture theory." The theory posits that because the regulated companies are likely to have superior information, they can easily manipulate the regulator to their own advantage. Alternatively, these firms can easily form themselves into a formidable lobbying group that may influence government policies. The second reason for a regulatory failure arises from the fact that the regulator itself is not perfect. We must not forget that by creating a regulator, we entrust an enormous amount of responsibility and power unto a single body. This resembles an autocratic government. We all hope for a benevolent and an efficient regulator, but there are both up-side and down-side risks involved when power is concentrated in a single entity.

The following are major regulatory dilemmas and conflict of interest situations in a regulatory organization:

1. Misconception of the role of a regulatory body: As growth in developing economies has been driven by the success of the industrial sector, it is not surprising that the survival and prosperity of producers, rather than the welfare of consumers, constitutes the focus of public policies. Thus, regulation is seen as a process to protect producers (by limiting competition) rather than consumers. While such a view would represent "regulatory capture", for many developing countries that strive ceaselessly for economic prosperity, protection of producers is a widely accepted norm. Collusion and behavior that may limit competition may be allowed if such moves are essential for the survival of the business. As consumer groups in developing countries are usually weak, their voices are unheard or are overfed. Misconception with regard to the role of regulation is probably the most fundamental and serious regulatory pitfall among Asian countries. With such misconception, regulations are prone to become nothing more than a rent-seeking device of private profiteers.

2. Too much discretion: As economies rush or are rushed to open up their service markets, liberalization is handled haphazardly; little preparation is put into drawing up appropriate rules and regulations. The principles, the method and the means with which the body is to regulate are left to the discretion of the committee-to-be. There are indeed pros and cons concerning the tightness of laws and regulations. Too detailed a law can leave regulations too rigid, while too lax a law may open the system to the peril of abuse of power and may lead to inconsistency, unpredictability and an unclear decision-making process.

Where the mandate of the regulator is unclear and where regulatory procedures are *ad hoc*, the regulatory authority is likely to wield a lot of discretionary power. Moreover, in the absence of an effective competition law and a comprehensive consumer protection law, the regulator will have to assume the enormous task of setting its own set of principles, measures and procedures concerning these matters. The absence of general sets of laws or rules that can be referred to

makes the task of regulation significantly more complicated and at the same time, prone to arbitrariness and inconsistencies.

3. Too little transparency: While too much discretion may arise from the ad hoc approach taken with respect to regulation, there are ways to limit the potential adverse results associated with discretion. Regulatory procedure can be made more transparent through public hearings, appeals provision, and notification and publication requirements. Therefore, in a country where the rules and the laws are weak, transparency is the soul of efficient regulation. Unfortunately, regulations in many countries are neither clear nor transparent and decision making neither participating, leaving the system highly susceptible to all the ills of regulatory failure.

When a regulatory body wields a lot of discretionary power and its regulatory procedures are not transparent, effectiveness depends ultimately on the relative competence of the committee members who set the rules under which they operate. As a result, success stories, or unsuccessful ones for that matter, are closely associated with a certain individual, or a group of individuals, who exercise authority.

Given that the regulatory performance in such countries relies heavily on the competence of individual committee members, can these countries then find highly qualified personnel to ensure effective regulation?

4. Lack of qualified personnel: A qualified committee member would have to be impartial and competent. Impartiality demands that a regulator should not have any direct or indirect vested interest in the business which he regulates, nor hold a political position. Competence requires an exceptional technical and operational knowledge of the business. After all, a regulator should know more about the business than the companies he regulates. With these parallel qualifications, this person will have to be a technocrat or a veteran businessperson who no longer holds a stake in the regulated business. Such an individual could prove non-existent in a developing country. First, the pay scale is generally too low to attract and maintain qualified personnel. Thus, the chance of finding a competent regulator from the government is remote. Secondly, in a fast-growing service sector, the persons who best understand the business are those involved in the business themselves. In a situation where the processes of regulation and liberalization convert an existing restrictive market to a more open one, as in most of the Asian countries, the choice of competent and technically competent personnel to man regulatory bodies gets severely shifted to the current crop of institutions in the public sector. It is therefore not surprising that half of the committee members of the many regulatory bodies are former employees of the State monopolies. The presence of former operators on the regulatory board may render the impartiality of the regulatory body not only questionable but in many cases to a

tunnel-vision often affecting the quality of regulation. The lack of qualified and experienced personnel poses a serious problem for most countries.

5. Insufficient Autonomy: Assuming that competent and well-qualified personnel can be found, this still does not guarantee efficient regulation. For the regulator to be able to perform its task effectively, a certain degree of independence from the government is required. Autonomy is determined not only by the institutional structure, but also the extent of financial independence. An independent source of financing, either from a guaranteed line in the national budget, licensing fees, or taxes, can certainly promote not only autonomy, but impartiality. Particularly in countries where corruption is rife and patronage is a way of life, financial independence is a requisite for an efficient regulatory body.

One other feature often noticed in the unfolding regimes in the recently liberated economies is the total lack of perception in government circles on the concept and principles namely reluctance on the part of bureaucracy that controlled the sector erstwhile in its mindset of regulation being equivalent to ownership. The apparent loosening of their hold on the units publicly owned and controlled by it to a proper nonsensical regulation greatly affects its thinking and action. It is also observed that the public sector companies, hitherto sheltered and cosseted by government, tend to look at regulations as inconveniences and threats to their inertia.

All these help to understand the pitfalls in the regulatory apparatus and help address the potential conflict of interest situation.

### 1.4. Between supervisor and government

The institutional structure of financial services regulation is important because of the impact of the efficiency and effectiveness of this on the direct and indirect costs of regulation and on the success of regulation in meeting its statutory objectives. To what extent should the structure of financial regulation be driven by the functions which financial services firms undertake, reflecting market developments in the financial services industry? Is there a first-best institutional arrangement which is independent of these market developments, arising perhaps from economies of scale and scope in undertaking financial regulation, or from some underlying logical of the structure of regulation with the objectives of regulation or with the institutional arrangements for monetary policy and for addressing systemic risk? Are there also implications here for the structure of regulation internationally, not just within national borders?

The existing arrangements for financial regulation involve a large number of regulators, each responsible for different parts of the industry. In recent years there has been a blurring of the distinctions between different kinds of financial services business.

In India, the main regulatory functions are carried out by non-governmental bodies. These responsibilities are largely conferred by the different Acts. Financial services have been regulated based on tripod based regulatory structure, comprising of the Reserve Bank of India, Securities Exchange Board of India and Insurance Regulatory and Development Authority. The High level Capital Markets Committee presently co-ordinates and monitors the financial regulatory system.

The second tier consists of a number of organisations belonging to various categories of statutorily recognised bodies. These include Self-Regulating Organisations, Recognised Professional Bodies, Recognised Investment Exchanges and Recognised Clearing Houses. Together they perform front-line authorisation of financial services businesses and markets.

The Ministry of Finance is responsible for the overall institutional structure of regulation and for the legislation which governs it; for the overall stability of the financial system, for the financial system infrastructure, for the efficiency and effectiveness of the financial sector and, under specified conditions, to undertake financial support operations; and

The financial regulators are responsible for the authorisation and supervision of financial services firms, for the supervision of financial markets and of clearing and settlements systems, and for regulatory policy in all these areas.

So while the regulator may take the view that in the overall interest of the financial sector, take certain decisions, the Government may take another decision looking at its political constituency. This can also lead to the conflict of interest situation.

## 1.5. Insider activities

Business decisions and actions must be based on the interest of the Company, not on individual's personal interests or considerations. A "conflict of interest" occurs when an individual's private interest or consideration interferes in any way, or even appears to interfere, with the interest of the Company as a whole.

Conflicts of interest are manifest in those instances where the actions or activities of an individual on behalf of the Company or otherwise also involve (a) the individual's or any of his/her

immediate family member, obtaining of an improper personal gain or advantage; (b) an adverse effect upon the interest of the Company; or (c) the obtaining by a third party of an improper or illegal gain or advantage to the detriment of the Company or a competitor of such third party.

An "immediate family member" of an individual includes his/her spouse, father, mother, child, brother, sister, grandfather, grandmother, grandson, granddaughter and legal dependent or his/her (current or past) spouse's father, mother, brother, sister, daughter, son, grandfather, grandmother, grandson, granddaughter or legal dependent wherever they reside or any other relative of the individual or his/her spouse residing in the same home with the individual.

It is not possible to list all situations in which a conflict of interest may exist or may appear to exist. The Company relies on the integrity and good judgment of its directors, officers and employees in avoiding situations that may create, or appear to create a conflict of interest.

**1.5.1. Personal financial interest**

As of today, disclosure norms for related party transactions are governed by AS 18 issued by the ICAI for all enterprises submitting to independent external audits. As disclosure is required on the audited financials, related party transactions are made known only after the fact. A person may have a personal interest in any financial transaction which he undertakes on behalf of the company.

However the company may adopt the following steps to avoid conflicts of interest situations in respect of its directors, officer and employees in areas involving personal financial interests. Each director, officer and employee must examine the affiliated person's own activities and shall promptly report to the Board of Directors the existence of any business corporation or unincorporated commercial enterprise in which the person or any immediate member of the family of the person has a material (or substantial) interest and which to the person's knowledge has in the past engaged, or may in the future engage, in financial transactions with the Company. A material or substantial interest in such an outside business enterprise would exist if such interest represents ownership of 10% or greater and such interest directly influences or appears to influence the Company's decisions or actions in relation to that outside business enterprise. Examples of outside business enterprises which might engage in transactions with the Company include insurance customers, brokers, agents, consultants, security dealers, real estate agents, mortgage bankers, advertising agencies, suppliers of goods or services and the like.

### 1.5.2. Confidential and inside information

An individual, during the course of his working, may come to possess confidential and inside information about the company which may be used to derive personal gains. Therefore it is essential that confidential information pertaining to the Company acquired by an insider must be held in the strictest confidence and may not be used as a basis for personal gain by the insider, any immediate member of the family of the insider or others. Financial or other corporate information regarding the Company is not to be released to any person unless it has been published or otherwise made generally available to the public in accordance with applicable disclosure regulations.

Each insider shall refrain from knowingly buying or selling, for the his/her own account or the account of any of his/ her immediate family member any real estate, chattel, security or other interest which the Company maybe considering buying or selling, or has decided to buy or sell, until the decision of the Company has been completely executed.

An insider will also refrain from transmitting any knowledge of such considerations or decisions or any other information, which might be prejudicial to the interest of the Company to any person other than in connection with the discharge of the insider's corporate responsibilities.

The governing principle is that if any material confidential information is received by an insider, the person must neither use such information for his or her immediate family member's benefit, nor should the person disclose it to others for their personal use, benefit or advantage.

### 1.5.3. Relationship to third parties

A company may enter into various relationships with third parties. Such information can be used by the insider to take an improper or illegal advantage or disadvantage to such third party or to any competitor of such third party. The Company should draw up a policy whereby each insider shall refrain from knowingly entering into any contract, agreement or transaction with a third party on behalf of the Company which involves an improper or illegal advantage or disadvantage to such third party or to any competitor of such third party.

### 1.5.4. Gratuities

An employee is in a potential conflict of interest situation if the person is placed under actual or apparent obligation to anyone by accepting, or permitting the person's family to accept, gifts or other favours where it might appear that they were given for the purpose of improperly influencing the insider in the performance of the person's corporate duties. This does not preclude the acceptance of items of nominal or minor value and which are of such a nature as to indicate that they are merely tokens of respect of friendship and not related to any particular transaction.

The company should come out with a policy in its staff regulations for preventing such potential sources of conflict.

### 1.5.5. Outside activities

An employee of the company can indulge in activities outside the office which take from time and attention required by the person's corporate duties, or involve obligations, which may in any way compete, or conflict with the interest of the Company. Such activities should be undertaken only with prior approval of the Board of Directors should be secured before accepting any such outside employment or activity.

### 1.5.6. Political activities

(1) Employee Participation. The company's generally does not encourage its insiders and employees to take an active interest in political activities. In all cases of participation in such activities, however, each insider and employee must act as an individual and must not in any way connect the company with the person's political activity.

As in the case of other outside activities, approval of the Board of Directors should be secured before seeking any political office or accepting any governmental appointment.

(2) Political Contributions. The use of corporate funds or any other corporate asset for any political purpose should be absolutely prohibited. This prohibition applies to time spent by an employee during normal working hours, use of corporate stationery or other supplies and equipment, office space, clerical help, and advertising facilities.

### 1.5.7. Improper payments

The company may offer the products, services and legitimate competitive business practices on the part of their employees and representatives in connection with its business. No payments in the nature of "kickbacks" or "bribes" intended to induce or reward favorable decisions, whether private or governmental, are to be used in connection with any phase of the Company's business.

### 1.5.8. Financial reporting & internal control guidelines

The Company adheres to a high standard of accuracy and completeness in the preparation and maintenance of its financial records. These records are the basis for operating the Company's business, for fulfilling obligations to subscribers, shareholders, employees, suppliers and others, and for compliance with the financial reporting and internal accounting control requirements of various governmental agencies.

It is the policy of the Company, therefore, to comply with the record keeping and reporting requirements of all applicable state and federal law.

The Company requires that all items of income and expense and assets and liabilities be appropriately entered on the books and that such entries accurately and adequately reflect legitimate business purposes as required by law.

### 1.5.9. Disclosure procedure

(1) If, at any time, an insider or his/her immediate family member finds that the person has, or is considering the assumption of, a financial interest or outside relationship which might involve a conflict of interest or cause embarrassment to the Company, or if the person is in doubt as to the proper application of this Policy Statement, the person should immediately make all the facts known to the Board of Directors and be guided by the instructions the person receives. Except as otherwise directed by those instructions, the person should refrain from exercising responsibility in any matter which might reasonably be thought to be affected by the person's adverse interest.

(2) Each insider will be expected to read and understand the contents of this Policy Statement and to review it periodically in order to be alert to situations, which could create a conflict of interest, or otherwise be contrary to the established policies of the Company.

## 1.6. General insurance

The general insurance industry contains numerous instances wherein there exists conflict of interest situation. We analyse some of them and give solutions how best these can be managed given the inherent nature of the activities.

### 1.6.1. Underwriting of risks – Premium chargeable/cross-subsidization

A general insurance company operates in a competitive environment and the underwriter is exposed to various pulls and pressures. While the marketing person exerts pressure to have his proposal accepted at the most favourable terms and conditions, the underwriter has to use his judgment to ensure that the risk is worthy of being underwritten at the technical rate. There exists a potential conflict of interest position if the underwriter is also made responsible for the marketing functions in the insurance company.

The way forward to avoid conflict of interest is by separating the two positions and making them independent.

### 1.6.2. Claims settlements

The reputation and character of the insurance company is determined by the claims settlement ability. The timely action on part of the insurance company goes a long way in mitigating the distress which falls on the insurance policyholder. The claims manager has to play a delicate role in balancing the expectation of the insurance policyholder as he expects to be paid in full the loss and the interests of the insurance company for whom he is employed. The claim settlement has to be effected by him under the terms and conditions of the policy issued by the company without compromising the expectations of the policyholder. The position becomes more acute when he is required to do the claims settlement in respect of a claims belonging to him or his close relative. To that extent the claims manager is in a conflict of interest position.

### 1.6.3. Provisions for outstanding claims

It is observed that conflict of interest situation arises whenever there is certain amount of discretion available or the rules are not defined so explicitly leaving room for interpretation. One such major grey area in general insurance companies is the provisions for outstanding claims. Depending upon the goals of the higher management, it has been observed in the past that the accountants have increased or decreased the provisions for outstanding claims to show a good or a bad profit for the company. The person responsible for undertaking this exercise is in a delicate position and has to ensure that there is no conflict of interest.

## 1.7. Life Insurance

The life insurance industry has very close relationship with the policyholder. The policyholder entrusts its savings to the life insurance companies in the belief that in case of any misfortune or accident, the life insurance company would compensate him or his family members from the disruption so caused. It is therefore more imperative for the life insurance companies to manage conflicts of interest situations. We illustrate these with some of the activities of the life insurance company.

### 1.7.1. Appointed Actuary System

In India we have adopted the Appointed Actuary System, whereby the Appointed Actuary acts as the ears and eyes of the Authority in the life insurance company. He is appointed in a life insurance company with the prior approval of the Authority.

He is responsible for rendering actuarial advice to the management of the insurer, in particular in the areas of product design and pricing, insurance contract wording, investments and reinsurance; ensuring the solvency of the insurer at all times; complying with the provisions of the section 64V of the Act in regard to certification of the assets and liabilities that have been valued in the manner required under the said section; complying with the provisions of the section 64 VA of the Act in regard to maintenance of required solvency margin in the manner required under the said section, drawing the attention of management of the insurer, to any matter on which he or she thinks that action is required to be taken by the insurer to avoid--

(i) any contravention of the Act; or

(ii) prejudice to the interests of policyholders;

and complying with the Authority's directions from time to time, etc.

All these place onerous responsibility upon him to discharge his duties with fairness and equity. The position of appointed actuary is therefore in a conflict of interest position as he has to watch the interest of the Authority and thereby that of the customer and also be loyal to the life insurance company for which he is employed.

### 1.7.2. Actuarial valuation of liabilities and distribution of surplus

The actuarial valuation of liabilities is of key importance as it based on these valuations that the insurance company declares the bonus for distribution to the policyholders. This is akin to reserving in case of general insurance business. The actuarial valuation of liabilities can have an impact on the benefits to be passed on to the policyholders. Hence the chief executive officer because of the competitive pressures may try to influence the actuary to declare a higher bonus based on the valuation exercise done by him. Here again the actuary has to ensure that the

conflict of interest position that he is in is minimised and is able to satisfy the demands of the policyholders and the company.

### 1.7.3. Loans against policies issued

The life insurance companies permitted loans to be taken against the policies issued by them. Such a situation is a potential conflict of interest position for the insurance company as the insurance company may try to maximise the returns by encouraging policyholders to either surrender their policies or allowing them to offer loans to the policyholders at a lower rate of interest to renew their policies.

## 1.8. Intermediaries

### 1.8.1. Appointment of surveyors & loss assessors & TPA's

One of the important functions of a general insurance company is to appoint an independent surveyor and loss assessor licensed by the Authority in case of all claims over Rs. 20,000/-. There are over 15,000 surveyors and loss assessors holding a valid license in the country. An employee performing this task is in a potential conflict of interest position as he has to watch the interest of the company, give immediate attention and proper service to the customer and appoint a competent surveyor to carry out his job.

In order to insulate the position of the person who does the surveyor and loss assessor's appointment, clear limits for survey appointment should be fixed by the company. Secondly the company should have a panel of surveyors and they should be given work on rotational basis so as to reduce the potential conflicts.

### 1.8.2. Empanelling of insurance brokers, insurance agents and corporate agents.

Every insurance company utilizes different channels of distribution for selling insurance policies. In such cases conflicts of interest arise when the agent/ broker/ producer sells a policy to the prospect based not on his needs or requirements but on the commission that he gets from the insurance company on the type of policy sold. Hence agents may give advice to the customer to buy an endowment policy where the commissions are high vis-à-vis the term insurance where the commissions are low even though the prospect needs term insurance. The agents/ brokers are therefore in a conflict of interest situation.

Banks acting as an agent under the Bancassurance gives rise to conflicts of interest situation as they may insist on the customer to take an insurance policy from them against an asset which is created out of the loan extended by them. Like-wise the banks selling insurance policies are in a conflict of interest situation.

## 1.9. Accounts & Investments

### 1.9.1. Appointment of statutory auditors

Every insurance company under the regulations framed by the IRDA has to appoint statutory auditors who verify the books of accounts of the company. The auditors are appointed from a panel approved by the IRDA. The first of the auditors are appointed for a period of 5 years and the second auditors are for a period of 4 years. The auditors are expected to present to the shareholder's the true and fair picture of the accounts of the company. The appointment of the auditors is an important task for the Board of the Directors who generally go by the recommendations made by the management. Not only is the impartiality of the auditors is to be maintained, but care has to be taken that they do not offer consultancy advice to the company as it will lead to conflict of interest situation.

### 1.9.2. Internal audit department

The internal audit department plays an important role in ensuring compliance with the internal controls of the company. The internal audit department is in a conflict of interest situation as they comment on the working of the persons and report on the compliance of the functions of those to whom they are ultimately answerable. The companies have formed audit committees to reduce the conflict of interest situation but the conflict persists.

### 1.9.3. Investments made by insurance companies

The insurance companies are in the business of managing funds of the policyholder's. They maximise the returns on the investments made by the insurance consumers and hence make insurance as a means of investment vehicle.

### 1.9.4. Loans & Contracts to Directors, relatives, senior officer relatives

The insurance companies provide loans to its directors, relatives, senior officers as part of the incentives to the employee. This is a conflict of interest situation as the senior management may try to give to itself higher monetary incentives at the cost of the policyholders. The issue of corporate governance therefore becomes relevant in such cases.

The way out is to have various committees to oversee the functioning of the company's management.

### 1.10. Self Regulatory Organizations

The Self Regulatory Organisation are a trade body/ pressure group representing a certain class of persons/ organizations having a common objective which works for the interest of that group. The Indian insurance industry in India also has the SRO's in the form of the Life Insurance Council and the General Insurance Council who represent the life and the general insurance industry respectively. As the Indian market develops, the role of the Self-Regulatory Organisations (SROs) will take on greater significance. The empowerment of the SRO's essentially involves grant of rights and responsibilities to market participants who, for their part, must be capable of ensuring effective regulation and must be able to meet these challenges. Failure to regulate effectively will lead to a deterioration of market integrity and stability and, ultimately, the intervention of the IRDA as supervisory regulator with oversight responsibilities. It is expected that much of the current developmental role currently played by the IRDA will be taken over by the SRO's.

The SRO's have to face the conflict of interest situation as on one side they have to look after the interests of the stakeholders and at the other time they have to act as a disciplinary authority. The SRO's are not able to take action against the erring undertake the task of acting as a disciplinary authority because of the stakeholders interest in the organization.

## 2. Description of practices adopted for mitigating the conflicts of interest in the insurance sector

Some of the Possible Solutions to address conflict of interest can be as:

a) Have adequate disclosures and transparency so that ultimately the customer decides for himself. Apart from full disclosures show comparisons and illustrations amongst similar products.
b) Let there be commoditization of products which would bring uniformity and facilitate comparison amongst various policies.
c) Unbundling the products or by allowing the customer to choose the coverages.
d) Allow cross-selling of products which is different from bundling.
e) Conflicts of interest in distribution can be addressed by enforcing the code of conduct.
f) The customer should be made aware of the pricing of the various parts/ components of the policies and based on that should decide which sections he would like to subscribe.
g) Have a relook at the tied agency system as agents are in the conflict of interest position.
h) Have consumer education programmes.
i) Have Chinese walls between the various entities.

**3. Description of legislative, regulatory and other mechanism already in place in the Indian context for addressing the issue of conflict of interest.**

3.1. Provisions contained in the Insurance Act, 1938

3.1.1. Section 3 – Non-issuance of composite license for life and general insurance. For the purposes to eliminating the conflict of interest amongst different insurance entities, the Insurance Act, 1938 allows for issuance of license to carry out life insurance business or general insurance business or reinsurance business. The three cannot be combined in a single license.

3.1.2. Section 5 – Restrictions on name of insurer – In order to prevent conflict of interest the Insurance Act, 1938 prohibits registration of an insurance company whose name resembles an already registered insurer.

3.1.3. Section 6A(1),(2),(4) – The capital of the company to consist of only ordinary shares each of which has a single face value and voting rights strictly proportionate to the paid-up amount of shares held by him. Transfer of shares only permissible with the prior approval of the Authority. Such checks prevent in the conflict of interest amongst different promoters.

3.1.4. Section 6AA – Manner of divesting of excess shareholding in certain cases – The Insurance Act, 1938 also lays down the manner in which the excess shareholding will be divested by the promoters so that they do not come into conflict of interest situation.

3.1.5. Section 10 – Separation of accounts and funds – The Insurance Act, 1938 in order to prevent mixing of funds, has specified that the funds belonging to life insurance business, fire insurance business, marine insurance business and miscellaneous insurance business shall be maintained separately.

3.1.6. Section 27, 27A, 27B – Investments – Investments made by insurance companies will have to made strictly in accordance with the provisions of the Insurance Act, 1938. These investment guidelines prevent in conflict of interest position.

3.1.7. Section 29 – Prohibition of loans – No insurer is allowed to grant loans or temporary advances either on hypothecation of property or on personal security or otherwise, except on loans on life policies issued by him within their surrender value to any director, manager, managing agent, actuary, auditor or officer of the insurer. This provision acts to prevent conflict of interest amongst the various roles which a director, manager, managing agent, actuary, auditor or officer of the insurer has to perform.

3.1.8. Section 31A – Provisions relating to Managers – This section of the Insurance Act, 1938 provides for a number of functions which cannot to be undertaken by the manager. This express provision has been put in the Insurance Act, 1938 to prevent conflict of interest in the functions that he performs.

3.1.9. Section 32A – Prohibition of common officers and requirements as to whole time officers – This provision of the Insurance Act, 1938 prevents managing director or officers carrying on life insurance business to be the managing director or other officer of any other insurance company,

banking company or investment company. This provision also takes care of the conflict of interest which may arise in the discharge of his duties.

3.1.10. Section 40 – Prohibition of payment by way of commission or otherwise for procuring business – This section of the Insurance Act, 1938 expressly states that no person shall pay or contract to pay remuneration or reward by way of commission or otherwise for soliciting or procuring insurance business except to agents. It is expected that such provisions will help minimise conflict of interest as only genuine agent will be entitled to receive commissions.

3.1.11. Section 40A – Limitation on expenditure on commission – Such limitations will curb the agents tendency to mis-sell a policy to earn higher commissions thereby minimising conflict of interest situation.

3.1.12. Section 48A, 48B – Life insurance agents not to be directors of life insurance companies – These provisions of the Insurance Act, 1938 has been specifically incorporated to prevent conflict of interests

3.2. Provisions made in IRDA's Regulations – The Authority has issued number of regulations for the effective functioning of the insurance industry in the country.

3.2.1. IRDA's (Insurance Advertisements and Disclosure) Regulations, 2000. These regulations are aimed at providing complete and correct picture to the insurance policyholder in respect of the products being offered to him by the insurance company. It is felt that by educating the policyholder the conflict of interest situation can be avoided as the policyholder will be able to distinguish the good from the bad.

3.2.2. IRDA's (Licensing of Insurance Agents) Regulations, 2000 – One of the express conditions placed in the code of conduct for an agent is that he cannot become or remain a director of any insurance company. This is to avoid the clash of interest which may arise in the discharge of his duties.

3.2.3. IRDA's (Appointed Actuary) Regulations, 2000 - The Appointed Actuary regulations specify the duties and functions of the appointed actuary and bring out the conflict of interest in the role that he plays in a life insurance company. The regulations equip him to discharge his role without fear or favour as the appointment and removal from his position can be done only with the approval of the Authority.

3.2.4. IRDA's (Protection of Policyholder's Interest) Regulations, 2002 – These regulations empower the policyholder to protect himself from the different positions wherein some person may twist it to the detriment of the policyholder.

3.3. Directions, Circulars and Notices issued by the IRDA – The Authority has been issuing number of directions, circulars and notices in order to minimise conflict of interest.

**4. Further measures to be taken for mitigating conflicts of interest in the Indian insurance industry**

4.1. Market Discipline – Market Conduct is one of the issues requiring immediate attention of the Authority. The Authority has been receiving reports form various quarters about the mis-selling which has taken place and the breaches in tariff that are occurring. This is not good for the overall development of the market. Market Discipline has to be brought about not only by supervisory intervention but also by the market players, who have to learn to act in a mature fashion. This can be done by persuasion.

4.2. Mandatory disclosure for increased transparency – Section 20 of the Insurance Act, 1938 provides for custody and inspection of documents and supply of copies. Such kind of mandatory disclosures increase transparency and go to the benefit of the policyholders. In addition the IRDA's (Protection of Policyholders Interest) Regulations, 2002 also equip the policyholder to demand greater attention and adequate disclosures which will minimise conflict of interest and the adverse impact on the policyholder.

4.3. Supervisory oversight – Increased supervisory oversight by way of off-site and on-site inspections will play a vital role in mitigating the effects of conflict of interest. The examination manual will be used to test the various controls in the organization and check that the conflict of interest positions are minimised by separation of function, effective delegation of duties, two signatories for cheque signing, separation of underwriting department from claims settlement department, separation of front from back office in case of investment functions, etc.

It can therefore be safely concluded that conflict of interest will always remain. Only thing that one can do is to minimise it. In case of corporates it can be best done by laying down an effective & transparent corporate governance rules and guidelines to empower the policyholder. This will enable him to make an educated choice of his needs and requirements and prevent from being misled.

# Annexure VII

## Conflicts of interest involving the triple bottom line

Triple bottom line is a phrase coined by Bill Atkins, meaning to represent the economic, social and ecological benefits which need to be taken into account by all the economic agents in the discharge of their functions / activities.

The concept is quite simple and intuitive. It is commonly observed that on most occasions, these three interests are at loggerheads. Often times, an economically attractive proposal could potentially have harmful social and ecological side-effects. Today, it's widely agreed and accepted, based on empirical research, that man's economic activities have brought the planet close to the precipice of ecological disaster – due to effects like global warming, rising sea-levels, serious and some times irreversible pollution of various natural resources, etc – which threaten the very existence of the inhabitants of earth. Clearly, man's economic activities cannot be allowed to threaten the life on the planet on which we live.

Though these type of conflicts have not entered the main stream of literature on conflicts of interest, it represents a fundamental conflict which has a special relevance in the Indian context, since environmental degradation has assumed serious dimensions as per various available reports. Internationally, there is wide-spread awareness of the importance of sustainable development, as reflected clearly in certain overarching initiatives like United Nations Development Programme – Finance Initiative (UNDP-FI) and Global Reporting Initiative (GRI).

However, in India, the awareness among economic agents is relatively limited. The virtual absence of formal ethical lending practices or ethical mutual / venture funds, is corroborative of this fact. It is well reasoned that the financial sector is the fountain place to spread such awareness, since all other economic agents deal with them in some context or the other – directly or indirectly. Of course, there is a role to be played here by all the stakeholders of society at large.

The highlights of the World Development Report 2003, have been given below, in order to be able to understand gravity of the situation relating to sustainable development.

### A Glimpse into World Development Report 2003 of World Bank

***'Sustainable Development in a Dynamic World'***

The WDR 2003, **Sustainable Development in a Dynamic World**, asserted that in the past 50 years global GDP grew fourfold. Despite high population growth rates in developing counties average per capita income increased by ~30%, adult illiteracy and infant mortality were cut by half. However, these achievements were accompanied by growing social stresses (conflict,

inequality, persistence of large number of poor people) and environmental degradation (rapidly growing water and air pollution in developing country cities, and run down of natural stocks -- some, such as the 70% of fisheries that are over fished and or the 5-10% of forests being destroyed each decade, are critical to the well-being of poor people in developing countries).The next 50 years could see another fourfold increase in the size of the global economy and significant reductions in poverty, provided that governments acted immediately to avert a growing risk of severe damage to the environment and profound social unrest. The report examined the relationship between competing policy objectives – reducing poverty, maintaining growth, improving social cohesion, and protecting the environment – over a 50-year horizon. It also noted that many good policies have been identified but not adopted or implemented, and traced this problem to distributional issues and institutional barriers (including institutional capture), reviewing institutional innovations that might help overcome these barriers.

In nearly 50 years, the world could have a gross domestic product of $140 trillion and a total population of nine billion. Better policies and institutions would have to be embedded in a strategy that managed a broader portfolio of assets (including natural and social capital). Without that, the WDR warned that social and environmental strains might derail development progress, leading to higher poverty levels and a decline in the quality of life for everybody. Expanding the role of markets and market signals is critical to improving productivity and the efficiency of resource allocation in the production and consumption of private goods. But improving welfare also requires the provision of complementary public goods that cannot be provided by markets and market signals. The WDR identified three institutional characteristics to improve the provision of public goods -- picking up signals early and from the fringes, creating fora to balance interests, and creating commitment devices to implement agreements over the long term. The WDR also emphasized that the burden of guaranteeing sustainable development must be shared locally, nationally, and globally. Developing countries needed to promote participation and substantive democracy, inclusiveness, and transparency as they build the institutions needed to manage their resources. Rich countries needed to increase aid; cut poor country debts; open their markets to developing country exporters; and help transfer technologies needed to prevent diseases, increase energy efficiency, and bolster agricultural productivity. The report added that civil society organizations contributed when they served as a voice for dispersed interests and provided independent verification of public, private, and nongovernmental performance; private firms contributed when they committed to sustainability in their daily operations and when they created incentives to pursue their interests while advancing environmental and social objectives; and governments contributed when they provided strategic guidance and an enabling framework for a variety of accountable partnerships between the State, civil society, and the private sector.

This is a fairly recent WDR; however, its impact is becoming apparent in a number of areas. Some of the concepts and topics highlighted in WDR 2003 (such as the important role of "spatial analysis" in linking economic, environmental, and social consequences of policy) have been incorporated into the ESSD network's work and poverty analysis. The inequality and governance issues raised in WDR 2003 parallel growing interest on these topics in the Bank. Some of the topics -- especially implementation issues -- require more research and are entering the Bank's research agenda. As for the larger development agenda, the WDR was presented at the World Summit on Sustainable Development in Johannesburg (in Aug/Sept 2002) which has generated has generated a number of follow-up requests to develop WBI courses for specific countries (in West Africa, Southeast Asia, China) and audiences. Perhaps one of the more significant impacts has been in China, where the staff working on the next 5 year plan in China have been required to read WDR 2003 by the National Development and Reform Commission and to take lessons from it to incorporate in the next plan. The NDRC has also requested the Bank to reflect some of the sustainability and urbanization issues raised in WDR 2003 in the Bank's work on China.

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