

**The Report of the Expert Committee on Legal Aspects  
of Bank Frauds  
2001**

CHAIRMAN  
**DR.N.L.MITRA**

1. Preface
2. Executive Summary and a Road Map
3. Chapter 1
4. Chapter 2
5. Chapter 3
6. Chapter 4
7. Chapter 5
8. Chapter 6
9. Illustrative Bill

National Law University, Jodhpur  
August 31,2001

Dr. N.L. Mitra,  
Chairman,  
Committee on Legal Aspects of Bank Frauds  
Reserve Bank of India

Dear Dr. Jalan,

**Submission of the Report of the Committee on Legal Aspects of Bank Frauds**

I am privileged to present to you the Report of the Expert Committee on Legal Aspects of Bank Frauds and an illustrative legislation to combat financial and bank frauds. Financial Fraud, per se, is no offence in India at present. Our recommendations include both preventive and curative aspects. The curative aspects include making financial fraud an offence with a shift of burden of proof. Serious financial frauds are required to be investigated by multi-dimensional investigative agency and to be tried in a fast track special court. In the preventive aspects, the committee recommended some systemic adjustment including making legal compliance report necessary and attaching certain functional responsibilities to the financial auditors.

2. We anticipate that there shall now be a national debate over the report and the draft legislation so that the Government may examine pros and cons before taking steps to legislative design. We request Reserve Bank to put the whole report and the draft legislation in its web site for such national debate. The report may also be sent to the appropriate authorities who are now seriously concerned with financial frauds.

3. We like to record our thanks to you in particular for the confidence reposed on us for this national task and your staff who supported us with all possible help. We are obliged to your Legal Department for extending all secretarial and other support.

With personal regards

Sincerely yours,

(N.L. Mitra)

Encl: as above

Dr. Bimal Jalan,  
Governor,  
Reserve Bank of India,  
Mumbai.

## **PREFACE**

The weakness of criminal law and criminal jurisprudence is writ large in the administration of justice in India. The common law pressure of the justice delivery system on account of 'proof beyond doubt' is very heavy especially in the offences relating to finance. The nation is suffering from a serious 'crisis of confidence'. No one can repose faith in others including entities and institutions. In such a situation, the banks and financial institutions can hardly grow. Such an atmosphere inflicts serious injury to the production and distribution system.

A fair economic system requires a fair financial system with public confidence bestowed on it. If we carefully note, India does not have a quality legal system to ensure quality credit. There is no single law to ensure quality of credit. Presently the only law that is used for creating security interest against credit is the Transfer of Property Act, 1882, which was designed in a feudal society and not for a dynamic system of ensuring comfort in trade, commerce and industry. In a feudal society predominantly with subsistence agriculture, possession and ownership of real property determines the social and political power structure. In a society with free trade, commerce and industry, movable properties including intangible are very important to ensure quality in the credit line. The main comfort in the credit system is the contract-sovereignty. Unfortunately, in India, parties to the contract cannot add efficiency in the mechanism of enforcement of security interest created in a credit-contract by the consent of both the parties.

Added with the above weakness, there is weakness in the administration of criminal justice. Financial fraud is not an offence in spite of the fact that the banks and financial institutions suffer heavily in frauds committed by the borrowers, more often than not, in collusion with the employees of the banks and financial institutions. In the last decade, instances of 'scam' have gone up. People, banks and financial institutions have suffered losses of thousand of crores. The situation is becoming explosive and can lead to anarchy at any time unless 'scam' is legally contained. Financial fraud is a very sensitive issue. It affects the public faith in the system structure. The whole banking system is predominantly based on public faith. Market systems are

structured in a society to ensure public confidence. Repeated market failure, undetected frauds in financial institutions and collusion of employees in financial fraud cause frustration in the public, which is a challenge to any good governance.

The Reserve Bank of India, by constituting this committee, following many other studies in this respect, has shown urgency in dealing with the menace through law and legal instruments. This committee devoted considerable time in researching into the issue and examined legal system of various countries in order to draw some analogy. The Committee ultimately submits its recommendations with a proposal of suitable legal intervention. Some provisions have been suggested to be added to the Indian Penal Code and the Criminal Procedure Code and some amendment suggested in the Indian Evidence Act. The Committee has suggested a Bill for establishing a Bureau for investigating serious financial fraud and has also suggested a fast track special court with sitting or retired High Court Judge to preside over. The Committee would like to have a national debate on its suggestion before the government acts on this report.

I am personally obliged to the Governor of the Reserve Bank of India for reposing faith in me for such an important task. I am also thankful to all the members of the Committee for very active participation and deliberation. Each one of them merits special mention. I will be failing in my duties if I do not mention the distinguished service of Mr. Antia, Advocate and Partner of Mulla and Mulla, Mr. Umarji, Executive Director of the Reserve Bank of India, Mr. P.R. Kulkarni, Deputy General Manager, Janakalyan Sahakari Bank Ltd., and our Member-Secretary Mr. S.C. Gupta, the Legal Adviser of the Reserve Bank. The Committee likes to put on record the services of the staff of the Reserve Bank of India who supported the Committee with all assistances in the meetings. We cannot forget those who from back ground sustained us with delicate dishes.

N.L. Mitra  
Chairman,

Committee on Legal Aspects of Bank Frauds

Dated August 31, 2001

### Executive Summary

1. **Financial Fraud and its ugly tentacles** : Financial fraud involving public fund is a matter of serious public concern and is an issue of governance. Presently, fraud as defined in the Law of Contract is only a civil wrong. But financial fraud is far too complicated to be treated merely as contractual or civil wrong. Of course, if an act of cheating, forgery, criminal breach of trust or embezzlement of funds or manipulation of accounts is involved in the fraud, it is an offence.
2. **Twofold approach** : There has to be two-fold approach to tackle bank and financial fraud. Firstly, preventive approach to minimize the number of incidents and secondly, prohibitive approach to deal firmly with incidents of financial fraud.
3. **System reform in banking practice** : Every bank, financial institution and financial intermediary should be required to develop Best Practice Code (BPC) within a time frame and submit the same to the regulator; make effective measures to internalize the BPC in its staff, effectively supervise the fictionalization of the BPC, control and monitor variation from the BPC, enforce BPC in the use of discretionary power and make documentation of the same, periodically review the use of discretionary power, conduct periodical legal system, audit and obtain compliance certificate.

4. **Insisting scrupulous following of regulator's guideline :** The job of the regulator is to insist on the compliance certificate from the institutions on regulator's guidelines. The degree of regulator's supervision and control has to be based on the number of defiance and non-compliance of guidelines and BPC. Growth of NPA must be linked with the degree of supervisory control and regulation and must relate inversely to future power of use of discretionary power.

5. **Financial fraud to be defined as an offence :** Financial fraud always calls for attention of the people. As a matter of fact, media has already distinguished 'scam' from 'fraud'. According to media practice, any act of defrauding the public that involves public fund such as government fund, public deposit, public investment, is an act of scam. The definition attributed to 'scam' by media and the public at large, is now worth for the legislature to recognize. In countries like UK or US, serious fraud or major fraud is an offence. Financial fraud in which a party commits a fraud by *suggestio false* or by *suppressio veri* or by culpable negligence, which results in loss of public fund or in denudation of public deposit or investment, is a major fraud, specially investigated by special agency in both UK and USA. In India there is an urgent need to attract legislative attention to such financial fraud to be seriously dealt with.

Financial frauds are required to be criminalized with the burden of proof to be shifted on the accused to prove absence of commission of fraud.

6. **Serious Financial Fraud :** A financial fraud involving an amount singly or in totality with series of transactions, rupees ten crore or more or causing national publicity and causing wide public concern; or where investigation and prosecution are likely to require high specialized knowledge of financial market conditions; or where cases require legal, financial, investment and investigational skills; or in cases which appear to be complex to the regulators, banks, capital market or appropriate governments; or cases involving international dimension, can be called serious financial fraud. It has to be treated separately.

7. **Separate Investigation authority for serious fraud :** A separate investigation bureau should be constituted with a Director at the head. The Bureau shall investigate all serious fraud cases (There is now a special cell in the CBI to deal with economic offences, which is to be made a full body on account of increase of such offences and complexity of the fraud.) Similarly, there should be a Committee to be constituted by nominees from all financial regulators, such as Banking, Insurance and Capital market to make preliminary inquiries in the allegations of frauds and advise the regulator whether such act amounts to financial fraud or to deal with such incidence of contractual or tortuous fraud.

8. **Who can approach the Bureau :** Concerned institution, concerned regulator, party suffering from fraud, Central Government, Court or the District Superintendent of Police within whose jurisdiction the offence has been committed and FIR lodged in a police station, may refer the matter to the Bureau if it appears to the party to be a fit case for serious fraud investigation. The Bureau shall establish in such places as the Bureau may determine from time to time.

9. **Special Court :** There shall be a Special Court or Courts constituted to try the cases investigated by the Bureau. Appeal against the decision of the Special Court shall lie to the Supreme Court.

10. **Search, seize and attachment of properties and funds :** The Bureau shall have sufficient number of investigators to be assisted by experts drawn from banks, insurance, capital market regulator, financial experts and information technologists appointed by the Bureau for such purpose. The investigator shall have power subject to the permission of the Court to search, seize

and attach any fund, account or properties acquired with such funds. The Special Court may confiscate such properties and restore the properties to the institutions defrauded.

**11. Tracing and restoration of property :** Properties acquired with amount defrauded can be traced even after conversion and the same can be attached. The court shall then forfeit the properties and restore the same to the institution from which the amount has been defrauded. The right on the restoration shall be *date ante*, i.e. as if the fraud has not been taken place. However, a purchaser or seller in good faith shall obtain compensation.

**12. Statutory Fraud Committee :** There shall be a Fraud Committee under the chairmanship of the nominee of the Governor of Reserve Bank of India and one nominee each from SEBI and IRDA. The nominee shall be an expert having knowledge and experience in banking, insurance, capital market operation and management, finance and management of financial systems. Any affected institution having an allegation against its own employee may either lodge FIR or may refer the matter to the regulator who shall send the matter to the Committee for enquiry and advise as to whether the case is fit for investigation by the Bureau or to be departmentally dealt with. If any case is referred by the District Superintendent to the Bureau, in such a case the Bureau shall also refer the matter for the advise of the Committee.

**13. Regular meeting of the Bureau with regulators sharing information:**

The regulators of the financial market shall periodically meet with the Bureau under the chairmanship of the Governor of Reserve Bank of India to share information and review actions taken in bank and financial fraud cases.

**14. Special prosecutors :** There shall be special prosecutors appointed by the Government for carrying on prosecution in major financial fraud cases investigated by the Bureau.

### **Road Map**

1. Draft a Financial Fraud Bill to :
  - (a) Definition of terms;
  - (b) Establishment of Financial Fraud Committee with allocated powers;
  - (c) Establishment of multi-disciplinary bureau for investigation of major financial fraud
  - (d) Power of the investigators
  - (e) Special prosecutor
  - (f) Special Court for major financial fraud
  - (g) Annexure –1 to criminalize financial fraud by amending Indian Penal Code
  - (h) Annexure –2 to amend the Indian Evidence Act to shift the burden
  - (i) Annexure –3 to amend Criminal Procedure Code to incorporate provisions for investigation by the officials of the Bureau
2. Preventive aspects to be notified by the regulator though guideline. The same is required to be infused and internalized by periodical motivational training
3. Fraud Committee may be constituted
4. Until the Act is passed, experts from banks, insurance, financial market regulators and finance should reinforce the financial offence investigation cell of the CBI. When the Bureau is constituted, the body has to be multi- disciplinary.
5. The liability of the Auditor is required to be fixed with provision for submission of report with required disclosure to the appropriate regulator.
6. In case of any allegation on account of fraud, the concerned bank and institution may (1) file an FIR with the Police; or (2) refer the matter to the Bureau/CBI; or (3) refer the matter to the Regulator to inquire whether the action of the in-house official was fraud or an act *bona fide* done in pursuance of business prudence.

7. The regulator may (1) refer the matter to the Bureau for investigation; or (2) refer the matter to the Fraud Enquiry Committee seeking its advice; or (3) refer the matter to the Government for taking appropriate action.
8. Annual report of the Fraud Enquiry Committee and the CBI/Bureau on Financial Fraud should be placed before the Parliament through the Ministry of Finance.
9. The regulator may stipulate time to institutions to draft their Practice Code and submit the same to the regulator to finally approving the BPC.
10. BPC for the discretionary power to be framed.
11. Monitoring strictly the variation where certificate of compliance is not given.
12. Annual legal system audit and compliance certificate to be insisted.
13. Regulator's guideline must be scrupulously followed.

## Chapter 1

### **CONSTITUTION OF THE COMMITTEE, TERMS OF REFERENCE AND HIGHLIGHT OF THE PROCEEDINGS**

**1. Constitution of the Committee:** The Board of Financial Supervision of the Reserve Bank of India has, for some time, been concerned with the increasing level and complexity of frauds and the difficulties being faced by the banks. Therefore, at the directions of the Board for Financial Supervision (BFS), the Reserve Bank of India constituted a Committee on Legal Aspects of Bank Frauds in August 2000. The Committee was constituted under the Chairmanship of Dr. N. L. Mitra, now Vice Chancellor, National Law University, Jodhpur, with the following members.

- (1) Mr. Raju Ramachandran, Senior Advocate, Supreme Court, New Delhi
- (2) Mr. K.S.Ravisankar, F.C.A.; Advocate, Bangalore.
- (3) Mr. B.H.Antia, Senior Partner, Mulla & Mulla and Craigie Blunt and Caroe, Mumbai
- (4) Mr.S.N.Sahai, Chief General Manager, State Bank of India, Mumbai
- (5) Mr. R.V.Iyer, General Manager, Bank of Baroda, Mumbai
- (6) Mr. M.R.Umarji, Executive Director, Reserve Bank of India, Mumbai
- (7) Mr.R.M.Joshi, Chief General Manager, Reserve Bank of India, Mumbai.
- (8) Mr. S.C.Gupta, Legal Adviser, Reserve Bank of India, Mumbai (Member-Secretary).

At the first meeting of the Committee, Ms. D.N. Raval, Executive Director, Securities & Exchange Board of India, Mumbai was co-opted as a member of the Committee. Subsequently, Shri P.C. Sharma, Special Director, Central Bureau of Investigation, New Delhi and Shri D.K. Tyagi, Director, Ministry of Finance (Banking Division), Government of India, New Delhi were inducted as Members. Later on, since Shri P.C. Sharma was elevated to the rank of Director of CBI and Shri R.M. Joshi was deputed to SEBI as Executive Director, their places were taken by S/Shri J.C. Dabas, Joint Director, Central Bureau of Investigation and M. Chellikutty, General Manager, Reserve Bank of India, Mumbai, respectively. Shri P.R. Kulkarni, Deputy General Manager, Janakalyan Sahakari Bank Ltd., was associated with the Committee as a special invitee.

The Reserve Bank of India (RBI) constituted this Expert Committee to examine issues related to fraud and to submit its report by the end of December 2000. In view of the fact, that the

Committee wanted to send a team of the members to UK and USA to examine the legal framework and the procedure of investigating and proceeding the term of the Committee was extended twice and the report of the Committee was required to be submitted within August 31,2001.

**2.The Terms of Reference:** The term of reference for the committee to address itself were as follows:

- (a) To define financial fraud and lay down procedural law to deal with financial fraud including the need for a special enactment in this regard;
- (b) To examine the process of investigation of bank frauds and prosecution of persons involved therein and suggest measures for improvement;
- (c) To examine and suggest measures to operationalise the recommendations of the Narasimham and Andhyarujina Committees relating to legal aspects of bank frauds;
- (d) To examine the need for special provisions for frauds perpetrated by staff of public sector banks; and
- (e) To examine the role of Reserve Bank of India with regard to frauds reported by banks.
- (f) In its second meeting, at the instance of the then RBI Deputy Governor, the Committee agreed to go into the frauds arising out of letter of credit, bill of lading and FCNR/NRI deposits accounts, etc.

**3.Debate Between Bank Fraud and Financial Fraud:** Since the terms of reference for the Committee included two terms, namely, 'financial fraud' and 'bank fraud' there was a considerable confusion to go for a conceptual clarity. Several issues came up for discussion, such as,

- (a) RBI expected the Committee to examine the issues relating to bank frauds in the light of recommendations of Narasimham and Andhyarujina Committee (This Committee did not deal with bank fraud. The Chairman of the present Committee and Shri Umarji a member of this Committee were also members of that Andhyarujina Committee);
- (b) Financial fraud may need to be comprehensively defined and it should not be dealt with half way through, specially because all financial frauds have somewhere involvement of bank frauds;
- (c) Financial frauds relating to capital and securities market are already dealt with SEBI regulations and hence dealing with all financial fraud in this committee would be difficult but gray areas may be covered to regulate areas which presently facilitate commission of fraud.

The Committee was very categorical and clear in its views that fraud as a 'market foul game' has to be regulated by the Regulator according to the nature of the work. It was also noted that if there was no regulator in any field of operation of law, it was the matter for the individual to bring the matter before the Court of law under the statutory legal provision or under the law of tort for seeking legal redresses. Regulators do not have any role to play once any act of a person or persons falls within the fold of criminal law. It was also noted that a regulator cannot criminalize any act of a market player by any regulation. Any foul play was required to be controlled or remedied by the Regulations. Criminalisation of an act of a person or persons is absolutely and exclusively the legislative power of the Union and the State. Naturally mandate of the committee cannot overlap with the functional power of any regulatory authority. However, the Reserve Bank of India requested the committee to advise the Reserve Bank about its responsibility in case any bank reports to the RBI about any fraud caused. So the Committee proposed to advise the RBI about its role within the regulatory framework as well. It was also noted that 'Financial fraud', if defined for the purpose of criminalisation, will be applicable in all cases when the same can be charged under a crime.

**4. Fraud: its dimension and typology:** The legal position in respect of frauds has three dimensions, viz., contractual; tortuous and criminal and are summarised as under:

**(a) Contractual dimension of fraud:** Fraud is defined in section 17 of the Indian Contract Act<sup>1</sup> (unlike UK law, where fraud is not defined and is based on common law practice) for the purpose of a contract and in so far as the operation of the Contract Act is concerned. In such event the contract becomes voidable. The party suffering from the fraud may terminate the contract on his option. He may also like to continue with the contract. Law provides absolute option to the concerned party as a special additional right to neutralize the advantage or gain by the party committing fraud. The court may also compensate him if he suffers from any damage before terminating the contract. But he has a burden of proof to show to the court that he was defrauded by the other party intentionally according to the definitional conditions laid down by the Act, that (a) a party having the knowledge of fact essential to the contract did not disclose the fact which would have altered the decision of the other party; (b) or a material misstatement was made knowing that the statement was false; and (c) that the party intended to obtain a favorable decision from the other party by committing such an act.

**(b) Tortuous dimension of fraud:** As a civil wrong with in the parameter of *right in rem* discourse, fraud covers any action or abstinence, statutory or otherwise, which may cause damages to other. Everyone has a right not to be defrauded in any situation. So if any fraud is caused on any person in any other situation other than the contractual situation whether it does or does not fall under any specified crime, the person can bring the matter to the notice of the district court for obtaining remedies. Thus, in any market situation, fraud is regarded as ‘foul’ play in the market game and as such, the regulator may neutralize the impact of the act by (a) penalizing the player by giving him warning for minor foul so that he does not dare it repeat (like showing a green card in a soccer game); (b) suspend him from the game; (c) debar him from playing the game permanently; and (d) impose penal compensation to indemnify the person suffering from fraud. For example, if the CEO of a bank has deliberately violated the financial prudential norm or guidelines in providing loan for any transaction, the Regulator may remove the CEO. If the regulations so provide, the regulator may even ask him to compensate the institution. **This Committee has nothing to do with these kinds of fraud related issues falling within the domain of the regulatory authorities excepting advising the RBI about its role in such a situation.**

**(c) Criminal dimension of fraud:** Fraud as such, is not a criminal offence in India. If any fraud is committed in a bilateral contractual situation or otherwise whether involving personal fund or public fund, also an act of cheating or if such an act involves impersonation, criminal breach of trust or criminal conspiracy, or forgery, or falsification or destruction of documents for wrongful gain, or embezzlement of funds, then and only then, such fraud can be an offence. Big ‘scams’ that often take place in the secondary capital market by way of ‘price rigging’ or ‘insider trading’ are not offences. These are ‘foul play’ only. In the next chapter these activities are examined so as to see how much gap exists in the substantive criminal law. However, in the example given in the last para, if the Regulator has any *prima facie* proof that the same act was done with an intention of wrongful gain to one or causing wrongful loss to another, or both, it becomes an offence. In such a situation, regulator may file an FIR and hand over the matter to the police for investigation and prosecution. The Committee shall consider how the offence relating to financial fraud, specially the major ones, can be effectively dealt with and how these offences are required to be investigated and prosecuted to obtain effective result. Very often, such activity or chain of activities brings long term and serious impact on the economy or/and adversely affect



the interest of the public or interest of the investors. The committee has to critically look into this area and point out the definitional limitations, if any, to adequately deal with financial fraud; procedure for expeditious investigation; steps for faster prosecution and judicial institution. If a new Act is necessary for all these, then the committee shall recommend the same as well.

**5. Is there any speciality in a financial fraud requiring a separate treatment?** It is important to bear in mind the distinction between a contractual or tortuous fraud and a financial fraud, briefly stated as follows :

(i) In contractual or tortuous relation, only two parties' interest is involved. It may be either of the contracting parties in case of fraud committed under a contract or one of the parties whose general interest is subjected to tortuous fraud. But in a financial fraud, interest of a third party or interest of the public is at stake, for example, a fraud involving public deposit, public investment or government fund.

(ii) Parties to the contract or in a tortuous situation having inverse relation each having strict interest to checkmate the other party to prevent commission of fraud but in a financial fraud, the interests of the contracting parties are not necessarily in adverse relation.

(iii) In a contracting situation or in tort, parties to the contract or the party defrauded in a tortuous situation, have the right to move the court to either terminate the contract or obtain compensation. But in a financial fraud, affected people do not have any status in the contract. As such, law has to provide special status to the affected people.

(iv) In a contract or tortuous situation, fraud may not necessarily involve direct financial interest, but in a financial fraud fund is a necessary condition.

(v) Dimension and impact of financial fraud often takes a shape of public concern. So the government has to be necessarily concerned. For example, whenever there is a story of a scam, the government becomes concerned. It disturbs the financial market, if not weaken it. It is the duty of the market regulator and the government to ensure that the market remains undisturbed. So financial fraud involves the public policy.

(vi) In both contractual fraud and criminal cheating by misstatement or suppression of essential fact as an element, is present at the beginning of the transaction. But all frauds do not become cheating mainly because of two issues:

(1) Fraud in contract is for obtaining an additional advantage. So if that additional advantage can be taken off from the party, why should it be called a cheating!

(2) In cheating, a public policy dimension is essential calling the attention of the state. In fraud that public policy dimension is not there in all cases because personal interest are the only criteria.

(vii) Financial fraud may not have suppression of information or misstatement. It may be concerned with deliberate attempt to price rigging in a financial market or playing with inside information to the detriment of hundreds of investors.

**As such, financial fraud calls for attention of the people. As a matter of fact, media has already distinguished 'scam' from fraud. According to media practice, any act of cheating the public that involves public fund such as, government fund, public deposit, public investment, is an act of 'scam'. The definition attributed to 'scam' by media and the public at large, is now worth for the legislature to recognize.**

**6. Methodology of the Enquiry by the Committee:** The Committee decided to follow both narrative and investigative methods for examining whether the present criminal law prescription

is enough for dealing with the financial fraud faced by banks and financial institutions. Accordingly, the Committee outlined the following:

- (a) A comparative study shall be made on criminalisation of financial fraud and dealing with the same in US, UK, Australia and European Community with that in India.
- (b) Study reports to be placed before the committee by various investigating agencies and the Department of Banking Supervision of the Reserve Bank.
- (c) Case studies are to be presented by CGM, State Bank of India, General Manager, Bank of Baroda; and DGM, Janakalyan Sahakari Bank Ltd.
- (d) A field study in UK and US by a team of Committee members to be made and a report on the study is presented before the Committee.
- (e) Investigational and procedural report is to be presented by CBI.

In pursuance of this, a team of members under the leadership of Mr. S.C.Gupta comprising, Mr.Sahay of SBI and Mr. J.C.Dabas of CBI visited UK and US and submitted the report before the committee.

**7. Job Analysis:** While Chapter two of this report deals with status of law and practice of Criminal law dealing with fraud, it is appropriate to note the nature of the present law and practice. The Committee in its meetings developed two opposite opinions on the adequacy or otherwise of the present realm of law and practice on criminalized fraud. The first opinion is in view of the Narasimham Committee report, which talks about absence of any coherent policy on financial fraud as financial fraud was never kept in view while defining offences of various kinds under our criminal legal regime. As a result, one-to-one offence of cheating or forgery is dealt with in the same manner as is done in case of financial fraud. Investigation is one-dimensional and the justice delivery is slow for which reason parties involved get enough time to destroy evidences and siphon all funds. According to this opinion, this committee is required to examine critically the present position in view of the need for protective cover to be provided for the financial institutions and banks and embellish the present legal situation by enactment of a new law. The other strong opinion was that there is no necessity of any new legislation. What is required is a multi-dimensional and specialized professional investigative system and a fast track justice delivery system. Keeping both these opinions in view, the following issues are discussed.

1. **Definitional limitation:**
- 2.

(i) ***On the question of intention in a chain of transaction:*** Financial fraud is generally committed not merely in individualized situation. They are committed in a series of contractual transactions between two parties in which public interest becomes the victim. An individualized definition of fraud-driven offence, like 'cheating' or 'forgery' makes intention as *apriori* condition. Most of the financial frauds committed between the contracting parties develop in course of transactions and the impact on the public interest being the victim is the result of *aposteriori* action of the contracting parties. An act of cheating requires an act to be done with the intention "up-front". Intention later on developed inside the transaction does not make it cheating. There is a typical contradiction in treatment under the Civil and Criminal law in matters of financial fraud. If the court finds an accused guilty in a financial fraud case in a contractual situation, the entire chain of transactions becomes void *ab initio* under the present contractual system. In some fraud related offence cases, the element of cheating is found by the court in later incidents also. It therefore means that Courts are inclined to believe that offences relating to fraud can be based on *aposteriori* intention. In a chain of contract, the intention at the

beginning might not be to defraud the people but for earning profit in a business but it may emerge after several years of contractual relationship between the parties. This is a typical scenario in banking fraud. The question, therefore, depends in all cases, whether these transactions are divisible or indivisible. In the eyes of Civil law, if these transactions are divisible, the moment a transaction becomes criminal, that transaction becomes void and terminated. Unfortunately Indian courts have never gone into this aspect of relation between civil and criminal law and did not develop compensatory jurisprudence though there are a few instances of the same. It is because courts either deal with criminal law or civil law at a time. Courts do not look at the legal system as a whole. One of the reasons for the trial courts to be both District and Sessions court is that courts are allowed to look to the inter-twin of the legal system as a whole.

(ii) *On the issue of relationship between the parties to checkmate each other to prevent fraud:* Narasimham committee was right in observing this definitional inadequacy. Definition given to fraud-driven offences, such as cheating, in individualized situation cannot respond to cases of multi-transactional financial fraud situation. There is extremely important difference between individualized fraud and financial fraud. In the former, parties to the contract (provided there is a contract) have adversarial relation, that is one will invariably try to checkmate the other in the rule game of contract so that the other cannot easily commit any fraud. But in a financial fraud case, the contracting parties do not necessarily have any adversarial interest. The aims of both the parties may converge. Thus, in such a situation both the parties to the contract may be willing partners or one can take advantage of negligence or ignorance of the other. This gives rise to a complicated situation of conspiracy. Proving criminal conspiracy in the framework of individualized situation is extremely complicated. Added with the same is the functional co-relation in institutionalized system. It is true that modern Criminal law in advanced countries has made corporate entities also subject to criminal liabilities. In India we are experimenting in the same line but not through classical Criminal law that is, through amendment to Indian Penal Code and Criminal Procedure Code. In some cases criminalizing through business law, say, Companies Act or by Negotiable Instrument Act has backfired creating confusion in the administration of Criminal law. Criminal law as a matter of fact, has to attain definitional perfection and at the same time delimit the area of offence with proper care. Police, prosecution, criminal courts and the prison are the ones to act in unison to maximise the effect of criminal justice.

(iii) **Tracing and restoration of the property:** Effective application of all the institutions can only ensure efficacy of criminal administration of justice. **Weakest link in criminal administration of justice is tracing of the property, especially in a financial fraud case. There has to be special power given to the investigator to trace forward the money or properties acquired with the amount defrauded and restoring the same from where these are taken.** Only this can ensure protection to public interest and at the same time guarantee individual's rights. Fraud-driven offences prescribed in the Indian Penal Code have definitional limitations in so far as organized financial frauds are concerned.

(iv) *Common law definition of fraud and its inadequacies:* The Common law definition followed in England is that any false statement or misleading statement or a statement recklessly made which is false or misleading in a course of transaction is a fraud. The Criminal Justice Act, 1987 of England follows the same tradition in two ways; firstly, by not defining fraud and secondly, by adopting a similar common law definition<sup>2</sup> in constituting certain associated offences related to serious fraud investigation. Therefore, English law takes the view that fraud

in the contract can become serious if it takes a public dimension. The fraud then becomes an offence. The Act has also not defined when a fraud becomes serious and leaves the matter to the discretion of **Serious Fraud Office(SFO)**. By way of a convention, **SFO** has already build up a practice of looking into all transactional frauds in which the amount involved is more than a million pounds<sup>3</sup>.

It is quite logical to think that any contractual relation, if it is confined in its entire “rights-duties-obligations,” must remain confined to parties themselves. In such a case if fraud is perpetrated by any party within the definition of fraud<sup>4</sup> and does not fall into the offences of cheating or criminal breach of trust or embezzlement of funds, may be dealt with by a civil court for causing fraud in a contract. But any such fraud committed by any of the contracting parties, which involves public money like depositors fund or investors fund, or government’s fund may be an offence if the transactional basis exceeds business prudence. As such, a fraud may be committed not only by suppression of essential fact or misstatement as to fundamental basis of contract at the beginning of a chain of transactions but may also take effect due to access to price sensitive information which may disturb the secondary capital market to the detriment of millions of investors or may even by forming a cartel by some market makers for rigging the price. Financial fraud takes different shape and character. Therefore, it is quite justified to differentiate financial fraud as a special offence because of the fact that there is the element of fraud in the sense of suppression of fact, or misstatements or playing with price sensitive information in a concealed manner or attempting to rig price in a market where thousands of investors’ or public fund is involved.

(v) **Major frauds:** Usual police and court system can deal with cheating or other existing fraudulent minor frauds. But a major fraud takes such a character, shape and size that it often takes a serious dimension having impacts on economy and administration of justice. As such, in such transactions, quicker multi-disciplinary investigation body and special court system may become necessary. Any misstatement or concealment of material fact or rash and negligent act or a statement, which is misleading resulting in third parties’ loss, should be a serious matter to be investigated. The incident is not required to be only at the initiation of the contract. The difficulty is that business is not a profession in India. No business bodies have taken the responsibility of defining business prudence either as an ethical standard or as a professional rule and prescribed best practice code and ethical standards. As such, suppression of material fact or falsification with or without intention is a common practice in our country. Rash and negligent statements are made without verification, which often causes material loss not only to the contracting party but also to many third parties. **Thus, there is a justification for criminalizing financial fraud falling beyond the purview of cheating and constitutionally validating serious fraud to be investigated by a specialized agency on the ground of reasonable classification.**

b) **Evidential Complexity:** From the point of view of law of Evidence, it becomes a challenge to prove (1) multi-transactional relations as separable, (2) identifying the causes of separability, (3) proving intention *apriori* in a transaction so as to make the offence explainable under the present framework as an individualized offence with only subjective proof without requiring any objective analysis. Though “motive” in Criminal jurisprudence provides the opportunity of objective analysis, all offences relating to fraud under Indian Penal Code do require no “motive” analysis. It is true that motive analysis is placed sometimes before the Court by the prosecution only for the purpose of proving ‘intention’. In a multi-transactional relation, this is the real hurdle. The committee had to discuss in length the evidential process as well. The Committee was of opinion that involvement of public fund or third parties investment or deposit or

contribution in any manner requires greater care and higher prudence. Similarly all the financial intermediaries and financial institutions dealing with public investments are required to prove beyond doubt their financial prudence to establish that there is no culpable negligence. **Therefore, wherever public fund, public deposit or public investments are involved and amount involved is more than ten crore and there is any suppression of a material fact or any non-disclosure of facts or negligence, or playing secretly with price sensitive information to corner the market, the burden of proof should lie on the party concerned to prove that the act or abstinence does not have any intention and hence not constitute financial fraud.** Similarly if more than one party are involved in the act or suppression, the burden of proof should lie on all the parties jointly and severally to prove that there is no criminal conspiracy. Similarly, **there should be legal presumption that all amounts deposited or invested by the party involved or his/her near relations after the commission of fraud without any definite explanation, shall be deemed to be a part of the funds alleged to have been defrauded. Properties acquired in own name or in the name of near relations, immovable or movable, the buying source of which cannot be explained, would also be presumed to be acquired with the whole or part of the amount defrauded.**

**c) Procedure of Investigation and Investigating Agency:** The most intricate problem relating to fraud-driven offences in multi-transactional financial relations between two contracting parties is the procedure of investigation. The investigation necessarily requires multi-disciplinary knowledge along with the expertise in the art and science of investigation. Often in a multi-transactional relation the intention or motive remains invisible at the time when the caucus is visible. In other words, the virus has been injected invisibly long back. Sometimes this is not so. Sometimes it is difficult for the investigators to analyze the motive and prepare a map sheet with motive analysis. The committee therefore devoted considerable time in evaluating the present procedure. Presently the Central Bureau of Investigation (CBI) has a special wing to investigate the financial fraud cases. The cell has representatives from the banking and financial sector. The way the onslaught on public funds and investments has been made in the last ten years is really phenomenal. Financial frauds are given a terminology called “scam” by the journalists. **As a matter of fact ‘corruption’ in the public office and ‘scam in the financial markets’ are the dreaded impacts of opening of the system that eat up all advantages of economic integration. These cause unaccountable misery to the people at large. Unless regulated, these social evils may explode the public anger and may result in anarchy any moment.**

In a Common law system, legislators observe the social phenomena and recognize such phenomena through enactments. ‘Scam’ has not yet entered into the literature of the legislative system. ‘Scam’ is not defined nor it is criminalized and therefore any bad name given or a punishment attributed is not according to the tenor of our present Criminal justice. In the absence of any definition, the investigators have these limitations for investigation. As for example, taking or sanctioning disproportionately larger amount of loan than the security provided is not an offence. Devaluation of the securities created in favour of a creditor is also not an offence. Excessive buying or selling behaviour (being tejiwala or mandiwala) is also not an offence in the absence of any definitional parameter of the behaviour of market players. Sanctioning loan to a debtor in violation of the prudential norm prescribed by the Reserve Bank of India, by a bank official can at best be a tort even if the behaviour cannot be explained by any norm of business prudence. Causation of such a tort because of violation of the instructions of the Reserve Bank, which is law in itself, is also not an offence in the absence of a clear definitional mandate to the investigators. So the investigators at present have the following limitations, (1) absence of clear

law; (2) limited access to sectoral knowledge in the team of investigation; (3) limited skill for investigating special kind of financial offences; and (4) the strength of investigating officials being far less than what is needed in a dynamic situation.

**d) Inadequate justice delivery system: The Committee is painfully aware that investment on Justice delivery system in India is poor. Post of Judicial officers are not created, if created not filled, if filled not trained, if trained no infrastructure is available. If everything is there, there is no trained prosecutor or adequate number of staff or proper investigators.** Input on training and knowledge on Indian judicial officers is either nil or negligibly molecular. The disposal rate though comparatively high in comparison with other countries but “important” cases continue to pile up. The condition of justice delivery system has become so bad that foreign parties are afraid of entering into any contract with Indians unless both of them agree to abide by the laws of some other country and select judiciary of another nation. The situation is really grave in administration of justice in financial sector. Proper legal rules are absent. **A vigilant brand of judicial officers sufficiently trained in financial systems can make things different because India follows the Common law tradition.** In England there is no criminal definition on fraud, yet Serious Fraud Office is established under the criminal law to investigate serious frauds committed in the country and their implications on the public interest like depositors or investors interest. If the impact is very high crossing a definitional threshold, the same is treated as an offence and prosecution takes place in the usual court of criminal jurisdiction. It is true that in advanced countries also jurists talk about the limitation of definition. **What the Committee means to emphasis here is that a good competent justice delivery system can act as an engine to drive the financial mobility of a country.** The committee therefore spent sometime on the consideration of this justice delivery system in the matter of financial fraud. It is true that the country is interested to see that parties engaged in matters of financial fraud are put behind the bar so that their numbers do not increase. The fear of punishment may moderate their behavior. This is in essence the center-point of deterrent justice system. But victims of crime in modern days give more importance to the restoration of their position by way of compensation than merely putting persons in jail. People are interested to see the ill-gotten properties, unaccounted resources obtained through fraud are quickly retrieved and such persons are put to heavy penalty. This is the core-philosophy in remedies available against tortuous situation. **It is true that tort law in India is not codified but it is also true that regulators are now prescribing their game rules on specific principles of tort law. Therefore sufficient attention must also be drawn to the tort law for remedying breach of right in rem of the depositors and investors.**

**e) Cross-border relationship:** With the increasing impact of global relations, investment flow, recourse to e-banking and cross-border contractual relations, it is quite possible that there shall be a spurt on number of incidence of financial frauds in India. Rule of law is itself a basic infrastructure in good governance, which includes appropriate game rule, adequate institutions, efficient justice delivery mechanism and immobilizing the rogues and ruffians. It also requires induction of knowledge, appropriate skills and efficiency in output-delivery system. In case this rule of law cannot be ensured, it is quiet possible that India may get the worst of globalization and our own capital also may fly. Keeping this in mind, the committee is also concerned with developing adequate game rules to deal with cross-border situations in financial frauds with countries having repatriation treaty with India.

**f) Summary of the task ahead:** The tasks ahead are :

- (1) Examine how the financial fraud can be defined and brought into an effective criminal justice jurisprudence;
- (2) What investigating agencies shall be necessary for effective investigation, tracing and attachment and restoration of the property and prosecution;
- (3) What type of justice delivery mechanism should be adopted to have quick and effective justice to investing public;
- (4) What effective regulations could be made effective to see that officials taking decisions based on business prudence and *bonafide* can be protected from unnecessary harassment in cases of investigation and prosecution on account of financial and banking fraud?
- (5) How cross-border financial frauds are required to be handled specifically in view of the questions of (i) Foreign judgment; (ii) Foreign proceedings; (iii) Indian Proceedings having foreign players outside the country; (iv) Help of foreign courts; (v) status of foreign and Indian legal representative; (vi) Foreign investigation by Indian investigator; (vii) Cooperation by Indian investigator in foreign investigation; and (viii) Enforcement of court decisions.

### **8. Suggestions in the basket of the Committee:**

In the fourth meeting of the Committee on 15<sup>th</sup> December, 2001, a draft definition was suggested by Mr. Antia as follows:

“Any person who on or after the appointed day by any statement, promise or forecast which he knows to be misleading, false or deceptive or by dishonest concealment of material facts or by recklessly making, dishonestly or otherwise, any statement, promise, forecast which is misleading, false or deceptive, and induces or attempts to induce another person (a) to make a deposit a sum of money with him or with any other person or (b) to enter into any agreement for that purpose, shall be liable on conviction to imprisonment not exceeding seven years or with fine or both.”

The Committee agreed to seriously consider the definition at the stage of drafting the statute. The following other suggestions were made by the members in various meeting of the Committee:

- (a) Special provisions for frauds perpetuated by staff should extend to banks in general and should not be restricted only to public sector banks.
- (b) A multi-disciplinary investigative body should be established under the proposed statute with direct accountability to the Parliament. There should be a provision in the Act to define the term ‘fraud’ by the disciplinary body. All bank fraud cases should be referred to the Reserve Bank of India for investigations and it should be left to the discretion of the Reserve Bank to decide whether the cases should be referred to the police for further investigation and filing the case in the court. Audit and inspection department should have cells to report the transactions directly to the Reserve Bank.
- (c) There must be a Special Court to try financial fraud cases, which are serious in nature. Ordinary criminal courts may try small financial fraud cases. From the Special court, the aggrieved party may take the matter to Supreme Court on appeal.
- (d) The law should provide separate structural and recovery procedure. The Special court must have criminal and civil jurisdiction. Every bank must have a domestic enquiry officer to enquire about the civil dimension of fraud. Above him there should be an adjudication officer and also a recovery officer to realize the amount and properties subjected to the fraud. The recovery officer should be appointed on the lines of the recovery officer appointed for recovery of debts.

- (e) A fraud involving an amount of ten crore of rupees and above may be considered serious and be tried in the Special Court.
- (f) It was suggested that there is a 'special bank fraud cells' in the CBI and therefore constituting a separate investigative agency may not be worthwhile. The Committee should also consider the suggestion of the Narasimhan Committee report to have a separate investigation force, which may be multi-disciplinary and having its organization structure like the one established under Customs and Excise Act.
- (g) The Financial fraud should include in its definition, diversion of fund, kite flying operations and alienation of security furnished to the banks.
- (h) The auditors and chartered accountants be made professionally liable for issuing false certificates on the financial fitness of the company and such act be treated as abetment to fraud.
- (i) There must be a provision of shifting of burden of proof upon the accused on the protection of property involving fraud.
- (j) It was also suggested that agricultural loans and small loans should be kept out of the purview of the fraud act.
- (k) There should be a separate provision for making the post-loan transfers void and to make provision for tracing up the property on the lines of Transfer of Property Act, 1882 in the proposed legislation.
- (l) The law must also provide in a separate chapter for trans-border financial frauds.
- (m) The responsibility of burden of proof is also to be shifted in the case of bank frauds.
- (n) The diarchic control on co-operative banks be replaced by a one uniform effective system.
- (o) There must be a separate provision for making the post loan transfer of assets put under security interest without the prior consent of the concerned bank or financial institution void.

**9. Highlights of the proceedings:** The committee held six rounds of meeting.

**The first meeting was held on September 30, 2000.** This meeting primarily discussed about the terms of reference, the methodology of functioning and analyzing the status report on law and practice relating to bank frauds. The committee decided to look into the broader framework of financial fraud and examine the issues of bank fraud as a sub-sect. It was nicely put by Mr. Umarji that "in all financial frauds somewhere banks will be involved". It is therefore better to deal holistically the financial fraud and then look to the banking fraud in specialty. The meeting also decided to examine different types of emerging frauds and also laid down the methodology of examining various issues by case study, comparative study with laws of U.S.A, U.K, Australia and some European Countries. The Committee also resolved to confine itself within the criminal dimension of financial fraud and address separately issue of tortuous liability to be handled by the Reserve Bank of India in bank fraud cases as a regulator.

**The second meeting was held on December 15-16, 2000.** Mr. S.P. Talwar, the Deputy Governor, addressed this meeting. It was also attended by Mr. P.C. Sharma, Special Director, CBI. In his address, Mr. Talwar extended the terms of reference by including financial fraud committed in trade relations and payment systems as well as operation of FCNR accounts. The committee agreed to the suggestion of studying eight to ten live cases in order to understand the size and dimension of frauds committed in the financial world. The committee requested Mr. Sharma to present a report on (a) the profile of economic cell structure constituted as a sub-sect of CBI; (b) a profile on bank frauds committed in India and 'investigated by the cell'; and (c)



difficulties faced by CBI in investigating financial fraud cases. The committee also requested Mr. Umerji to give an overview of frauds committed in FCNR/NRI accounts. In this meeting, several preventive aspects on financial frauds were discussed. The members stressed the need for development of a best practice code for banks and financial institutions, internalizing these best practices in the norms of behavior through motivation and training, both orientation and in service, developing a legal audit system and submission of compliance reports specifically pointing out deviances in rules and the reasons thereof, developments of prudential norms for the in house operation of banks and financial institutions and developing a vigilance system. The committee agreed to devote some time for the purpose of laying down essential guidelines for prevention of fraud as advised by the deputy governor. In this meeting, there were discussions on model definition of financial fraud as proposed by Mr. Antia. By and large the definition was acceptable to the members but the main problem of defining a fraud related offence with *a priori* intention remains in the definition. In U.K or U.S.A, a contractual fraud but having implication on public deposits or public investments is considered as a 'serious' or 'major' fraud and therefore such an act becomes an offence by virtue of its magnum size. For such a fraud to become an offence, *a priori* intention is not insisted on account of huge impact on public interest. In U.S such a major fraud happens when the amount involved is above ten million dollar. In case of U.K. an economic fraud gets the criminal dimension if the public money involved is more than one million pound. In India we do not have any concept of financial fraud to be criminalized even when the contracting parties are dealing with public money of high volume. Indian legal system makes no distinction between individualized fraud driven offences and financial fraud involving public money. The definition proposed by Mr. Antia does not materially change the position. The committee agreed to further consider the possibility of fine-tuning the definition proposed by him.

The committee also devoted considerable time for designing an appropriate investigating institution. There were two opinions firstly, that financial fraud, having regard to its intricate involvement concerning financial technique, banking and financial institutional machinery, money and capital market involvement, it is desirable that this ought to be multi-disciplinary investigating agency. The second opinion was that regard being had to special financial investigating cell in CBI, no new institution was needed. It was pointed out that this cell draws experts from banking and financial sectors. The members ultimately came to the conclusion that a separate institution will better serve the cause on account of involvement of CBI in multifarious activities and that it would suggest a separate multi-faculty investigative institution to deal with financial frauds.

The meeting also discussed at length about the necessity of having a separate Act to deal with financial and banking fraud in the line of Criminal Justice Act, 1987 of England. This Act, incidentally, established the Serious Fraud Office in England to investigate into all incidences of serious frauds.

**The third meeting was held on January 20, 2001.** In this meeting, the members of the Committee expressed the view that the Indian Parliament has legislative competence to create financial fraud as a federal offence applicable through out the country<sup>5</sup>. In so far as creating a new agency for investigation by the Indian Parliament it was felt that there is no Constitutional barrier. Even at present, the Court can allow anyone to investigate<sup>6</sup>. The judiciary is relying now more on the investigation by CBI in almost all variety of cases. Besides Entries 8, 45 and 48 of List I of Schedule VII of the Constitution relating to Parliament's legislative competence on Central Bureau of Investigation and investigation, banking; stock exchanges; and future markets

provide for the competence of the Union Government to make law for prescribing financial offences and providing for investigative machinery. The Entry 1 of List II of Schedule VII of the Constitution of India deals with public order, which is concerned with offences that violate public order. It was noted that there is no item in these two, which deals with investigation as the subjects of investigation of the Union List. The Police power to investigate offences is provided in Section 156 of the Criminal Procedure Code, 1973 which deals with enquiry into the offences under their jurisdiction with or without the warrant from the Magistrate, depending upon the cognizable or non-cognizable nature of the offence. Therefore, the members felt that there was no reason why Parliament cannot provide for creation of financial fraud as an offence and provide for multidisciplinary institution for investigation. By way of reference, it was pointed out that the Enforcement Directorate or the Customs and Central Excise force have been constituted with investigational power. Also, investigation has been not accorded to the State Police force by way of any Constitutional provision. So the Parliament can prescribe new offences under the Indian Penal Code or any other Act and can establish specialized investigation agencies.

In this meeting case study reports were presented by Mr. P.K. Sarkar, Deputy Managing Director and CFO of State Bank of India. As a fall out of the presentation, several matters relating to prevention of fraud came up for discussion including *inter alia* (i) in house operation to legal compliance and certification process; (ii) development of best practice code for observance of prescribed and professional code; (iii) in house watchdog; (iv) information networking between the member banks; (v) codification of standard audit practice on fraud and error; (vi) fraud defense networking; and (vii) special program for developing auditor's consciousness on fraudulent transactions in banks and financial institutions. The special importance in fraud related issue is timely intervention. If it is timely intervened subsequent actions can be brought under new offence as has been done in the Criminal Justice Act, 1987. But if one loses the time the virus of fraud may completely destroy the evidential system.

The role of internal staff of a bank in financial fraud was also examined in the meeting. The role of the staff can be divided under three specific heads. (1) Action taken with due diligence and in good faith; (2) Action taken negligently without regard to due diligence and (3) Transactions conducted in collusion. The case studies presented by Mr. Sarkar vividly explained that financial and banking frauds could not be accomplished without the participation of an internal staff. Frauds are committed usually in any one of the following ways – (I) preparation of letter of credit (LC) far in excess of the sanctioned limit, (ii) establishment of LCs in favour of associate concerns; (iii) sale of goods under an LC, in transit and diversion of sale proceedings; (iv) drawings on cash credit account beyond sanctioned limit; (v) diversion of funds; (vi) removal of stocks and securities; and (vii) non realization of receivables.

In an empirical study in Bangalore by a group of NLSIU scholars it was found that (a) most of the grass root level workers of banks are not conversant with RBI guidelines, instructions and directives; (b) grass root workers also not conversant with management of Non Performing Assets; and (c) most of the banks do not have their own standard of prudential norms, best practice code and any system of in-house study regarding legal compliance. In the Staff training these issues are required to be highlighted, skills provided and attempt to build up due diligence code inside the organization. Motivation therefore is very low. Staff concerned with FCNR accounts were found wanting in their knowledge about the Reserve Bank's governing principles and standards. **Therefore, this committee feels that equal importance must be given, if not more to the constructive and preventive side of the financial management to save the system from fraud. The committee therefore emphasizes, (i)**

**orientation training courses** for each staff at the time of recruitment and also at the time of promotion in order to understand the due diligence to be practiced on the desk; (ii) development of best practice code by every bank and financial institution for its own staff to make both internal and external evaluation of the staff performance; (iii) distribution of RBI and bank management guidelines, directives and instructions to every staff including the security staff; (iv) establishing an in-house legal compliance certification process to be enforced from each desk and specially from each management category staff making the staff accountable; (v) a reporting system to be introduced for making each variation from the norm, guideline, best practices and directives to the watchdog committee within a reasonable time of a decision taken in defiance to the guidelines, instructions and best practices; (vi) a critical auditing system to all credit transactions over a stipulated amount and documenting essential information about the customers for regular review; (vii) initiating motivating program for development of knowledge to critically appreciate fraud methodology by the auditors; and (viii) last but not the least, ensuring best practices to be followed in each desk for asserting rule of law in financial management. Law and legal principles are required to be internalized by each staff instead of entering into some contractual relations in ignorance of the legal system and then creating problem for the financial institutions.

**The fourth meeting of the Committee was held on February 24, 2001.** In this meeting Mr. Dabas of CBI presented a report on bank frauds prepared by the CBI. Mr. Dabas explained that in the majority of the financial cases, prosecution is based on the charges of cheating, criminal breach of trust (when there is trust relationship existing between the operator and the beneficiary), forgery and criminal conspiracy. According to him unless the *mala fide* intention could be established at the beginning of the transaction, it is not possible to submit the charge sheet. Non-observance or non-compliance or violation of instructions and guidelines of the regulator by the accused could be at best one of the grounds of establishing *mala fide* intention but could not be enough ground for *ipso facto* a charge. It was therefore pointed out by Mr. Sahai, a member of the Committee that intention of the party is the important factor and not the quantum of loss suffered by a bank. The opinion immediately highlighted the drawback on account of the definitional gap between civil law and criminal law on complicated issues like financial fraud. Here the beneficiary enriching without any cause does not have the burden of proof to show how such enrichment has been caused. It is the responsibility of establishing beyond doubt by the prosecution that the person had the intention to enrich at the beginning of transactional relationship entered into. In many of the offences relating to person the action presupposes the intention. A person attempting to rape commits the offence without any requirement of a proof that he intended to do so. In India, the first Law Commission while attempting to draft the Indian Penal Code deliberately avoided the concept of *mens rea*. The reason is also explained in the first and second Law Commission reports in which it was pointed out that the structure of the Indian society, as it was, warranted stricter criminal law principle than what was obtained in England. Unfortunately the Indian judiciary did incorporate the whole philosophy of *mens rea* in Indian Criminal jurisprudence. It has been done through interpretation of some of the definitions provided in the statute like, 'fraudulently', 'dishonestly', 'intentionally' etc. The definition was given specifically to these terms for the purpose of Indian judiciary not having the need to incorporate the Common law philosophy of *mens rea*. It protects an individual making an aggression against the rights of public depositors, public investors and financial institutions. Naturally they are the sufferers in the present legal system both on account of delay as well as on account of default in the codified criminal law.

The Committee also discussed in details about the task of the management of the banks and financial institutions on account of involvement of their staff. Theoretically contractual liability and tortious liability can be reposed on the entity through vicarious process. But it is not so in the case of crime. There was of course long debate on employer's liability to meet the laws due to employee's indulging in crime. In the Common law such a question is resolved in two ways. Firstly, everyone has a right not to be defrauded which is a right in *rem*. Violation of this right happens to be a tort. Therefore, employer is liable for the act of the employee to compensate the third party.

Secondly, an insurance product can be created for risk proportionalisation and indemnification through the collection of premiums from the entire community of depositors or investors and meeting the claim of those who suffer from financial fraud. The management can retrieve their sustained loss in the case of tort through regulatory mode of prescribing regulations making the staff liable to be penalized by the authorities in the event of violation of norms. From various presentations it was very strongly felt that public sector management generally take the regulatory mode with impunity in order to be good to the erring staff. It could be because of unlawful militancy of trade unionism, which indulges in-group demonstration to save their comrades in default. **One can sympathize with such management practice but cannot accept the standard. Anarchy in the nucleus could completely destroy the system.** Therefore, anarchy at any stage cannot be supported. Anarchy in the management is far more treacherous than the anarchy amongst the staff. It is not only the question of capability but it is also the question of character. A financial institution and a bank is in itself an SRO. The regulatory authority strengthens it further. In between these two organizations what is required to be ensured is that best practice norms are evolved and practiced by each and everyone. The regulators have to assure that anyone who indulges in norms breaking is quickly immobilized and ultimately weeded out. An active and vigilant SRO can minimize financial fraud to occur.

There was a debate on the prosecution of the staff. SRO has also to look into the affair and completely rule out participation of its staff from an act of crime. **No innocent staff should be harassed but at the same time no offender should go out of the clutch of the criminal law. Therefore each SRO must have in-house investigator.** If the SRO is convinced that the other contracting party is absolutely responsible for the fraud-driven offence and its own staff acted absolutely on due diligence and *bona fide* belief, the SRO may submit its in-house investigation report to the regulator and the regulator may take steps to see that such officers are not harassed in the case of investigation.

The meeting also discussed the problem in interpretation of the legal system. If the employee acted honestly and prudently without any deviation and following all norms there may not be any complication, though the regulator is put into the shoe of the judge. This itself is an objectionable step. A regulator cannot be a judge. More complication could arise when the staff is negligent. When this negligence is culpable, it is a matter to be decided by the Judge and not the regulator. It is therefore advisable for both SRO and the regulator to allow the investigating authority to investigate and collect all evidences from the SRO and the Regulator to show that the staff concerned does not have participation in the offence either through conspiracy or aid and abetment or by way of culpable negligence. **However any act done in good faith with due diligence shall have to be protected by the statute with a provision that officers holding the charge of a contractual relationship contested in a financial fraud case can be proceeded against only with the approval or prior consent of an authority of the regulator.**

Mr. P.R. Kulkarni presented a detailed study report on frauds committed in Co-operative Banks. According to him unsatisfactory level of caliber of the employees, lack of expertise, absence of vigilance set-up or preventive deterrent further the cause of fraud in the Co-operative banks. It has also been narrated how co-operative banks are allowed to play with political interference and unprofessional management. Mr. Joshi explained the dichotomy prevalent in the regulatory system of co-operative banks. According to him the supervisory dichotomy is because of the regulatory control of RBI and ownership and control of the State Government through the Registrar of Co-operative societies. It was suggested that a unified regulatory system must ensure efficient management of funds. Otherwise the Committee apprehends that bigger frauds may now come through ill-managed co-operative banks.

The meeting also discussed about an outline draft of a Bill and suggested that the Bill had to contain definitions like **adjudicating authority, appellate authority, attachment, financial transaction, financial intermediaries, proceeds of fraud, inter-connected transactions, officer in default, aiding and abetting fraud, financial fraud and banking fraud**. There should be **an establishment under the Director General of Investigation of financial fraud**. The office must have power to draw officers from stock market, financial market, banks and other financial institutions as also from the police staff for investigational purposes. A cabinet sub-committee comprising the Prime Minister, Home Minister and the Finance Minister could select the DGIF. The Director General must have an investigating authority in the form of a committee under his chairmanship composed of a nominee each of the Governor of RBI, Chairman, SEBI, Ministry of Finance, Ministry of Home Affairs, nominee of IRDA and two independent experts drawn from organizations like CBI and Central IB. The investigators must have the power of investigation under Cr.P.C and enquiry under C.P.C. In view of this peculiar nature of banking business there must be a sanctioning authority for prosecution on major frauds, which may be constituted by the RBI. Each investigating team must have multi-disciplinary framework.

**The fifth meeting was held on May 19, 2001.** In this meeting the delegates comprising Mr. S.C. Gupta, Mr. Dabas, Mr. Sahai placed their accounts on their visit to U.S and U.K to study the regulatory and Criminal justice system in so far as financial and bank frauds are concerned with. They explained how U.K had an open-ended definition of fraud and left the matter to the honest discretion of the SFO and the Crown's Court. The experience of civil society's participation in the fraud management network in the U.S was a novel experience. The Committee made detailed suggestions and also opined that existence of hard evidence could be the only good protection for proceeding against honest officers, but in case of any doubt; honest officers were not proceeded against.

The meeting again discussed about the position of officers in fraud related cases. Mr. Umerji's argument of ensuring the system where from mere deviation of norms or on the doubt of negligence a bank official ought not to be harassed was well appreciated for the purpose of defining a fair-trial system.

**The sixth meeting was held on June 23, 2001.** In this meeting the Chairman presented the draft of the Report of the Committee as also the draft illustrative Bill prepared by Shri Antia. While presenting the Report, the Chairman referred to the complexities connected with evidence mechanism followed by the common law judiciary. The draft Report also contained the discussions undertaken by the Committee and the status report of the fraud related legal systems prevailing in India. It also contained a comparative study of US and UK law as also the

principles adopted by the European convention on human rights. The draft Report also elaborately discussed the functions of Serious Fraud Office in UK. It also proposed the classification of frauds into serious and other frauds. Thereafter the Committee deliberated on draft legislation prepared by Shri Antia. It was decided that instead of Preamble, the draft Bill would provide an extended title. At the instance of the members of the Committee, it was agreed that the provisions relating to shifting of burden of proof, appeal to the Supreme Court, authority under the Act to investigate and the non-bailable and cognisable nature of the offence would also be brought into the Act.

## **Chapter 2** **STATUS REPORT**

**1. Jurisprudential test of a good legal system:** The competence of a government to tackle financial fraud is in doubt not only in India but also throughout the common law countries.<sup>7</sup> Lord Ruskil's Committee made 112 recommendations for tackling the financial fraud in England. Based on the Committee Report the Serious Fraud Office (SFO) was established in 1988. The Committee Report, however, did not look into the philosophical basis and the comparative strength and weakness of the Common Law System and the Civil Law system.

In any legal systems<sup>8</sup>, the following characters determine the effectiveness and efficacy of the legal system:

- (a) Certainty, clarity and definiteness of legal propositions;
- (b) Predictability of decisions;
- (c) Procedural equality in the rules according to principles of natural justice;
- (d) Appropriate institutional certainty and regulatory authority;
- (e) Definite imperatives, both moral and physical; and
- (f) Efficiency of the dispute resolution system based on proportionality to time, space and motion

It is therefore necessary for any law reform exercise to test the legal propositions suggested in the context of the above characters. It may be pointed out that the post 1956 syndrome of legislative process in India cannot pass any of the above tests. Legal propositions are not understood by the people for whom these are meant. There is no certainty in the legal system both on account of incompleteness and superfluous provisions. Legal propositions are far too complicated to have clarity. There is a high degree of procedural complexity and uncertainty. Sometimes appropriate authorities are not designed. If there are authorities, training learning device is not appropriately planned. Procedure of sanction is too poor and complicated. It is necessary therefore to examine the appropriate legal structure and test the same according to the above needs.

## **2. The Concept of Fraud in Common Law<sup>9</sup>**

Fraud as a concept not only involves criminal but civil liability as well. In legal parlance, a mere false statement cannot be said to amount to fraud. Fraud is said to be committed when one person causes another to act on a false belief by a representation, which she/he does, not believe to be true. Thus a person may not have definite knowledge or belief that a particular statement is not true.<sup>10</sup>

English law incorporates the principle of fraudulent misrepresentation as a ground for recession of a contract or a binding transaction into which the parties was induced to enter. In *Derry v. Peek*<sup>11</sup>, it was stated that fraud is proved when it is shown that a false representation has been made either knowingly, or without belief in the truth, or recklessly or carelessly, whether it be true or false.<sup>12</sup>

A fraudulent contract or transaction is voidable at the instance of the party suffering from the fraud or misrepresentation. The remedies available to that party who has been fraudulently induced to refrain from entering into a contract, extends to a claim for damages. In case the misrepresentation is such that a person is induced to enter into a contract, the representee can file an action for damages or repudiate the contract. The representee may also institute proceedings for the recession of the contract or transaction, or set up the misrepresentation as defense to any action or proceedings instituted for direct/indirect enforcement of the contract or transaction.<sup>13</sup>

As far as criminal liability for fraud is concerned, there exists a significant linkage with the concept of deceit. English statutory law fails to provide a definition of the offence of fraud. Stephens however provides a classic definition of fraud, which consists of the following two essential elements: *first*, deceit or an intention to deceive or in some cases mere secrecy; and *secondly*, either actual injury or possible injury or an intent to expose some person either to actual injury or to a risk of possible injury by means of that deceit or secrecy.<sup>14</sup>

Deception forms a very important part of the definition of fraud.<sup>15</sup> Deception in this context induces the victim to act to his own detriment and to the deceivers profit. A deception may also be fraudulent in the absence of an intention of leaving the victim financially worse off in the long run. It is sufficient that the deception induces the victim to take a risk which she/he would not have otherwise taken.<sup>16</sup> In the context of financial fraud, this may include a situation wherein a company falsely projects its market valuation, in order to attract investors to invest in the same. In the context of conspiracy of defraud, it had been held that this element of deception stands proved if it can be shown that the conspirators had the intention to defraud, irrespective of the outcome.<sup>17</sup>

As has already been stated above, deception may induce conduct of a particular nature. For example, by fraudulently representing to a bank official, a person may manage to transfer funds from someone else's account to her/his own.

Apart from deception, fraud in common law may also be committed by evasion of statutory prohibitions. Thus in a case where a person smuggled goods without encountering a customs officer, it was held that even though there was no element of deception, fraud could be said to be committed because the smuggling had been done in violation of statutory prohibitions.<sup>18</sup> Here again the principle that it is objective of the fraudster and not the methods employed by her/him is important, is reiterated.

In the context of organized crime such as financial fraud, the offence of conspiracy to defraud is also important. At common law it is in indictable conspiracy for two or more persons to agree to act unlawfully, and for this purpose it is unlawful to defraud a third party. The offence is punishable with 10 years imprisonment.<sup>19</sup> In order to prove conspiracy to defraud, it is important to show that the prejudice caused to the victim was intended to be caused by the conspirators, that is either it was their purpose or at least they knew this would be the effect of what they had agreed to.

The issue in the case of transnational crime however is that if the conspiracy took place outside the territory of a country, then where must the alleged offenders be sued? The *Whisky label case*<sup>20</sup> created some confusion in this regard. In this case, the respondents had agreed to

produce, label and distribute bottles of whisky in such a way that at the point of sale they could be passed off as a well-known brand. There was no question of the conspirators themselves selling the whisky to someone else. The court expressed the view that this was a conspiracy to defraud the purchasers, but since the offence was to be committed in Lebanon, the prosecution could not frame the above charge. This judgment has been criticized on the basis that the conspirators here had also intended to cause damage to the company by selling products fraudulently under its name, and that since the company was an English company, the jurisdictional problems could have been overcome.<sup>21</sup> Subsequent cases<sup>22</sup> which held that if the object of a conspiracy is to defraud within the jurisdiction then it is no bar to a prosecution that everything done in pursuance of the agreement is done elsewhere: it is enough that the parties' ultimate intention is to defraud within the jurisdiction.

Since intention forms a very important part of criminal law jurisprudence, the test must be the core intention of the offender. Applying this logic the Whisky label case seems to be correctly decided. This is because the main intention was to defraud Lebanese purchasers, and hence it was rightly decided by the court that due to jurisdiction problems the offence could not be punished.<sup>23</sup> Common law thus has wide confusion and uncertainty in formulating the basic legislative framework as to what is a financial fraud, which ought to be criminally treated.

### 3. "Fraud" in India

Though followers of Bentham were bent upon experimenting utilitarianism in the prescription of Indian legal system right from the days of first Law Commission headed by Sir Macauley, the codification of Indian laws was systematically based upon the British Common law system. Fraud *simpliciter* did not find its place in the definition of any offence in the Indian Penal Code, 1860. Of course, following the Common law structure, some definitions and some offences were culled out from the realm of fraud. A person is said to do a thing fraudulently, under this Act, if he does the thing with the intent to defraud but not otherwise<sup>24</sup>. Such a definition doesn't take us far except that intention is the key factor in acting fraudulently. The Roman law of *suggestio falsi* and *suppresio vari* also has the element of intention but anyone suggesting falsehood with intention of suppressing truth deliberately where it is needed to be expressed, commits only a civil fraud. Naturally, any act fraudulently done is not an offence. The fraud becomes offence when it becomes cheating. Whoever, by deceiving any person, fraudulently or dishonestly induces the person so deceived to deliver any property to any person, or to consent that any person shall retain any property or intentionally induces the person so deceived to do or omit to do anything which he would not do or omit if he was not so deceived, and which act or omission causes or likely to cause damage or harm to that person in body, mind, reputation or property, is said to "cheat"<sup>25</sup>. The other fraud-driven offences are cheating by impersonation<sup>26</sup>, breach of trust by a clerk or servant<sup>27</sup>, breach of trust by a public servant, banker, merchant factor, broker, attorney or an agent<sup>28</sup>, forgery<sup>29</sup>, making of a false document<sup>30</sup>, forgery of valuable security, will, etc.<sup>31</sup>, forgery for purpose of cheating<sup>32</sup>, using as genuine a forged document<sup>33</sup>.

## CHAPTER 3 ANATOMY OF FRAUD AND GUIDELINE FOR PREVENTION

### A few illustrations of financial fraud:

(1) The office bearer of a Stock Exchange having some confidential and price sensitive information about a company passes on the information to one broker to take his position in the



market causing a sharp fall in the price of shares. This is a financial fraud by way of insider trading.

(2) A company having raised its capital by public issue has not commenced business and is not traceable for any response to the shareholders. This is a financial fraud by a vanishing company.

(3) A person took project finance from a Bank creating a security interest by hypothecating its plant and machinery. The company afterwards transfers the plant without the permission of the Bank. This is a financial fraud by suppression of fact.

(4) A person having taken credit from a bank on the security interest of charge being created on inventories, described as sealed tins containing mustard oil, replaced the goods with 'tins with Ganga water'. This is a financial fraud by misstatement.

(5) A person floats a scheme for tripling money and raises public fund and vanishes with the amount. This is a financial fraud by cheating.

(6) A person opens a letter of credit on goods on transit by ship and transfers the goods on the way and taken the consideration without the information being communicated to the banker. This is a financial fraud by suppression of fact.

(7) A person opens a FCNR account with a power of attorney from an NRI and uses the same as the security interest on his overdraft borrowing. Money is removed from the overdraft account to another bank. This is a financial fraud by way of suppression of fact and misstatement.

(8) A person in debt intentionally doing an act for making the creditor unable to realise his credit, is a financial fraud by a fraudulent act.

(9) A plantation company collecting contributions from public with a promise that after twenty years a contributor of rupees one thousand would be paid rupees one lakh being the value of the contributor's teak plant allocated against his contribution, not found doing any plantation work at all or doing a sham work for a show, is a financial fraud by a false promise without having intention to perform.

(10) A company promising a time sharing resort and raising public fund without taking any step for the project implementation within a reasonable time and not informing the participants as to the cause of delay or not having any intention to perform the promise, is a financial fraud by fraudulent intention.

(11) A banker violating the guideline of the bank or of the Reserve Bank without acting prudently and sanctioning the loan with an intention of making a wrongful gain or providing an opportunity for gaining wrongfully by the debtor or causing a wrongful loss to the bank commits a financial fraud by fraudulent action.

(12) Any act of price rigging in the Stock Market is an act of financial fraud by a fraudulent act.

(13) A debtor creating security interest on stocks and shares at the market value and thereafter playing with the intention of reducing the value of those shares in the share market commits a financial fraud by fraudulent actions.

(14) An act, which in the event of insolvency or bankruptcy may be considered as fraudulent preference, is a financial fraud.

(15) A person transferring any fund from one account to another account by means of electronically operated system without proper authority, commits a financial fraud by fraudulent means.

(16) One or more interlinked Overseas Corporate Bodies (OCBs) from any foreign land specially through Mauritius (tax haven) route generating foreign investments for the purposes of playing in the stock market through a broker without any disclosure in order to rig prices, is a financial fraud because of *malafide* fraudulent intention.

The above are some illustrations of financial fraud. No one can imagine and prepare an exhaustive list of financial fraud. It depends upon human ingenuity and therefore methods and manners may take complicated route based upon the intelligence of the people who do it. Unscrupulous but intelligent financial giants resort new devices for committing financial fraud and siphoning money at the cost of the people. They take all the facilities of a soft state having uncertain legal process and a lenient or corrupt government. The illustrations above are only few instances taken from various case studies and reports just to explain the varieties in the methodology of committing financial fraud. The essential conditions are not very different. These are, (a) misstatements, non-disclosures, suppression of fact, using asymmetry of information as a method of wrongful gain; (b) a fraudulent intention of wrongful gain inflicting wrongful loss; (c) siphoning of public money like government funds, investors' funds or public deposits.

### **Prevention of fraud**

Bank frauds have been a cause for concern for the financial sector of many countries. The Reserve Bank of India, in exercise of its supervisory powers vested with it, has been focusing on the bank frauds perpetrated by staff and outsiders. The Reserve Bank of India has identified the following as fraud-prone areas.

- (1) Deposit Accounts
- (2) Issue/Payment of Demand Drafts and other Transfer Instruments
- (3) Discounting/Purchase of Telegraphic Transfers
- (4) Letters of Credit/Guarantees and Co-acceptances
- (5) Investments
- (6) Credit Portfolio
- (7) Other Common Frauds.<sup>34</sup>

The majority of frauds committed are through deposit accounts like Savings Bank, Current and Overdraft/Cash Credit, wherein there is a facility to withdraw cash either by cheques or withdrawal slips. The frauds are most likely to be perpetrated through:

- (i) Opening of accounts in fictitious names and then withdrawing therefrom the proceeds of cheques, drafts, etc. deposited therein. Moreover, some people open fixed deposit accounts in several fictitious names or in names of persons not liable to pay income tax and arrange of loans or overdrafts against the security of such deposits;
- (ii) Fraudulent withdrawals from properly opened accounts; and
- (iii) Manipulations in accounts.

The Reserve Bank of India has suggested some safeguards to prevent these kinds of frauds. These are specified below.

- (1) Opening of accounts and monitoring of new accounts – the opening of accounts should be personally monitored by the Branch Manager or the Officer-in-charge (in bigger branches). Due importance should be given to procedure of introduction in preventing the opening of accounts by undesirable persons. There must be a gap of at least 6 months between the time an introducer opens his account and the introduces another prospective account-holder to the bank.
- (2) Joint Accounts – banks should examine every request for opening of joint accounts very carefully. The internal control and vigilance machinery should cover the opening of joint accounts.
- (3) Accounts of Bank Employees – the accounts of the employees should be maintained in separate ledgers. All transactions relating to employees, by way of deposits, advances,

collection of proceeds, etc. should be subjected to strict scrutiny, taking into account the cadre of the employee as also the volume and size of transactions.

- (4) Dormant accounts – the deposit accounts which have not been operated upon over a period, of say two years, should be segregated and maintained in separate ledgers.
- (5) Operation of Accounts – there are two areas in the operation of accounts where caution is to be exercised.
  - (i) payment of cheques: due caution must be exercised in the verification of drawers' signature, custody of specimen signature cards, supervision over issuer of cheque books and control over blank cheque books/leaves. The banks should also consider fixing suitable ceilings beyond which no cash withdrawal should ordinarily be allowed, unless the account holder himself is personally present to withdraw the money.
  - (ii) Balancing of ledgers: the system of balancing ledgers periodically by persons other than the ledger keepers and the exercise of appropriate supervision will go a long way in prevention of unauthorised entries in customers' accounts.
- (6) Cheques, drafts and other instruments sent for clearing/collection  
The types of frauds in this category are:
  - (i) Collection of an instrument in the accounts of a party other than its payee.
  - (ii) Withdrawal of full amount before realisation of proceeds and subsequent failure of the party to make good the amount of the instrument is received back dishonoured.
  - (iii) Failure to send the instrument to the drawee branch.
  - (iv) Destruction of the instrument while in transit or at the drawee branch.
  - (v) Availing the 'withdrawal against clearing' facility against instruments known to have been drawn without funds.
  - (vi) One party and its associate or two different parties having accounts in two branches indulging in transactions mentioned in (v).
  - (vii) Unused cheques returned to banker shall be destroyed.
- (7) Monitoring of Deposit Accounts – the fraud here involves cash withdrawals for large amounts.
- (8) Precautions in respect of opening of accounts and issue of cheque leaves to customers/employees.
- (9) Irregularities in NRE/FCNR deposits
- (10) Deposit accounts in benami or fictitious names
- (11) Benami transactions by branch manager of a bank
- (12) Misuse of banking channels for violation of fiscal laws and evasion of taxes.

Instances of the payment of forged or altered drafts and mail transfers continue to be high and a matter of concern. The precautionary measures, which should be taken to prevent losses on account of fraudulent issue of these instruments, are indicated below:

- (i) Blank demand draft and mail transfer forms should be treated as security items and branches should take adequate safeguards against their pilferage.
- (ii) Banks should exercise abundant care and caution in the design, printing etc of the draft forms.
- (iii) Banks should supply all their branches with devices like pin point typewriters or protective cheque writers.

#### **Other preventive measures for frauds:**

1. Administrative measures for prevention of frauds

- (a) Recruitment of officers should be carefully verified;
- (b) All employees handling various duties should be made aware of the essential safeguards, which should be observed in the discharge of those duties;
- (c) The duties and responsibilities of employees should be clearly laid down;
- (d) The principles of dual custody and not allowing any voucher, register, ledger to remain unchecked by a higher authority should be observed at all times;
- (e) Banks should take steps to transfer their officials at reasonable intervals and insist on their going on leave periodically. The retention of official continuously at the same branch in charge of the same portfolio had been a contributory factor in the perpetration of frauds;
- (f) Checking on the life style of employees;
- (g) Disciplinary actions;
- (h) Maintenance of security items, records, etc;
- (i) Educating the public; and
- (j) Strengthening the machinery of internal controls.

Additional measure of internal control for safeguarding bank's interests in the following cases:

1. Balancing of transactions relating to clearing of cheques, drafts, etc.;
2. Books of instructions;
3. Material alterations in a cheque – if the bank is convinced that fraud has been committed by its staff towards any constituent, it should at once acknowledge its liability and pay the just claim instead of unnecessary litigation;
4. Prompt communication of contents of Reserve Bank's circular to branches and other offices;
5. Furnishing of opinion reports on borrowers;
6. Safe custody of specimen signatures of officers;
7. Regulation of the issue of blank cheques by banks;
8. Grant of advances against third party deposits;
9. Fraudulent encashment of foreign currency;
10. Periodical balancing of books;
11. Setting up of audit committee of board of directors;
12. Frauds in FCNR/NRI accounts;
13. Fraud by parties promising to arrange for large deposits;
14. Credit monitoring system; and
15. Grant of advances to a Group of concerns by several banks.

### **Classification of frauds**

Frauds can be classified into the following:

- (1) Misappropriation of cash tendered by a bank's constituents and misappropriation of cash in remittances.
- (2) Withdrawal from deposit accounts through forged instruments.
- (3) Fraudulent encashment of negotiable instruments by opening an account in fictitious name.
- (4) Misappropriation through manipulation of books of accounts.
- (5) Perpetration of frauds through clearing instruments.
- (6) Frauds in demand drafts – issue and encashments.
- (7) Misutilisation/overstepping of lending/discretionary powers and non observance of prescribed norms/ procedures in credit dispensation.
- (8) Opening/ issue of LCs, bank guarantees, co-acceptance of bills without proper authority and consideration.

- (9) Frauds in foreign exchange transactions through non adherence of RBI's prescribed norms and procedures.

### **Modus operandi**

The modus adopted for perpetrating bank frauds continued to be (a) opening of new fictitious deposits accounts by persons not properly identified by the bank followed by deposit of fake/stolen/forged instruments in such accounts and immediate withdrawals of the proceeds, (b) submission of false stock/financial statements to avail of finance, (c) clandestine removal of goods hypothecated and siphoning of sale proceeds, (d) acceptance of deposits both Resident and Non-Resident through middlemen and thereafter allowing/availing of overdraft against fraudulent discharge of these deposits receipts by forgoing power of attorney and loan documents of third parties who were also not properly identified, (e) raising of accommodation bills, (f) kite flying,<sup>35</sup> (g) manipulation in outward/inward clearing, (h) raising unauthorised debits on nominal heads of account, (i) manipulating and tampering with the books of accounts by passing unauthorised entries, (j) sanction of one time ad hoc credit facility to non-clients, (k) issue of letter of Credit, Bank Guarantees without recording in the branch books, (l) issue of pay orders/demand drafts without consideration, (m) fake documentation, etc.<sup>36</sup>

### **Detection of frauds**

The existing format of reporting does not contain the information as to how the fraud is detected. Some frauds get detected during the course of reconciliation of outstanding entries in nominal heads of accounts or impersonal accounts. Others surface on account of depositors lodging a complaint for non-receipt of deposit receipts. The frauds perpetrated by means of forged security documents were noticed only when the security was enforced for recovery of outstanding amount. In most cases, the knowledge of fraud is due to an anonymous complaint of change in incumbency.

### **Investigation and staff side action**

Investigations concentrate mainly on fixing staff accountability and were more in the nature of initiating staff side action. Investigations lacked objectivity, fairness and critical analysis. With respect of staff side action, it is evident that in the case of fraud, the members of staff were placed under suspension immediately after the bank reached to the conclusion of their involvement in the commission occurrence of fraud. Often there is a delay in lodging FIR before the police or filing complaints before the courts. There is also a delay in disposal of bank fraud cases. The cases of fraud, involving dishonesty, misappropriation, criminal breach of trust, cheating, forgery etc. are covered under sections 403 to 409, 417 to 420 and 465 to 477 A of the Indian Penal Code and these offences are triable by the Court of Magistrate. Normally it takes more than 5 to 10 years before the case comes for hearing.

### **Circumstances which facilitate the perpetration of fraud**

The following factors facilitate the perpetration of fraud:

- (1) Wrong persons got introduced both in deposit and borrowal accounts without detailed enquiry/scrutiny and thus were given access to banking services.
- (2) Certain persons acting as Middlemen/brokers without proper identification were entertained as agents of so called depositors/ borrowers.

- (3) Large credit, debit and cash transaction in newly opened accounts did not arouse the suspicion of the staff and no attempt was made to verify the genuineness of the transactions with reference to the business of the account holder.
- (4) Reconciliation of inter-branch accounts, clearing adjustment account, follow-up of large outstanding entries in the nominal heads of accounts remained pending for a long time.
- (5) The role of controlling office particularly in regard to receipt and scrutiny of control returns and house keeping was far from being effective.
- (6) There were huge arrears in the areas of balancing of books.
- (7) The bank's critical stationery, its stock on hand, indent, custody, issue, movement, loss etc, was not properly monitored.
- (8) Appraisal and review of borrowing accounts were carried out as a matter of routine and early warning signals were not acted upon.
- (9) Inordinate delay in completion of investigation of detected frauds by Investigating Agencies and also delay in completion of departmental action not only failed to send a clear and strong message to the errant staff but also demoralised honest staff who because of the case being treated as composite one, came within the purview of investigation.
- (10) Unlimited computer access was provided to vendors and staff not related to the book-keeping and supervision.
- (11) The system of concurrent audit as operative in the banks failed to achieve its objectives inasmuch as the early signals of gross irregularities were not timely reported and acted upon.

#### **Chapter 4**

### **COMPARATIVE STUDY OF U.S AND U.K LAW**<sup>37</sup>

#### **1. Legal Regime Governing Financial Fraud in the United Kingdom**

The Serious Fraud Office<sup>38</sup> deals with issues of serious fraud in the UK. In case a financial fraud is considered to be of a serious and complex nature, the SFO takes up the responsibility of investigating and prosecuting the persons concerned.

The SFO was set up under the Criminal Justice Act, 1987.<sup>39</sup> The SFO became fully operational in 1988. Its immediate objectives included:<sup>40</sup>

1. The development of a coherent approach to the investigation of serious fraud;
2. The development of expertise in specialist areas, such as stock exchange fraud, insurance fraud and computer fraud;
3. The more efficient use of the new procedures established by the Criminal Justice Act, 1987<sup>41</sup> for prosecuting serious and complex fraud; and
4. The presentation of cases in new and more accessible ways so that juries could understand the issues.

The SFO is accountable through its Director to the Attorney General and to the Parliament. The Director is required to make an annual report to the Attorney General on the discharge of her/his functions. In addition to the Director, the SFO is staffed by a Deputy Director, a Chief Accountant and a hierarchy of assistant directors (who are lawyers or accountants), other lawyers, investigators and accountants, and administrative staff.<sup>42</sup>

In this chapter the functioning of the SFO will be looked into detail. As such the emphasis will be on the investigation procedure of the SFO the manner in which trials of serious frauds are conducted and the difficulties that are faced by the SFO while discharging its responsibilities.

### **Investigation of Serious fraud:**

There is no statutory definition of serious fraud in the UK. Section 1(3) of the Act, 1987 empowers the Director of the SFO to “investigate any suspected offence which appears to him on reasonable grounds to involve serious or complex fraud”. Since there is no definition of serious fraud, the Davie Report made recommendations on the criteria that the SFO should adopt while deciding whether to accept a case. These recommendations which have been implemented, lay down the following:<sup>43</sup>

1. The cases involved should be such that the sums involved were in the order of at least £1 million.
2. Cases, which are likely to give, rise to national publicity and widespread public concern.
3. Cases where the investigation and prosecution of the case was likely to require highly specialised knowledge of, e.g., stock exchange practices or regulated markets;
4. Cases involving a significant international dimension;
5. Cases where legal, accountancy and investigative skills needed to be brought together; and
6. Cases which appear to be complex and in which the use of Section 2 powers<sup>44</sup> must be appropriate.

Once a case is referred to the SFO it is vetted to decide whether it ought to be accepted for further investigation. The vetting process incorporates factors such as the nature of the allegation, the suitability of the case for investigation by the SFO as opposed to another body, and the resources available to deal with any investigation.<sup>45</sup>

When a case is accepted, a case team of lawyers, accountants, police officers and support staff is appointed. A lawyer, who as a case controller is responsible for ensuring an expeditious and effective investigation and for any ensuing prosecution, heads the team.<sup>46</sup>

Unraveling major fraud often involves examining vast quantities of documents left in a deliberately obscure and fragmented form. In order to properly evaluate the information contained in such documents, the documents are seen by experts such as police officers, accountants, lawyers, bankers, stockbrokers and computer specialists etc, with a view to producing the information in a compact and coherent form for presentation in court.<sup>47</sup>

Case conferences are held at regular intervals throughout the investigation providing a forum for agreeing joint lines of action. They are attended by representatives from all the different disciplines from the case team, including prosecuting counsel, who are engaged at an early stage. At the conclusion of each case a final conference is held to review the case and learn from the experience gained.<sup>48</sup>

### **Powers of the S.F.O. under Section 2 of the Criminal Justice Act, 1987:**

The powers granted to the SFO under Section 2 of the Act, 1987 are said to be the most important feature of the legal regime relating to investigation of the serious fraud by the SFO. Briefly put, these powers are<sup>49</sup>:

1. The power to require persons to answer questions or furnish information with respect to any matter relating to the investigation- the interviews are conducted by a lawyer or an accountant and not by the police. The interviews are taped and copies of the same are provided to the interviewee. With regard to the power of

questioning of the SFO it has been considered at what stage of the investigation must such questioning cease. In *R v. Director of S.F.O., ex p. Wallace Smith*<sup>50</sup> it was held that the powers conferred by Section 2 extended to “any matter relevant to the investigation” and that investigation did not cease when a suspect was charged.

2. The power to require persons to produce documents and to take copies of them and provide explanations- a question which arises for consideration here is, whether the SFO must identify the documents which are required to be produced. Arguments for both sides can be put forth. Keeping the wording of Section 2 (3) in mind, which expressly refers to “specified documents”, it could be argued that the SFO must identify the documents required to be produced. However, there may be situations where the SFO has no knowledge of the nature of documents available with a person, except that the person concerned has in their possession documents that are relevant for the investigation. As a pro-active measure it could be said that as far as possible the SFO must ask for specific documents, and in the absence of such knowledge it would be up to the court to authorise production of all concerned documents.

The above power of the SFO is not merely limited to the persons under investigation, but also extends to third parties. In *R. v. Director of S.F.O., ex p Saunders*<sup>51</sup>, it was held that the SFO’s right to require production of documents, by third parties at least continued after the charges had been laid. However, as obiter dicta it was also stated that as long as an undertaking not to disclose the documents existed the person had a ‘reasonable excuse’ for failing to comply with the notice.

3. The power to search for and seize documents- Sections 2(4)-(7) provide that the SFO may apply to a justice of the peace for a warrant to search for, and seize, documents which it appears may be relevant to the investigation. The provisions apply where it is believed that the recipient of a Section 2 notice might destroy or conceal the documents rather than comply with the notice, where it is not practicable to serve a notice, or where one has been served and has not been complied with. Section 2(6) stipulates that a member of the SFO or a person authorised by the Director shall accompany the constable executing the warrant.<sup>52</sup>

Keeping in mind the sweeping nature of these powers the following safeguards are also built into the Act, 1987, in order to prevent abuse:

- ⚡ **Inadmissibility of statements:** Section 2(8) of the Act provides that a statement given in response to a requirement imposed by Section 2 may not be used in evidence against the defendant in subsequent criminal proceedings, unless the subsequent proceedings are on a prosecution for an offence of deliberately or recklessly making a false or misleading statement, or on a prosecution for another offence where, in giving evidence, the defendant makes a statement inconsistent with Section 2.
- ⚡ **Reasonable excuse and other safeguards:** A person may refuse to comply with the requests made by the SFO under Section 2 if the person has a ‘reasonable excuse’ to do so. The term ‘reasonable excuse’ has not been defined by the Act.<sup>53</sup> We thus have to turn to judicial interpretation. In *R v. Arrows Ltd (No.4)*,<sup>54</sup> the SFO sought production of documents held by liquidators, on the ground that even though the Companies Court had made an order prohibiting disclosure of certain transcripts, that



would not provide the liquidators with a 'reasonable excuse' for failing to produce the same before the SFO. Rejecting this argument of the SFO it was held that in the absence of an express provision, which overrides the powers of the Court to hold documents, the liquidators could be said to have a 'reasonable excuse' from withholding documents that they held under the orders of the Court.

The scope of the observation seems to be limited to cases where the documents are held in the custody of the court, in the light of the decision in *A v. B Bank (Governor and Company of the Bank of England intervening)*<sup>55</sup>. In the present case, A had obtained an injunction restraining B Bank from disclosing documents and information. The bank of England had served a notice under the Banking Act, 1987, s.39 that confers on the Bank of England powers similar to those conferred on the SFO under Section 2 of the Act. It was held that the injunction did not give B bank a 'reasonable excuse' for failure to comply with the Section 39 notice. The basis for the decision was that the documents here belonged to A or B bank—they were not in the custody of the court, as is the case in liquidation proceedings, where the documents are in the custody of the court.

From case law it appears that the following do not constitute a 'reasonable excuse':<sup>56</sup>

- a. The person under investigation has been charged;
- b. The recipient has not had the opportunity to apply for legal aid, or has not been legally advised and is not legally represented;
- c. The SFO has not disclosed to the interviewee the nature of its inquiries or the areas upon which it seeks to question her/him, or has not given her/him advance disclosure;
- d. The recipient may be obliged to incriminate her/himself;
- e. The recipient of the notice is subject to a court order securing compliance with an obligation, the existence of which, of itself, does not amount to a reasonable excuse
- f. The recipient is the spouse of the person under investigation and is therefore not a compellable witness for the prosecution<sup>57</sup>
- g. The information or documentation sought is confidential.

From the above discussion it is clear that the term 'reasonable excuse' has been interpreted narrowly in the context of serious fraud investigation. In fact the distinctions drawn between admissibility of evidence and investigation of serious fraud in *R v. Director of S.F.O., ex p Johnson*<sup>58</sup>, is significant here. The suggestion seems to be that at the initial investigation stage the SFO must be able to gather all possible clues to get to the root of the crime. Once the investigation is complete and the evidence is presented at the prosecution stage, evidence could be sieved out on the rules of admissibility of the same. The inference one can draw is that rules of admissibility and appreciation of evidence must not hinder the investigation process of the SFO since purportedly illegal clues could lead to direct and significant evidence relating to the crime.

Apart from reasonable excuse, Section 2(9) of the Act permits the withholding of information or documents on grounds of legal professional privilege<sup>59</sup>, and Section 2(10) on grounds of banking privilege. Public interest immunity can also be invoked.<sup>60</sup>

## **Section 2 powers and the European Convention on Human Rights:**

The European Convention on Human Rights recognises the principles of fair trial and the right to privacy of a person<sup>61</sup>, both of which may come under a challenge as a result of the extensive powers of the SFO in Section 2.

In *Saunders v. United Kingdom*<sup>62</sup>, Saunders alleged that the use by the prosecution at his criminal trial of transcripts of evidence, which he had given to inspectors appointed by the Department of Trade and Industry to investigate the affairs of Guinness, contravened Article 6 of the Convention. Saunders contended that the use of powers conferred by the Companies Act, 1985, S.434, which were backed by the sanction of imprisonment if he failed to comply, deprived him of a fair hearing.

The European Commission declared his claim as admissible. The majority found that a person who incriminates himself under threat of punishment and provides evidence for use against himself at his trial might be seriously prejudiced. The Commission concluded that it was not compatible with the spirit of the Convention that varying degrees of fairness should apply to different categories of accused criminal trials. The Commission further stressed that the privilege against self-incrimination is an important element in safeguarding an accused from oppression and coercion during criminal proceedings.

Apart from the decision in Saunders' case, in other areas also the SFO's powers may be challenged. For example, as we have already discussed the scope of the 'reasonable excuse' defense is extremely limited. The distinction drawn is one between admissibility of evidence and investigation. It may be argued that certain investigation may itself lead to incrimination. For instance, the SFO can use the documentation and information obtained by use of Section 2 powers from a person under investigation to identify, procure from other sources, admissible incriminating evidence against a proposed defendant.

In *Funke v. France*<sup>63</sup>, the European Court did look into the above matter. In the present case Funke was asked to produce bank statements, which he refused to do so. Funke was convicted for refusing to produce documents. Funke challenged the same as being violative of his right to fair trial. Rejecting the argument of the French government, that the actions of the authorities were in public interest, it was observed that even though it may be necessary to conduct house searches and seizures to obtain physical evidence, the law must contain safeguards such as requirement for a judicial warrant of search etc. The court also looked into the difficulties, which were encountered by states while investigating and prosecuting fraud. However, they emphasised the need for "proportionality". The Court stressed that the powers conferred were very wide and that the customs officers had exclusive competence to assess the expediency, frequency and scale of their exercise. Further, there was no requirement of a judicial warrant.

From the above trend of case law it appears that principles of fair trial cannot be violated even in the light of serious crimes such as financial fraud and that the powers of the investigator would have to be exercised proportionately as compared to the rights of the alleged offenders. Such an approach was clearly stated in the *Saunders case* by the European Court of Human Rights.<sup>64</sup>

### **Presentation and Prosecution of a fraud case:**

Usually a fraud case is looked into by the magistrates' court. The Criminal Justice Act however creates a procedure for transfer also, by which a case can be transferred from the magistrates' court to the Crown Court without committal proceedings. The power to transfer a serious or complex fraud case is vested with "designated authorities", which consist of the

Director of the SFO, Director of Public Prosecutions, the Commissioners of Inland Revenue, the Commissioners of Customs and Excise and the Secretary of State.

In prosecutions conducted by the SFO, counsel are in practice instructed at a relatively early stage of the investigation, and the decision to transfer a case is made by the case controller in the light of the counsels advice.<sup>65</sup> Section 4(1) of the Act lays down the criteria under which the power to transfer can be exercised. These are<sup>66</sup>:

1. If the defendant has been charged with an indictable offence;
2. If the designated authority is of the opinion that the evidence of the offence charged
  - i. would be sufficient for the proceedings against the person charged to be transferred for trial, and
  - ii. reveals a case of fraud of such seriousness or complexity that it is appropriate that the management of the case should without delay be taken over by the Crown Court; and
3. A notice of transfer is served not later than the time at which the designated authority would be required to serve a notice of the prosecution case.

The requirement of ‘sufficient evidence’ usually means ‘sufficient evidence against the accused to put him on trial by jury for the offence charged’. This requirement in contested committal proceedings requires proof of only a *prima facie* case or case to answer.

Section 4 (1) (b) (ii) of the Act requires the designated authority to have regard to case management considerations in deciding whether to transfer a case. The kind of factors that will usually determine whether a transfer is appropriate include:

1. The number of defendants and charges laid;
2. The nature and seriousness of the charges laid;
3. Whether there is a combination of fraud charges and other charges which cannot be transferred, so that a transfer of the fraud charge would result in fragmentation of the case;
4. The complexity of the factual and legal issues involved;
5. The volume of documentation (in terms of both witness statements and exhibits); and
6. Listing considerations- for example, the prosecution will wish to avoid the case being delayed in the magistrate’s court.

Even though Section 4(3) of the Act states that a ‘designated authority’s decision to give notice of transfer shall not be subject to appeal or liable to be questioned in any court’, in *R v. Salford Magistrates’ Court, ex p. Gallagher*<sup>67</sup>, it was held that a designated authority’s decision to transfer a case was subject to judicial review. Since such a challenge would be made on the basis of bad faith etc. it would be appropriate to challenge the merits of such a decision by applying for dismissal of transferred charges under Section 6 of the Act. This is because the Act does not require the designated authority to state its reasons for deciding the transfer. This omission in the view of the researchers is uncalled for. As we have already observed, the decision to transfer is made by looking at case management factors, the nature of the case etc. if such issues have already been taken into consideration one sees no reason why the same should not find a place in the decision constituting the transfer. Such an omission is clearly in violation of administrative law principles of natural justice and therefore against a democratic set up and its underlying principles.

As far as information to the defendant is concerned, the SFO supplies each defendant with a bundle containing the notice of transfer, a notice containing details of the proposed venue for trial (referred to as a Form 2 notice), a Form 2 notice must also indicate to the defendant

her/his right to apply for bail, and to apply for any charges to be dismissed. It also contains details of the defendant's bail position and an *alibi* warning. In addition, it must contain a list of witnesses (together with copies of the statements or other documents outlining their evidence) on whom the prosecution intends to rely, indicating in each case whether the magistrates' court is to be invited to make the witness fully or confidentially bound. The statement of evidence and an index of documentary exhibits is also supplied to the defendant.<sup>68</sup>

The defendant under Section 6 has a right to apply (either orally or in writing) to the Crown Court for the transfer to be dismissed. This can be done on the ground that there is insufficient evidence available against her/him, for the jury to properly convict her/him.<sup>69</sup> The decision of the Court relating to an application for dismissal is also subject to judicial review. Even though the Act does not confer such a power on the Court, in *R v. Central Criminal Court, ex p. Director of SFO*<sup>70</sup>, it was held that Section 6 of the Act does not take away the jurisdiction of the High Court<sup>71</sup>, but that such jurisdiction should be exercised in an extremely limited manner.

### **Stages of prosecution of a serious fraud case:**

#### *Stage I- Preparatory hearings:*

The judge upon application from the parties concerned, or upon her/his motion may order a preparatory hearing. Under Section 7(1) of the Act, the judge has the discretion to order a preparatory hearing if it appears to him that the evidence on an indictment reveals a case of fraud of such seriousness or complexity that substantial benefits are likely to accrue from such a hearing for the purpose of<sup>72</sup>

- a) Identifying issues which are likely to be material to the verdict of the jury;
- b) Assisting their comprehension of such issues;
- c) Expediting the proceedings before the jury; or
- d) Assisting the judge's management of the trial.

Section 9(3) of the Act defines the scope of the powers of the judge to make orders at the preparatory stage as follows<sup>73</sup>:

- a) The judge may determine a question arising under the Criminal Justice Act, 1987, s.6, (relevance of external law to charges of conspiracy, attempt and indictment);
- b) Any question as to the admissibility of evidence; and
- c) Any other question of law relating to the case.

The scope of a preparatory hearing is quite wide. The judge in the course of such a hearing may order the prosecution to supply to the court and the defendants a prosecution case statement<sup>74</sup>, order the prosecution to prepare its evidence and other explanatory material in a form likely to aid comprehension by the jury and to supply it in that form to the court and the defense, admission of factual issues by the parties, require the defendant to serve a statement in writing setting out in general terms the nature of the defense and indicating the principal matters on which the prosecution is being opposed, order the cross-service of case statements between the defendants, notice of objections and points of law contained in the prosecution case statement etc.<sup>75</sup>

Thus the main objective of a preparatory hearing seems to be to simplify the case for consideration by the jury, and to save time by avoiding arguments relating to matters to which both parties are agreeable. Such a procedure has an extremely important part to play in extended crimes such as financial fraud, where the number of transactions may be endless and extremely complicated. Moreover the fact that any departure from orders made at the preparatory stage means that he jury would be informed about such non-

compliance, ensures that the parties take the process seriously and abide by the decisions made there under<sup>76</sup>.

✍ *Stage II-Presenting a fraud case:*

In most fraud cases the transactions are usually long drawn and extremely complex. In organized crime, which may have a transnational character also, there may be a number of people involved. The problem therefore is to identify all the transactions involved, the accused persons involved and the exact nature of their involvement. In order to overcome these problems, the SFO often chooses sample charges on which the alleged offenders must be indicted. Since it is difficult to indict every person according to the level of their involvement, a broad charge of conspiracy to defraud is often framed, for which all the alleged offenders involved are indicted.

This approach of the SFO has been subject to criticism. It is argued that a broad charge of conspiracy to defraud may be misleading as to the involvement of all the offenders, since it tends to create a presumption that all of them were equally involved in the commission of the crime.

The case of *Griffiths*<sup>77</sup> illustrates the danger involved in a failure to analyse the true nature of an agreement. Griffiths and his accountant were alleged to have devised scheme to defraud the Ministry of Agriculture, which had instituted a scheme to give subsidies to farmers who spread agricultural lime on their fields. It was alleged that in a number of instances Griffiths had greatly exaggerated the quantity of lime, which had been spread. Seven farmers were allegedly induced to take part in this scheme, but there was no evidence that any one farmer knew that any of the others were involved or knew that Griffiths was doing this with other farmers at all. The prosecution charged a general conspiracy to defraud. The Court of Appeal held that there was no general agreement, but one central agreement between Griffiths and his accountant and a series of separate agreements with each farmer. Paull J. delivering the judgement said:

“...all must join in one agreement, each with the others, in order to constitute one conspiracy. They may join in at various times, each attaching himself to that agreement; any one of them may not know all the other parties but only that there are other parties; any one of them may not know the full extent of the scheme to which he attaches himself. But what each must know is that there is coming into existence, or is in existence, a scheme which goes beyond the illegal act or acts which he agrees to do...”

From the above judgement it would seem that it would be prudent to charge each alleged offender separately for a substantive offence of theft, misappropriation etc. as the case may be. The prosecutors however oppose such a course of action. In their view the nature of serious, transnational or organised crime is such that even though each individual may not know the entire design of their acts, the collective acts add to the seriousness of the crime. Moreover the actual think tanks of the crime may not be involved in the execution of the same. Charging of substantive offences alone may mean that one is unable to get to the root of the crime.<sup>78</sup> This may be especially true for frauds such as financial, bank and securities fraud, where transactions may be carried out through agents, brokers, investors etc.

A half way house approach between these two opposing viewpoints is to ensure that the prosecution proves the existence of a ‘core agreement’ in the execution of which the parties to the conspiracy act.<sup>79</sup> Such an approach serves the prosecution purpose also since in the presence of a core agreement, the various devices used by the alleged

offenders may be used as evidence from which the guilt of individual offenders may be inferred, or evidence of the general intent of the agreement may be deduced, or it may be inferred that a particular device was within the general contemplation of the agreement.

### **Problems faced by the SFO in investigation of serious fraud:**

In a lecture at the ISCRL Commercial and Financial Fraud Conference, held at Malta in July 1999, the Director of the SFO found the following irritants in the investigation of serious fraud<sup>80</sup>:

- ✍ Problems with obtaining evidence from overseas jurisdictions. This is because of the divergence in laws in different countries. One example of the problem faced by the SFO relates to production of computer evidence. According to the Criminal Evidence Act, 1984 of the UK in order to present computer evidence before a court of law, a certificate under Section 69 of the said Act is required certifying that the computer was working properly on the day that it generated the evidence. Most overseas jurisdictions do not have such a requirement and therefore fail to understand the relevance of the certificate to English law. Due to this difficulty, a lot of times the SFO has been unable to adduce essential computer generated evidence from abroad.
- ✍ Getting witnesses from abroad to testify in England is another major problem faced by the SFO.
- ✍ The fact that 'fraud' is not a clearly defined offence in English criminal law compounds the problems and uncertainties faced by the SFO. In the absence of a comprehensive definition of fraud, the SFO has to choose from a huge litany of offences, none of which meets the bill when technology produced concepts like electronic fund transfers, which have no conventional counterpart.<sup>81</sup> One of the major problems relates to offences of dishonesty. Such offences in the view of the SFO are linked to the offence of conspiracy to defraud, an offence that is no relevance when there is only one alleged offender. The need therefore is for a paradigm shift in criminal law-one from the mechanics by which the crime is committed to the exact nature of the crime.
- ✍ Problems of simplification of the trial process are numerous, since the amount of evidence is large and the number of transactions insurmountable. To this extent the SFO has suggested that the powers of the judge at the preparatory hearing be widened so as to allow her/him to treat certain facts as proved, in the absence of convincing contrary arguments<sup>82</sup>.
- ✍ The jury in most cases finds it difficult to understand the complex nature of the offence involved. The increasing complication in financial crime, especially with the deployment of more and more technology compounds this problem. The SFO therefore has suggested removal of jury trials in financial fraud cases. It in turn argues in favour of a panel of financially or commercially aware lay members with banking or accountancy backgrounds etc. who could be of assistance to the judge.<sup>83</sup>
- ✍ Since a lot of problems are faced by the SFO in the conduct of the trial itself, it has been suggested that improvements might be made by concentrating cases in a few suitably equipped fraud centres and by providing specially-trained judges with appropriate management skills. The centres would be equipped with information technology, television links with other countries to obtain evidence from overseas

witnesses and real-time transcription facilities as well as adequate storage space for documentation and exhibits.<sup>84</sup>

The above discussion is reflective of the deficiencies that remain in the investigation process of serious fraud, in spite of the wide powers conferred upon the SFO. Definitional and jurisdictional problems, coupled by the lack of international cooperation complicate matters for the SFO. One of the major problems is that the trial process still takes a very long time and remains fairly complicated. These problems are intrinsically linked to the nature of crimes investigated into by the SFO, i.e. "serious and complex fraud". These can only be solved by more and more effective categorisation of fraud transactions, more effective use of preparatory hearings and greater international co-operation.

### **THE LEGAL REGIME GOVERNING FINANCIAL FRAUD INVESTIGATION IN THE EUROPEAN UNION**

The European Union has evinced an interest in dealing with issues of fraud seriously, since fraud as a crime is seen to have far reaching implications for the financial health of the community at large. Statistically speaking, in terms of revenue, 2% of the fraud cases discovered account for the 66% of the amounts at stake. On the expenditure side 8% of the cases account for 74% of the amounts at stake<sup>85</sup>.

The National Criminal Codes or equivalent bodies of legislation all make provision for offences that can embrace both the Community's and the member states' financial interests. Of these, obtaining by deception, forgery and issuing forged documents and fraudulent conversion are the most important. Some member states (the Netherlands, for example) list dozens of provisions to be found in a great number of separate enactments that can be used against fraudsters, depending on the form the fraud takes.<sup>86</sup>

Most member states believe that the ordinary criminal offences are adequately defined to protect the Community's financial interests. Assimilation for enforcement purposes is implied in provisions creating offences and penalties that are applicable in a like manner: to Community and national interests.<sup>87</sup>

Even so, it is clear from some of the reports that the trend is towards making fraud against the Community's financial interests an offence in its own right. The trend has gathered momentum with the Convention on the protection of the Community's financial interests on which an agreement was reached at Cannes and which was signed on 26 July 1995. Article 1(2) requires member states to take the necessary and appropriate measures to transpose into their criminal law the provisions of Article 1(1) (defining what constitutes fraud against the Community's financial interests) so as to make the conduct described therein a criminal offence. The purpose, as is clear from the explanatory report, is that member states should make fraud either a specific or an express offence or at least bring it within the general definition of the offence of fraud.<sup>88</sup>

There is a trend towards the development of multidisciplinary control structures with responsibility for all areas of fraud prevention and with wide-ranging investigative powers. In this way the member states hope that more effective steps can be taken to combat organised financial crime, which is not necessarily confined to one particular sector. The Serious Fraud Office is a good illustration of such a multi-disciplinary approach.

### **Definition of fraud in the European Union:**

Fraud affecting the European Communities' financial interests is looked at from the expenditure and revenue perspective<sup>89</sup>:

- ✍ *In respect of expenditure*, any intentional act or omission relating to the use or presentation of false, incorrect or incomplete statements or documents, which has as its effect the misappropriation or wrongful retention of funds of the general budget of the European Communities or budgets managed by, or on behalf of, the European Communities, non-disclosure of information in violation of a specific obligation with the same effect and the misapplication of funds for purposes other than those for which they were originally granted;
- ✍ *In respect of revenue*, any intentional act or omission relating to use or presentation of false, incorrect or incomplete statements or documents, which has as its effect the illegal diminution of the resources of the European Communities or budgets managed by, or on behalf of, the European Communities, non-disclosure of information in violation of a specific obligation or misapplication of a legally obtained benefit with the same effect.

In order to deal with financial fraud in an effective manner the Convention on the Protection of Financial Interests of the Community lays down member states must criminalize the preparation or supply of false, incorrect or incomplete statements or documents. Participation or instigation in any fraud case is also sought to be criminalized. It also states that the penalties envisaged by Member States must be proportionate, effective and dissuasive. With regard to serious fraud, that is where the pecuniary limit exceeds ECU 50,000, the Convention stipulates that Member States must lay down penalties involving the deprivation of liberty, which can give rise to extradition.<sup>90</sup>

In respect of trans-national fraud, the Convention envisages co-operation in investigation, prosecution, and enforcement of sentence and at every other stage of investigation, between the concerned Member States. With regard to jurisdiction over trans-national fraud, the Convention lays down the following rules:

#### **National courts have the jurisdiction in the following cases:**

1. Where fraud, participation in fraud or attempted fraud has been committed in whole or in part within its territory including the situation in which the benefit of the fraud has been obtained in that territory;
2. Where a person within its territory has knowingly committed the offence of participating in or instigating ('knowingly assists or induces') fraud committed in the territory of another Member State or third country. The terms 'participation' and 'instigation' are to be interpreted in accordance with national law.

In deciding issues of jurisdiction the following principles are to be kept in mind- the scale of the fraud committed in their respective territories, the place where the misapplied sums were obtained, the place where the suspects were arrested, their nationalities, previous prosecutions, and so on.<sup>91</sup>

In order to ensure that the financial interests of the Community are adequately protected against financial fraud, the EU had put in place a task force for coordination in Fraud Prevention, known as the UCLAF. The European Anti-fraud office replaced the UCLAF in 1999 (hereinafter referred to as the "OLAF").<sup>92</sup> The following investigation procedure is adopted by the OLAF<sup>93</sup>:

- ? In case, fraud is committed by an individual, who is placed in an institution within the EU, the OLAF requests the member state concerned to launch an investigation. Hereafter, the investigation procedure of the member state concerned comes into play.



- ? The OLAF investigators are closely involved in directing the investigation process. Once the investigation is complete, the OLAF sends its report to the national supervisory authorities, which can make use of it to take action against the offender.
- ? An external investigation can be opened if there are reasons to think that irregularities have been committed (Article 5) and the criteria for action by the Office (Article 2) are met.
- ? With regard more particularly to administrative investigation procedures, the Regulation requires Commission inspectors to be duly authorised and to carry a written authorisation from the director of the Office. Only OLAF inspectors have a standing authorisation. For each mission a written authorisation is issued, specifying the subject matter and purpose of the inspection (Article 6(1) and (2)).
- ? The Commission, preferably in close cooperation with the competent authorities of the Member State concerned, conducts checks and inspections. Member States are informed in good time of the subject-matter, purpose and legal basis of the checks so that they can give all requisite help (Article 4). If an economic operator objects to the inspection, the Member State concerned provides the requisite assistance so as to take the appropriate precautionary measures (Article 7(2)) and to allow Commission inspectors to perform their task (Article 9).
- ? The administrative investigation culminates in a report reflecting the procedural requirements of the national law of the Member State concerned (Article 8(3)). The material and supporting documents gathered are annexed to it. The report has the same status as a national administrative inspection report; it constitutes admissible evidence in administrative or judicial proceedings in the Member State in which its use proves necessary. Where the inspection is conducted jointly with national inspectors, they are asked to countersign the report drawn up by the Commission inspectors.
- ? On the basis of Regulations 1073/99 and 1074/99, all external administrative investigations are now opened by a decision of the Director of the Office, of his own initiative or following a request from a Member State (Article 5). The Director of OLAF directs the conduct of the investigation, which run continuously for a period of time proportionate to the circumstances and complexity of the case.
- ? When an investigation has been in progress for more than nine months, the Director informs the Supervisory Committee why it has not been possible to wind up the investigation and of the expected time for completion (Article 11).
- ? At the end of the investigation, OLAF draws up under the Director's authority a report which takes account of the procedural requirements of the national law of the Member State concerned. This report is then sent to the relevant administrative or judicial authorities of the Member State concerned, in accordance with the Regulation concerning external investigations.
- ? Internal investigations are still opened by a decision of the Director of OLAF, acting on his own initiative or following a request of the institution or body in which the investigation is to be carried out. The Office can still carry out on-the-spot checks and inspections into economic operators, as provided for by Regulation 2185/96. But, as in the case of external investigations, the inspectors must be duly empowered and hold a written authorisation from the Director of the Office. The office conducts on the spot checks in the following circumstances-
  - a) For the detection of serious or trans-national irregularities or irregularities that may involve economic operators in several Member-states;

- b) Where, for the detection of irregularities, the situation in a Member State requires on-the-spot checks and inspections to be strengthened in a particular case in order to improve the effectiveness of the protection of financial interests and so to ensure an equivalent level of protection within the community; and
  - c) At the request of the Member State concerned.
- ? The report drawn up following an internal investigation and any related supporting documents are sent to the institution or body concerned, the interested party being informed. They then draw the disciplinary conclusions from the internal investigation and its findings and inform the Director of the Office of the action taken on the investigations, within the period determined by him in the conclusions of his report. The Director of the Office sends the report to the judicial authorities, if appropriate.
- ? When there is a major transnational dimension to a case, the Office supports the investigation activities of the Member States. This support can take the form of:
- a) co-ordination of operational activities by OLAF;
  - b) bilateral or multilateral assistance, where the Office provides the investigating authority with information, supplies or know-how.
- ? The OLAF gathers data either by way of reports from member states or other sources. The information relating to irregularities, may either be of a proven or suspected case.
- ? In respect of each irregularity, the OLAF opens a new file. Files are closed either without action – when the information has been validated or the checks and inspections are completed – or when it is reasonable to consider that all the follow-up procedures are completed. Data protection laws of the EC apply to information collected during the investigation of financial fraud as well.
- ? The Office endeavors to determine the financial loss on the occasion of each operation. The financial consequences of each file are calculated. The amounts may be estimated if the scale of the fraud remains to be defined with precision. As regards recovery of amounts involved in the fraud, the policy is that as far as possible the money must be recovered from the actual fraudsters.

From the above discussion it is clear that the function of the OLAF is mainly to assist member states in the investigation of serious fraud, except in certain cases where it undertakes to investigate the matter itself. The OLAF mainly ensures co-operation amongst Member States. In spite of the enactment of the Convention on the Protection of the Financial Interests of the Community, the EU has been unable to achieve any significant results in trying to combat financial fraud. The main problem lies with the varied systems of criminal law prevalent in different Member States. Moreover the weaknesses of the mutual judicial and administrative assistance procedures have made it difficult to counter the development of crime.

In order to deal with these problems it has been recommended that a European Public Prosecutor, a judicial body with the function of bringing prosecutions in the courts of the Member States and of exercising ongoing control of criminal investigations across the Community territory in order to enforce the law and protect the Community's finances, be appointed. The point is not to communitarise the administration of criminal justice, which would remain within national powers.<sup>94</sup>

The experience and efforts of the European Union may be of little interest in the context of a country such as India, since the emphasis of the EU approach is on inter-governmental assistance and co-operation. The nature of assistance and co-operation that the EU envisages within it is also not possible of being transposed at the international level. This is because the

efforts of the EU are a result of the basic understanding and status of an integrated body, an effort that is seemingly impossible at the global level.

### **FRAUD UNDER AMERICAN LAW**

The term fraud is essentially a generic one and is used in many senses. Its ability to assume various degrees and forms has made the task of defining it extremely difficult if not impossible. **So much so that, many jurists prefer to define the term loosely because they are of the opinion that a strictly defined meaning of the term of “fraud” shall prove to be a hindrance in the enforcement of law, as human ingenuity will definitely be able to defeat the definition. It is therefore better to allow the facts and circumstances to dictate the meaning of fraud.**

Although this logic finds great favour with most scholars it still does not negate the necessity to understand the basic requirements, which constitute a fraud, for without such an understanding, the existence of the concept shall itself be suspect. Various books and judgments have at different points of time used different expressions to explain the underlying concept of fraud. Thus, fraud has been referred to as **unfair dealing; malfeasance; a positive act resulting from a willful intent to deceive; an artifice by which a person is deceived to his hurt; a willful, malevolent act, directed to perpetrating a wrong to the rights of the others; anything which is calculated to deceive, whether it is a single act or a combination of circumstances, or acts or words which amount to a suppression of truth, or mere silence.**<sup>95</sup> In other words, fraud in its general sense is deemed to comprise anything calculated to deceive, including all acts and omissions, and concealments involving a breach of legal or equitable duty, trust or confidence justly reposed, resulting in damage to another.<sup>96</sup>

Fraud as defined in legal dictionaries is “a misrepresentation or concealment with reference to some fact material to a transaction that is made with knowledge of its falsity or in reckless disregard of its truth or falsity and with the intent to deceive another and that is reasonably relied on by the other who is injured thereby.”<sup>97</sup>

Fraud has also been sought to be explained in terms of being the equivalent of the antithesis of good faith i.e., bad faith. In this context good faith may be defined as “an honest intention to abstain from taking any unconscientious advantage of another, even though the forms and technologies of law, together with an absence of all information or benefit of facts which would render the transaction unconscientious.”<sup>98</sup>

Another term which is considered to be synonymous to fraud is “deceit”. In exact terms however, deceit is a species of fraud<sup>99</sup>. Deceit is actual fraud and consists of any false representation or contrivance whereby one person overreaches and misleads another to his hurt. On other words, deceit excludes the idea of mistake. An action for damages at common law based upon fraud is called an “action of deceit”. “Collusion” is an agreement between two or more persons to defraud another of his rights by the forms of law or to secure an object forbidden by law.<sup>100</sup> As far as the design of law goes, collusion is considered to be a species of fraud.<sup>101</sup>

### **Classification of fraud:**

Fraud is primarily classified into four categories:<sup>102</sup>

1. Fraud constituting of direct imposition
2. Fraud which may be presumed from the relation of the parties
3. Fraud as may be collected from the intrinsic value of the bargain
4. Fraud which may arise from the contract being an imposition on third parties

A much broader classification of fraud is that into “actual fraud” and “constructive or legal fraud”. An actual fraud is a fraud committed with the actual intent to deceive and thereby

injure another (*called also fraud in fact*).<sup>103</sup> In other words a fraud in fact requires intentional and successful employment of any cunning, deception or artifice to circumvent, cheat or deceive another. Actual fraud falls under the two heads of *suggestio falsi* and *suppresio veri*. A constructive fraud, on the other hand is conduct that is considered fraud under the law despite the absence of an intent to deceive because it has the same consequences as an actual fraud would have and it is against public interests (as because of the violation of a public or private trust or confidence, the breach of a fiduciary duty, or the use of undue influence, *called also legal fraud*). The distinguishing factor between actual and constructive fraud is therefore the element of intent. While actual fraud rests upon an actual intent to deceive, constructive fraud arises from a presumption, which in turn may find its basis in either the relationship between the parties to a transaction or the circumstances under which such a transaction is entered into. Constructive fraud requires a mere breach of equitable duty.<sup>104</sup>

**Distinguishing cause of action based on contract from one based on fraud/deceit:**

In a cause of action based on contract, recovery is based upon the express liability assumed by a person in his contract whereas in a cause of action based upon fraud, recovery is based upon the liability incurred for a violation of the duty of honesty and fair dealing which has been enjoined upon the defendant by law.

**Effect of fraud:**

Fraud vitiates every transaction and all contracts. As per the general law of contracts, an agreement induced by fraud is voidable, and not void. A plaintiff can rely upon fraudulent representations to avoid a contract even if the representations are of not of a nature, which would attract an indictment for false pretences. Fraud as effectual as capacity, etc. is adequate enough to prevent actual consent. The right to avoid a contract induced by fraud must be exercised before third party rights accrue.

**Legislative provisions on fraud:**

It has been unanimously accepted that under the police power the legislature may provide against frauds upon the public. There are a number of federal statutes on fraud and deceit. In criminal prosecution the general rules of criminal proceedings are applicable.

## Chapter 5

### **Gap in the management and Administrative legal system**

**1. No in-house procedural legal order; No best practice code:**

The banks and financial institutions, by and large, have not developed any 'best practice code' for the management and functional staff. The Best Practice Code (BPC) relates to detail procedural rules for entering into transactional relations. Generally speaking, detailed procedural practices followed in each transactional relation on each table by each staff and officer involved in any transaction are documented. The same document is then examined with the comparative document of national and international practices followed by comparable institutions. The Expert Committee thereafter, recommends the best practice principles at micro-level transactional relation. BPC suggested, is then experimented and if found providing ideal result, recommended to all staff and officers to follow. BPC is then used as the threshold prescription for the staff and officers to follow. Any variation thereafter is scrutinized by the managerial process to evaluate the variation in the interest of the trade. One example will make the BPC clear. Say for example, there is a proposal of an NRI to open an account in a bank. It must be clearly prescribed in the BPC as to who can introduce, how the introduction shall be scrutinized, how the identity shall be established, what would be the procedure of affirmation of the identity, so on and so forth.

Detailed procedural rules followed in general when well documented and experimented with desired result become BPC. BPC then provides the comparative index to rationalize and proportionally the management control and accountability according to the degree of deviation from the BPC. In the absence of BPC, there is no established procedural rules to lead relational growth.

## **2. Use of discretionary power at every level :**

While the discretionary power is an essential ingredient in decision making both in the private sector as well as the public sector, the only difference perhaps is that in the private sector, if the result of the discretionary power is adverse to the entity, the decision maker is shown the door. In the public sector, the official is **provided with the insulation for *bona fide* act**. One has to deeply understand that **discretionary power must not be confused with arbitrary and ad hoc power**. The discretionary power is generally ‘the power of judging’. The power of judging has three essential elements - (a) fact and fact analysis; (2) decision and (3) rationale for the decision. This is a skill that can be developed with sustainable training and retraining. This is one of the most challenging tasks of management skill and administrative law to be imparted to the staff and officials. It is always necessary to well document case studies in an organization and then conceptualize the BPC for guiding the exercise of discretionary power. There is a very vague notion of discretionary power to be distinguished from ad hoc and arbitrary power among officials. Most of the officials exercising such wide discretionary power do not have any idea of the administrative law of the country. As such, whenever there is any suggestion on the ‘rule of law’ based system to be used in India, the attempt is shelved because of the pressure of the apprehensive management of the banks and financial institutions that it would then not be possible for the officials at various stages to take any business decision. The fear is primarily because there is no BPC for discretionary power use. But it has to be borne in mind that discretionary power is a double-edged sword, in the hand of a capable person it sparkles and in the hand of a mediocre, it destroys the system. It also makes the system invariably work under pressure in the absence of any BPC. The use of discretionary power has been seriously injured by political hegemony in India. No economic institution can survive in such a situation.

But the rule of law is itself an infrastructure, especially in the financial industry. Therefore, the fear that a ‘rule based system’ would stand in the way of use of discretionary power is unfounded. An arbitrary use of power by way of adventurism and under external pressure has to stop. Take the example, just for the purpose of thinking; Microsoft could have done what it has, with impunity and acclamation in India. But in US, it had to be disciplined within a very strict rule based system. No rule based system permits arbitrary use of power in any ad hoc manner.

## **3. No legal system audit, no compliance certificate :**

The financial sector is based on the principle of contract-sovereignty, and constant creation of right-duty. As such, law and legal system is a ‘raw material’ in the financial service industry. Unfortunately, there is no legal system audit and functional accountability. There is no system of submission of legal compliance certificate even if the value and volume of transaction is very high. There is also no responsibility for the system auditor to report any instance to the regulator.

## **4. Non-compliance of RBI guidelines and FCNR/NRI account related fraud :**

It appears to the Committee that in spite of various safeguards advised by the Reserve Bank, the facility of loans and advances against the security of such deposits was misused, more often fraudulently, as it was open to the banks to accept such non-resident deposits through the agents or brokers. The banks were granting loans against such deposit accounts to the Indian residents, immediately after opening of such accounts. Even though the normal requirement of verification

of the signature of depositor on the power of attorney and verification of such power of attorney by Indian Consulate General in the concerned country was generally followed, it was found that the attestations on such power of attorney by the Indian Consular Offices were often forged and no such powers of attorney were ever granted by the depositors. In one case, the bank staff was suspected to have sanctioned loans without proper verification and in another case; the fake deposit receipts were prepared out of stolen deposit receipts for grant of loans. In yet another case, deposit receipts were handed over to power of attorney holders who sent fake duplicates to depositors and availed loans against the originals. In all the actual fraud cases reported and made available to the Committee, involvement of the staff was evident in all cases.

There is one missing link in the facts of reported frauds i.e. how the NRI chooses a particular bank to keep his foreign currency funds. That link is usually a resident who acts as a broker between the depositor and the bank. Since the depositor has choice of banks to keep his funds even without the help of broker, he does not pay anything to the broker. But the broker may receive his commission from or through the bank. In fact, it is the loan facility against such deposits as can be seen in the reported frauds of the bank. In certain cases where the banks are facing liquidity problems, the banks advise their borrowing customers to arrange for deposits so that their loans can be sanctioned/released. During such time, deposits fetch a price over and above the regular interest. Such kick-backs are shared by the brokers with the depositors so that they patronize such banks in preference to others who may not arrange for the additional interest in cash. Since such practices are fraud-prone, the banks will have to be advised of the need to take steps to ensure that in their zeal to mobilize more and more deposits, the branch managers of banks do not indulge in any such mal practices and as far as possible avoid dealings with middlemen in the matter of mobilization of resources.

After several such instances of frauds in respect of non-resident deposit accounts came to the notice of the Reserve Bank, it issued a circular on 8<sup>th</sup> January 2001. Though this circular also does not prohibit the brokers from soliciting the deposits on behalf of the banks in India, the banks have now been directed to follow the following safeguards meticulously, viz.:

- (i) Fixed deposit receipts should be handed over or sent to depositors directly against acknowledgement.
- (ii) Loans against NRI/FCNR(B) deposits to third parties should be granted only when the depositor himself executes the loan documents in the presence of bank officials and a witness acceptable to the bank. Advances to third parties against such deposits should not be granted on the basis of power of attorney.
- (iii) Where a fraud has been perpetrated in a non-resident account and there is no involvement of the concerned non-resident depositor and his innocence has been proved to the satisfaction of the bank, banks may pay the deposit proceeds to the depositor on due date even when the investigation is in progress. Bank may, however, obtain necessary documents including an indemnity bond with an acceptable surety from the non-resident depositor before releasing the amount.
- (iv) In the event of death of non-resident depositor, banks need not insist on succession certificate as a matter of routine. Since different countries follow different procedures for issuing succession certificates, banks should take a practical view and ascertain the procedure followed in the country of residence of the depositor and, thereafter, obtain such minimum documents for their record as would satisfy the requirements of their having rightful claimant.

The Committee is of the view that if the bankers follow the RBI guidelines more carefully; the number of such frauds can be brought down substantially. The Committee, however, does not find any infirmity in legal provisions and, therefore, refrains from making any recommendations on this item of reference.

#### **5. Role of Reserve Bank of India in Frauds reported by banks :**

The Committee is required to examine the role of the Reserve Bank of India with regard to frauds reported by banks. The Committee has examined the position obtaining in respect of commercial banks (other than Regional Rural Banks) in this regard. It is observed that the Reserve Bank of India has a comprehensive reporting mechanism whereby all banks are required to report actual/suspected frauds either to the Central Office or Regional Offices of the Department of Banking Supervision (DBS) of RBI. The banks are required to report all actual/suspected frauds in excess of Rs.1 lakh each to the Regional Offices of DBS with full particulars in the prescribed proforma as soon as such frauds come to their notice but within three weeks of detection. The Central Office of DBS receives individual reports on actual/suspected frauds of Rs.1 crore and above and also in respect of frauds by unscrupulous borrowers involving an amount of Rs.5 lakh and above. The fraud reports are required to indicate, among other things, the modus operandi of the fraud, amount involved, the amount of expected loss, chances of recovery, staff involvement and the action taken against the delinquent members of the staff. Cases of individual frauds involving amounts up to Rs.1 lakh each are not required to be reported individually. The banks are, however, required to report such frauds in a consolidated form category-wise on a quarterly basis in the prescribed format.

Besides, to enable Reserve Bank of India and the Government of India to have full information about the incidence of frauds and the action taken by banks to prevent them, the banks are required to furnish to RBI certain statements on quarterly/half-yearly basis. While quarterly statements deal with further developments in respect of frauds reported to RBI, half-yearly statement on frauds is required to indicate the stage of Police/CBI investigation as well as the recoveries made. Quarterly statements are also required to be sent by the banks on frauds outstanding and closed during the quarter. Besides, there are reporting systems in place for following up vigilance aspects in the public sector banks.

The above reporting system seems to have been designed to serve the following objectives :

- (i) To examine new modus operandi, if any, adopted in respect of a fraud and circulate the same among banks.
- (ii) To issue caution advice to banks giving details of unscrupulous borrowers so that they will be careful while dealing with such borrowers.
- (iii) To ensure that banks have taken prompt steps to recover their dues and have reported to fraud cases to CBI/Police.
- (iv) To collate data relating to frauds and vigilance cases in order to report to the Board for Financial Supervision.
- (v) To consolidate data pertaining to frauds/vigilance cases (in respect of public sector banks) to report to Government of India/Parliament from time to time.

The Committee feels that while violations of any regulation come within the purview of the regulator, any act of omission or commission by a bank or any of its employees or constituents or others attracts the provision(s) of a criminal law, it goes outside the purview of the regulator. The regulator has no further role to play. The Committee is, therefore, of the view that the present system for monitoring fraud and its investigation is burdened by too many layers imposing large regulatory costs on the banks. Furthermore, it is felt that rather than following up each individual

case of fraud, the RBI as a regulator/supervisor should be more concerned about the systemic impact of such fraud. For instance, a fraud of Rs.10 crore in a large public sector bank may not be of much regulatory/supervisory concern; at the same time, a similar fraud in a small private sector bank may be of serious concern to the regulator/supervisor. It is, therefore, felt that the response of the RBI to such frauds should take into account the whole picture. Furthermore, individual monitoring of frauds could be left to the banks themselves. A review of such monitoring could be made at the time of the periodical inspections of the banks.

The investigating agencies, viz., CBI and the Police take unduly long time to complete the investigation and to close a case. In view of this, the RBI would be spreading its supervisory resources too thin if it were to follow up each individual fraud case up to its logical end. The Committee is, therefore, of the view that the reporting system for frauds needs to be rationalized so that there is no duplication of efforts and that the reporting is done only in respect of information necessary for the Reserve Bank of India in exercising its regulatory/supervisory responsibilities.

#### **6. Credit transaction data registration and information sharing :**

In India there is no one law for credit transaction, no public registry and sharing of information. We follow the common law system of privity of contract. But there has been system reform in the home country of common law, but we have not changed. There is no one law for security interest creation, priority determination and enforcement. All these supplemented with no information sharing amongst the institutions and also with the regulator concerned, cripple the financial service industry. Fraud is only the resultant action. Control, prevention and prohibition of financial fraud call for reform in both financial sector law and criminal law.

## **Chapter 6** **RECOMMENDATIONS**

1. **Prologue :** The Committee, in its critical review of the system as obtained presently, observed two very wide systemic gaps in the law and practice in dealings of the banks and financial institutions with the public frauds. These systemic gaps are as follows :

Firstly, wide gap in the law and practice of banking law and practice. As for example :

# No **clear and certain best practice** code in the organization;

# Weak **internalization system of the rule of law** being the best practices in the organization and management;

# No discipline in the use of **discretionary power** to be used in the manner and circumstances as laid down;

# No appreciation of administrative law to use **discretionary power as being the judging power that involves decision and reasoning to be well documented**; and

# No institutional plan for the judging power to be linked with incentive and promotional system in the organization.

Secondly, **the poverty in the criminal jurisprudence** is also very apparent in India. Many jurists argued for a long time that criminal law in India is heavily class biased. Absence of financial fraud in the list of offences in the penal code is evidence in itself that 'white collar crime' is treated differently in India with all leniencies. The Committee has, therefore, prepared its suggestions in two parts.

**Part I deals with the preventive aspects of management of financial fraud** to keep it happen only in rare cases. This part suggests steps to contain a clean in house financial management.



**Part II deals with prohibition of financial fraud and introduction of a deterrent jurisprudence** so that financial fraud, being a serious offence to derail a system as a whole, is adequately and firmly dealt with.

### **PART I**

#### **In-house preventive management as a part of good governance : Administrative legal order**

The Committee has emphasized the role of preventive aspects to minimize institutional frauds with the participation of any internal staff. In the presentations made to the Committee, various in-house committees of the institutions and of the regulators pointed out that it would be very difficult to perpetrate a fraud without the assistance, co-operation and involvement of an insider. The Committee considered the essential elements of good management in order to have a clean system in deployment of public funds both on short term and long-term investments. The recommendations to this regard are as follows :

1. **Development of Best Practice Code** : Each bank and financial institution and intermediary must, within the time-frame indicated by the regulator, prepare a **Best Practice Code (BPC)** for its officers and staff to provide detailed rule based procedural system in customer related matters and application of judging power.
2. **System of internalization of BPC** : There has to be adequate in-house training-retraining system for internalizing the BPC and all directives of the Institution and the Regulator.
3. **Internal Check and Internal Control** : There must be introduced system of internal check and internal control in the system management and reporting.
4. **Legal Compliance Certificate** : A legal compliance certificate needs to be mandated in all transactions exceeding a value limit. In case of exercise of judgment power (discretionary power), an explanation should be needed about the circumstances requiring the exercise of discretionary power and the manner in which the same is exercised with a comment as to whether all **due diligence** care been taken or not.
5. **Legal Compliance Audit** : Every institution should have legal compliance and due diligence audit every year and submission of the report to the regulator and to the shareholders.
6. **Data building on the exercise of discretionary power and monitoring the same** : Discretionary power is the judging power of exercising the power in circumstances only when it is essentially needed and there is no other method left. It is not wild and fact-divorced speculative power or an arbitrary power. As such, every institution should build up data of its management and staff exercising discretionary power recording all the reasons for such exercise and the consequences. A very close monitoring shall reveal how people use the power and with what result.
7. **Appropriate incentive system** : Use of discretionary power must be result oriented either positively or negatively. Incentive and promotion system in an organization may have some correlation with the data of exercise of judging power and the rationality and appropriateness of such decision.
8. **Liability of the accounting and auditing profession** : If an accounting professional, whether in course of internal or external audit or in the process of institutional audit find anything susceptible to be fraud or fraudulent activity or use of excess power, or smell any foul in any transaction, he should refer the matter to the Regulator. Any failure should be considered as professional incompetence and attach liability.

**9. System of credit registration and data information sharing :** Legal support to quality improvement of credit system, priority determination and enforcement is poor. The record of registration of the credit data would in itself improve the quality of information and reduce the chances of financial fraud. Such information sharing system among the constituent institutions shall also simplify the evidential process and enforcement.

**10. Responsibility of Reserve Bank of India in Frauds reported by banks :** The Committee feels that while violations of any regulation come within the purview of the regulator, any act of omission or commission by a bank or any of its employees or constituents or others attracts the provision(s) of a criminal law, it goes outside the purview of the regulator and the regulator has no further role to play. The Committee is, therefore, of the view that the present system for monitoring fraud and its investigation is burdened by too many layers imposing large regulatory costs on the banks. Furthermore, it is felt that rather than following up each individual case of fraud, the RBI as a regulator/supervisor should be more concerned about the systemic impact of such fraud. For instance, a fraud of Rs.10 crore in a large public sector bank may not be of much regulatory/supervisory concern; at the same time, a similar fraud in a small private sector bank may be of serious concern to the regulator/supervisor. It is, therefore, felt that the response of the RBI to such frauds should take into account the whole picture. Furthermore, individual monitoring of frauds could be left to the banks themselves. A review of such monitoring could be made at the time of the periodical inspections of banks.

The investigating agencies, viz., CBI and the Police take unduly long time to complete the investigation and to close a case. In view of this, the RBI would be spreading its supervisory resources too thin if it were to follow up each individual fraud case up to its logical end. The Committee is, therefore, of the view that the reporting system for frauds needs to be rationalized so that there is no duplication of efforts and that the reporting is done only in respect of information necessary for the Reserve Bank of India in exercising its regulatory/supervisory responsibilities.

## **PART II**

### **Prohibitive aspects in the recommendation to deal with Financial Fraud : Administration of criminal justice**

**1. Separate Act to deal with Financial Fraud :** Financial frauds commonly understood as 'scam' have now become a major concern for governance. All the market players now should get a signal that financial frauds specifically the major ones disturbing the public life have to be criminalized with deterrent punishment. The criminalisation of financial fraud and its investigation and prosecution will depend upon – (a) amendment to the Indian Penal Code, (b) amendment to the Criminal Procedure Code and (c) institutionalization of investigation procedure if a special procedure is needed for treating serious financial fraud.

A substantive procedure will need to be inserted defining financial fraud in the Indian Penal Code as well as providing for the nature of the offence and terms of punishment. Similarly, for providing a special procedure for investigation and for conferring power of investigation to a specialized agency, the Criminal Procedure Code may be required to be amended. Similarly, it would be necessary to shift the burden of proof and as such the provision of Evidence Act may be required to be amended.

The same can be done in two ways. Individual statutes may be amended as suggested or an Act can be passed on financial fraud, which may contain schedules for containing other statutes in the model outlined in the Information Technology Act, 2000. The Committee after scrutinizing

various previous reports including the Narasimham Committee strongly **recommends a separate statute to deal with financial fraud. The Act may be named as the Financial Fraud (Investigation, Prosecution, Recovery and Restoration of property) Act, 2001. The Act may have the long title as “An Act to prohibit, control, investigate financial fraud; recover and restore properties subject to such frauds; prosecute for causing financial fraud and matters connected therewith or incidental thereto”.**

**2. Financial Fraud to be Criminalised :** Financial fraud needs to be criminalized by inserting a definition for the offence on ‘financial fraud’ and a penal provision in the Indian Penal Code in a new Chapter XXIV with Section 512 and 513. The definition may be as follows : **“Financial fraud means and includes any of the following acts committed by a person or with his connivance or by his agent, in his dealings any bank or financial institution or any other entity holding public funds : (a) the suggestion as a fact, of what which is not true, by one who does not believe it to be true; (b) the active concealment of a fact by one having knowledge or belief of the fact; (c) a promise made without any intention of performing it; (d) any other act fitted to deceive and (e) any such act or omission as the law specially declares to be fraudulent.”**

A few illustrations can be added with the above definition suggesting the following acts or omissions as offence : (a) Insider trading; (b) Price rigging in the financial market; (c) Any act of deceiving a bank or a financial institution; (d) Any act, which can be a fraudulent preference in an insolvency or bankruptcy proceeding; (e) Any unauthorized act or market interception or deceit whether done through institutions in India or abroad; (f) Vanishing company; (g) Any company raising public money through equity or loan without having any intention to perform the objectives laid down by the company or by any unincorporated body of group of persons. Such illustrations may only narrate the wide scope and dimension of the offence.

The offence must be made cognizable with imprisonment up to seven years and also fine. But a serious fraud must be made punishable with imprisonment up to ten years and fine of double the amount involved in the fraud. However, the minimum punishment should be for five years. Such a provision can be provided in Section 513 of the Indian Penal Code.

**3. Serious Financial Fraud to be separately treated :** After reviewing the Criminal Justice Act, 1987 of UK and also the procedure of handling the major frauds in US the Committee is of the opinion that serious financial frauds must be investigated by separate specialized agency whereas other financial frauds may be treated in the similar manner as is done in the case of cheating. Serious financial frauds have major public concern and often have serious impact on the financial system. Therefore, such serious frauds are required to be specially investigated and dealt with through a fast-track procedure by a specialized agency. Serious financial, market and bank frauds may be referred to such specialized agency for investigation and prosecution by (a) the regulator; (b) the concerned bank or SRO; and (c) by any State or Central Government. The Judiciary also nowadays asks for investigation by the CBI.

However, the major problem is one of classifying serious financial fraud. The Committee is of the opinion that the general recommendation of **Davie Committee report of England can be the guideline for classifying the serious financial fraud, which may be as follows : (a) cases involved should be such that sums involved are ten crores and above; (b) cases likely to give rise to national publicity and wide spread public concern; (c) cases where investigation and prosecution require high specialized knowledge of financial market prices or of the behaviour of banks and SROs; (d) cases involving significant international dimension; (e) cases where legal, financial, investment and investigative skills are required to be brought**

together; and (f) cases which appear to be complex to the regulators, banks, SROs or to the appropriate government. Since the above classification is reasonable, it is not violative of any constitutional principles.

The above provision can be included in the body of the Financial Fraud Act itself.

4. **Strict Liability and Shift of Burden of Proof :** The Committee recommends that the financial fraud and banking fraud should not be rigidly defined excepting that the basic character of this fraud-driven offence would involve third parties' interest in the contractual relationship between the two parties which may be shareholders of an entity at large or investing public or depositors of the bank. The Committee also examined the strict liability of proof on *apriori* intention and observed that in major frauds *apriori* conditions are not so important as that of financial impact. In a series of transactional relations, the Committee feels that the strict liability needs to be imposed on the contracting party to maintain the obligation of disclosure continuously throughout the agreemental relationship. The impact of activity of the contracting parties ought to be considered as a strict liability. Therefore, **the Committee has recommended the inquisitorial system of proof in the evidential process.** This can be done by amending the provision of the Indian Evidence Act by inserting a new section, say **Section 114B, on presumption as to the intention to cause fraud as follows :**

“When a financial fraud has been committed by a person or an abetment or criminal conspiracy made for such financial fraud, the Court shall presume intention of the party or parties committing act of abetment or criminal conspiracy or attempt for such financial frauds, of the parties committing such offence as the case may be unless such intention is disproved by the accused.”

5. **Special responsibility of the regulator :** Once an entity like a bank or a financial institution or a self-regulatory organization alleges any financial fraud, it may refer the matter to the regulator. All the regulators jointly may constitute a fraud committee to make a preliminary inquiry about the allegation and advise the regulator either to refer the matter to the investigating authority if there is an offence committed as alleged or to deal with such incidences of contractual or tortuous fraud that might be committed by the parties. **The Committee may also inquire into the incidence of involvement of any banking staff. An officer of the bank or financial institution acting *bonafide* with due diligence and not violating the best practices or violating the best practices for business prudence may be advised to be treated departmentally and not to be prosecuted against.**

6. **Criminal behaviour not within the fold of Regulatory function :** The Committee examined the functions of the regulators and also the suggestion that the market regulators should be responsible for regulating market frauds. While appreciating the opinion, the Committee likes to underscore the point that criminalization of fraud is the exclusive jurisdiction of legislative process. It does not come into the realm of regulators responsibility. No regulation can criminalize any fraud. It can only stipulate the conditions of market and suggest that the market players would be disciplined in case of such conditions are violated. This discipline includes tortuous liability of compensation and also penal compensation. The market regulators can even expel the player from the market altogether. The Committee strongly recommends that major financial frauds should *ipso facto* become an offence. Perpetration of financial fraud even diminishes the credibility of governance. Market regulators have to discipline the market players for the interest of the game by standardizing the rules of behaviour, development of professional and ethical standards amongst the market players, self-regulation, standardized rules of qualification, capital adequacy, etc. and also with definite rules for de-memberment by way of

expulsion from the market game in a well defined situation, liability of paying compensation (damages) in the case of fraud and paying penalties to the professional body.

**7. Separate Institution for Investigation of Serious Financial Fraud cases :** After examining the pros and cons of having separate investigational institutions, the Committee strongly feels that investigating into the affairs of serious financial fraud requires not only the skills for investigation through professional training in police sense but it also requires special institutional knowledge and experience in investment system, financial legal structure, market systems and finance and monetary system. It requires an in-depth knowledge of market regulatory process. Therefore, the Committee strongly recommends that there should be a special institution for dealing with serious financial fraud. Presently, serious financial and bank frauds are investigated by a special cell of the CBI. The cell, which is under the charge of a Special Director, draws expertise from various fields. There are banking experts, financial market experts, chartered accountants involved in these special cells. The Committee envisages that with the growing numbers of incidents of market frauds and the serious complexities of such transactions, often in cross-border activities. The strength of the present cell is really insignificant. **The strength of the cell needs to be increased and the autonomy of this investigational special body is also required to be emphasized. This is the reason why the Committee has recommended that the cell should now be given the status of a bureau and separated from the CBI and brought under the Ministry of Finance.** Such provision can be incorporated in the body of the Financial Fraud Act.

**8. Office of Director for Investigation of Financial Fraud :** The Committee recommends the establishment of office of Director for investigation of financial fraud and a multi-disciplinary body under his chairmanship. The Director must be sufficiently qualified to become the Director of CBI. Such a person may be appointed by a Cabinet Sub-Committee of the Prime Minister, Finance Minister and Home Minister and shall be directly responsible to the Finance Minister. The office must have sufficient number of experts from various fields into its investigating team. These investigating officials may be drawn from the Police force, banking sector, SEBI, IRDA, Chartered Accountants, Financial Analysts and Information Technologists. Each investigating team is to be composed by the Director keeping in view the sectoral needs for investigation. The investigation team shall have all powers as provided under Criminal Procedure Code. While providing for the legal structure, the Committee recommends that the provisions of the Criminal Justice Act, 1987 of England may be taken as a model. Such provisions can be stipulated by amending the relevant provision of the Criminal Procedure Code.

**9. Search, Seize and Attachment :** The investigating officer shall have the power to search, seize and attach all tangible and intangible assets including bank accounts, which may be alleged to be acquired fully or partly by perpetrating the offence. Such properties may be confiscated by the court order and restored to the institution, which suffered on account of the fraud. The investigating authority shall have the power to trace all properties acquired with the fruits of fraud directly and indirectly and attach the same.

**10. Special Courts :** The Committee strongly recommends Special Courts for trying the accused under the proposed Financial Fraud Act so as to provide a fast-track justice delivery mechanism for this type of offences. The Committee also underscores the necessity of having Judges sufficiently knowledgeable in the economic system, market functioning and regulatory mechanism. The Presiding Officers of such Special Courts will need to be strengthened by accrediting financial assessors who can provide the financial systematic advise to the Judge in case of need.

11. **Cross-border Financial Fraud** : The Committee also recommends to integrate legal principles for cross-border financial fraud including rules for, (i) foreign representatives; (ii) foreign court proceedings; (iii) sharing of information; (iv) implementation of foreign court judgment; (v) seeking assistance of foreign courts; (vi) Indian representative in foreign courts; and (ix) co-operation between the institutions. The Criminal Justice Act, 1987 of England has some provisions in this respect. Similar provisions can be provided in the Financial Fraud Act to be followed in the case of countries with which India has a treaty of extradition.

12. **Draft Legislation** : The Committee has proposed draft legislation for illustrative purpose.

*An illustrative legislation*

**The Financial Fraud (Investigation, Prosecution, Recovery and Restoration of property)  
Bill, 2001**

An Act to prohibit, control, investigate financial frauds; recover and restore properties subject to such fraud; prosecute for causing financial fraud and matters connected therewith or incidental thereto.

**CHAPTER I**

**PRELIMINARY**

(1) This Act may be called “The Financial Fraud (Investigation, prosecution, recovery and restoration of property) Act, 2001.

(2) It extends to whole of India.

(3) It shall come into force on such date as the Central Government may, by notification in the official Gazette, appoint, and different dates may be appointed for different provisions of this Act and any reference in such provision to the commencement of this Act shall be construed as a reference to the coming into force of that provision.

1. Definitions:

(1) **Attachment** means prohibition of transfer, conversion, disposition or movement of property or any part thereof by an order issued under this Act.

(2) **Bank** means ‘bank’ as defined in Recovery of Debts Due to the Banks and Financial Institutions Act 1993 and includes a society carrying on the business of banking and registered under Central or State law relating to cooperative societies.

(3) **Committee** means Financial Fraud Enquiry Committee constituted under Section 3 of the Act.

(4) **Financial institution** shall have the same meaning as assigned to it under clause (c) of section 45-I of the Reserve Bank of India Act, 1934.

(5) **Financial Intermediary** means and includes a share-broker; sub-broker; financial agent; share transfer agent; mutual fund banker to the issue; trustees under a trust deed; registrar to the issue; merchant banker; underwriter, portfolio manager; investment adviser; insurance agent; Commission agent; depository; and any other person engaged in the task of intermediation for another person in any transaction associated with a financial market, whether registered with the Security and Exchange Board of India or not.

(6) **Investigating authority** means an authority, which is responsible to investigate an allegation of financial fraud under this Act or under the Code of Criminal Procedure, 1973.

(7) **Notification** means a notification published in the Official Gazette.

(8) **Person** means and includes:-

- (i) an individual'
- (ii) a Hindu Undivided Family
- (iii) a firm
- (iv) a trust governed under Indian Trust Act
- (v) a society registered under a society Registration Act
- (vi) a company
- (vii) an association of persons or body of individuals, whether incorporated or not
- (viii) every artificial juridical person, not falling within any of the preceding sub-clauses and
- (ix) any agency, office or branch owned or controlled by any of the above persons.
- (x) Societies registered under the Central or State law relating to co-operative societies

(9) **Prescribed** means prescribed by rules made under this Act.

(10) **Property** means any property or assets of every description, whether corporal or incorporeal, movable or immovable, tangible or intangible and includes deeds and instruments evidencing title to, or interest in, such property or assets wherever located.

(11) **Public Fund** means funds collected from public either by deposit or by issue of equity or loan instruments or through public investment in any scheme or the Government fund or any amount collected from public otherwise.

(12) **Regulator** for the purpose of the Act, means all or any of the following:

- (i) the Reserve Bank of India established by The Reserve Bank of India Act 1934 (ii) Security Exchange Board of India established by the Securities & Exchange Board of India Act, 1992 and (iii) Insurance Regulatory and Development Authority established by Insurance Regulatory and Development Authority Act, 1997 (iv) any other regulator under a statute passed by the Parliament.

(13) **Special Court** means the Special Court established under this Act.

(14) **Transfer** means and includes sale, purchase, mortgage, pledge, gift, loan or any other form of transfer of property, alienation of right, title, possession or lien.

## CHAPTER II

### Financial Fraud Enquiry Committee and Bureau of Investigation of Financial Fraud

**3. Financial Fraud Enquiry Committee:** There shall be a Financial Fraud Enquiry Committee constituted as follows:

- (a) Chairman of the Committee to be nominated by the Governor of the Reserve Bank of India;
- (b) One member nominated by the Chairman of the Security Exchange Board of India;
- (c) One member to be nominated by the Chairman of the Insurance Regulatory and Development Authority;
- (d) One member to be nominated by the Department of Company Affairs, Ministry of Law and justice, Government of India;

- (e) One member to be nominated by the Ministry of Finance to inquire into the cases referred to the Committee to make appropriate inquiry and to advise the appropriate regulator on whether to proceed further into the allegation of commission of an offence, under Section 512 of the Indian Penal Code or to take any other action or not.

**4. Qualification of the Chairman and members of the Committee:** The Chairman and members of the Committee shall have the following qualification and tenure:

- (a) Chairman of the committee shall be a person of proven ability having sufficient experience in the administration and management of a banking institution and may be a serving or retired officer having held the position not below the rank of Executive Director of the Reserve Bank of India or Chairman or Managing Director of a Banking Institution;
- (b) A member nominated by the Chairman, SEBI having adequate knowledge of finance with sufficient experience in capital market operations and management and who may be a serving or retired officer having held the position of Executive Director of SEBI or position of a Chairman of a Stock Exchange;
- (c) A member nominated by the Chairman, IRDA having proven ability and knowledge of insurance industry and who may be a serving or retired officer of an insurance company having held a position not below the rank of a Chairman of a Company.
- (d) Members nominated by the Ministries must be holding position not below the rank of a Joint Secretary.

**5. Tenure:**

- (a) The Chairman and members of the Committee shall be appointed for a period of three years;
- (b) The age of retirement shall be seventy years;
- (c) If there is any vacancy on account of resignation, death or incapacity or due to operation of law, the appropriate authority shall nominate to fill up the vacancy.
- (d) No decision of the Committee can be challenged merely on the ground that all the vacancies of the Committee are not filled in.

**6. Function of the Committee:**

- (a) The Committee shall have the power of inquiry in all matters referred to it by a regulator or by the Union Government in order to examine whether a decision of an officer of a bank or any other financial institution or a financial intermediary or any other higher official involved in such decision making and its implementation, has been taken in the best interest of the business of the institution within the parameter laid down by the appropriate regulator.
- (b) For the purpose of enquiry, the Committee shall have the following powers of the Civil Court namely :
  - (1) summoning and enforcing the attendance of any person and examining him on oath;
  - (2) requiring the discovery and production of documents;
  - (3) receiving evidence on affidavits;
  - (4) issuing commissions for the examination of witnesses or documents;
  - (5) reviewing its decisions;



- (c) The Committee shall endeavour to advise the appropriate Government or the regulator within 3 month on matters referred to it under clause (a) above.
- (d) No member of a Committee shall be personally responsible for any advice given.

**7. Bureau of Investigation for Financial Fraud:** There shall be a **Bureau of Investigation for Financial fraud** to be constituted by the Central Government as under :

- (a) Director of the bureau as its Chairman; and
- (b) Not less than four other members to be nominated by the Ministry of Finance from such officials not below the rank of executive director from any bank or financial institution or experts who have wide knowledge and experience in law, banking, investment, capital market operation and management, finance, market regulations and regulatory functions.

**8. Powers of the Central Government to appoint the Director:** The Central Government shall appoint the Director of the Bureau from amongst persons who are sufficiently qualified to be the Director of Central Bureau of Investigation, on such terms and conditions determined by rules.

Provided that the bureau shall follow the same rules and regulations of the Central Bureau of Investigation until it has separate rules and regulation of its own.

**9. Powers and Functions of the Bureau:** The Bureau shall have following powers and functions:

- (a) It shall investigate all cases of serious financial frauds referred to it by the bank or Financial institution affected by such an offence alleged to be committed under Section 513 of the Indian Penal Code, 1860 or by a regulator or by the Union Government or by the District Superintendent of Police under whose jurisdiction a case to this effect is registered in a police station.

*Explanation:* An offence committed under Section 513 of the Indian Penal Code, 1860 shall be a serious offence, if and only if, the case (i) involves a sum exceeding Rs.ten crore; or (ii) is likely to give rise to widespread public concern; or (iii) its investigation and prosecution require high specialized knowledge of financial market or of the behavior of banks or other financial institutions; or (iv) involves significant international dimensions; or (v) in the investigation of which there is requirement of legal, financial, investment and investigative skills to be brought together; or (vi) which appear to be complex to the regulators, banks, Union Government or any financial institution.

- (b) The Bureau shall have the power to open its office at such places with such investigating and supportive staff as may be decided by the Bureau from time to time. Provided that the Bureau shall have its headquarters at Bombay and offices at Kolkata, Chennai, Delhi, Bangalore, Hyderabad and Ahmedabad as such other places as may be decided by the Bureau from time to time for the quick investigation, recovery of property and prosecution.
- (c) The Bureau shall appoint such number of investigating officers from the members of Indian Police Service and from other services as may be decided by the Bureau and

request the appropriate Government to make the services of such officers available to the Bureau.

- (d) All the investigating officers of the Bureau shall have the powers of officer in charge of the police station for the purpose of investigation under the code of Criminal Procedure, 1973 (Act No.2 of 1974)
- (e) The Bureau may also procure the services of such number of experts in accountancy, banking, investment, insurance, financial market regulation, capital market organization and management, and information technology as may be required by the Bureau from time to time for the purpose of advising its investigating officers on matters involving special knowledge and technique to investigate.
- (f) The Bureau may arrange for training of its investigational and supporting staff in all branches of financial system.
- (g) The investigating officers of the Bureau shall have the powers provided in Chapters VII-A and VII-B of the Code of Criminal Procedure, 1973 for search, seizure and attachment of the properties and the proceeds of financial fraud involved in the offence committed in any contracting country or within India as the case may be.

### **CHAPTER III**

#### **Special Court**

##### **10. Establishment of Special Court:**

- (1) The Central Government may by notification in the official gazette establish such number of Special Courts as may be necessary from time to time.
- (2) A Special Court shall consist of a sitting or a retired judge of the High Court nominated by the Chief Justice of the High Court within the local limits of whose jurisdiction in which the Special Court is situated, in consultation the Chief Justice of India.
- (3) When the office of the judge of the Special Court is vacant by reason of absence or leave, the duties of the office shall be performed by such judge of the High Court who may be temporarily posted by the Chief Justice of High Court concerned, in consultation with the Chief Justice of India.

##### **11. Jurisdiction of Special Court:** Notwithstanding anything contained in any other law for the time being in force, any prosecution in respect of financial fraud referred to in Section 512 of the Indian Penal Code, 1860 and investigated by the Bureau of Investigation for Financial Fraud under Section 9 of this Act, shall be instituted only in the Special Court.

##### **12. Jurisdiction of Special Court as to joint trials:** The Special Court shall have the jurisdiction to try offences relating to serious financial fraud including conspiracy, abetment and all other offences relating to the same as can be jointly tried therewith as one trial in accordance with the Code of Criminal Procedure, 1973.

##### **13. Procedure and Powers of Special Court:**

- (1) The Special Court shall, in trial of all cases, follow the procedure prescribed under the Code of Criminal Procedure, 1973.
- (2) Save as expressly provided in this Act, the provisions of the Code of Criminal Procedure, 1973 shall, in so far as they are not inconsistent with the provisions of this Act, apply to the proceedings before the Special Court and the Special Court shall be deemed to be a Court of Sessions.

- (3) The persons conducting a prosecution before the Special Court shall be deemed to be a Public Prosecutor.
- (4) The Special Court may pass upon any person convicted by it, any sentence authorized by law for the punishment of the offence of which such person is convicted.
- (5) The Special Court may pass an order for tracing and attachment of the property defrauded. When the order for attachment is passed by the Special Court, the property will vest in the Receiver and Administrator of the Court.
- (6) While dealing with any other matter brought before it, the Special Court may adopt such procedure as it may deem fit consistent with the principles of natural justice.
- 14. Appeal :** (1) Notwithstanding anything in the Code of Criminal Procedure, an appeal shall lie from any judgment, sentence or order, not being interlocutory order, of the Special Court to the Supreme Court both on facts and on law.
- (2) Except as aforesaid, no appeal or revision shall lie to any court from any judgment, sentence or order of the Special Court.
- (3) Every appeal under this section shall be preferred within a period of thirty days from the date of any judgment, sentence or order of the Special Court :
- Provided that the Supreme Court may entertain an appeal after the expiry of the said period of thirty days, if it is satisfied that the appellant had sufficient cause for not preferring the appeal within the period of thirty days.
- 15. Restoration of the property :** Where an order of attachment has been made under subsection (4) of section 13 in respect of any property of a person and thereafter an order for forfeiture and restoration of property is made by the Special Court, all the rights and titles in such property shall vest in the bank or financial institution affected by such financial fraud as if the fraud has not taken place.
- 16. Receiver and administrator:** All properties seized by investigating officer and attached by the Special Court in a financial fraud case shall be vested in the Receiver and Administrator appointed by the Special Court who shall take possession and administer the property until such property is restored to the concerned bank or financial institution, as the case may be or is disposed of in such manner as has been directed by the Special Court.

## CHAPTER IV

### Miscellaneous

- 17. Bar of suits in civil court:** No suit or other legal proceeding shall lie against the Central Government or the regulator or any other person or authority under the Act for any damage or loss caused or likely to be caused by anything done or intended to be done under this Act or in pursuance of any order, regulation or direction made or given thereunder.
- 18. Special responsibility of the Auditors:** (1) It shall be the duty of a statutory auditor of every bank, financial institution or financial intermediary to report to the regulator whether or not he has detected any financial fraud in the affairs of the business of a person.
- (2) Where the auditor detects any financial fraud, he shall make a report to the regulator giving details of the frauds so detected and the aggregate amount of the money involved in such financial fraud.
- (3) Failure by the auditor to report any financial fraud to the regulator will render him liable to a fine up to rupees one lakh by the concerned regulator after providing him reasonable opportunity of being heard.

**19. Act to have overriding effect:** The provisions of this Act shall have effect notwithstanding anything inconsistent therewith contained in any other law for the time being in force or in any instrument having effect by virtue of any law other than this Act.

**20. Power of the Union Government to make rules:** (1) The Central Government may, by notification, make rules to carry out the provisions of this Act.

(2) Without prejudice to the generality of the foregoing powers, such rules may provide for all or any of the following matters, namely :-

(a) the salaries and allowances and other terms and conditions of service of the Chairman and members of the Fraud Committee and other officers and employees attached to the Committee;

(b) the salaries and allowances and other terms and conditions of service of director and members nominated by the Ministry of Finance and investigating officer.

(c) Any other matter which is required to be, or may be, prescribed.

**21. Amendment to Act 45 of 1860:** The Indian Penal Code shall be amended in the manner specified in the First Schedule to this Act.

**22. Amendment to Act 1 of 1872:** The Indian Evidence Act, 1872 shall be amended in the manner specified in the Second Schedule to this Act.

**23. Amendment to Act 2 of 1974:** The Code of Criminal Procedure shall be amended in the manner specified in the Fourth Schedule to this Act.

### Schedule – I

#### Amendment to the Indian Penal Code, 1860

After Chapter XXII, the following shall be inserted :

Chapter XXIV

**512 - Financial Fraud** – Financial fraud means and includes any of the following acts committed by a person or with his connivance, or by his agent, in his dealings with any bank or financial institution or any other entity holding public funds;

(a) the suggestion, as a fact, of that which is not true, by one who does not believe it to be true;

(b) the active concealment of a fact by one having knowledge or belief of the fact;

(c) a promise made with out any intention of performing it;

(d) any other act fitted to deceive;

(e) any such act or omission as the law specially declares to be fraudulent.

Provided that whoever acquires, possesses or transfers any proceeds of financial fraud or enters into any transaction which is related to proceeds of fraud either directly or indirectly or conceals or aids in the concealment of the proceeds of financial fraud, commits financial fraud.

*Illustrations:*

(a) A, B & C, the directors of a public limited company raise capital by public issue and thereafter neither the directors nor the company is traceable. The directors are guilty of financial fraud.

(b) “A” takes project finance from a banking company creating a security interest by hypothecating his plant and machinery. He afterwards sells the plant and machinery without knowledge or permission of the banking company. “A” is guilty of financial fraud.

- (c) At the request of “A”, a banking company opens a letter of credit on goods on transit by ship. “A” transfers the goods on high seas and takes the consideration without informing the banking company. “A” is guilty of financial fraud.
- (d) “A” opens a foreign currency non-residence account with a power of attorney from non-resident Indian and uses the same as a security of his over-draft borrowings. Subsequently “A” removes money from his over-draft account. “A” is guilty of financial fraud.
- (e) The directors of a plantation company collect contributions from the public with a promise that after 20 years, each contributor of Rs.1,000/- would be paid Rs.1 lakh being the value of contributors’ teak plan. There are no plantations at all. The directors of a plantation company are guilty of financial fraud.
- (f) “A”, a computer engineer is engaged by a bank to repair the computers. “A” transfers funds from the accounts of the customers of the bank by means of electronically operated system and without any authority from the bank. “A” is guilty of financial fraud.

**513(a) - Punishment for Financial Fraud** – Whoever commits financial fraud shall be :

(a) punished with rigorous imprisonment for a term, which may extend to seven years and shall also be liable to fine.

(b) Whoever commits serious financial fraud shall be punished with rigorous imprisonment for a term which may extend to ten years but shall not be less than five years and shall also be liable for fine up to double the amount involved in such fraud.

Provided that in both (a) and (b) all funds, bank accounts and properties acquired using such funds subjected to the financial fraud as may reasonably be attributed by the investigating agency shall be recovered and restored to the rightful owner according to the procedure established by law.

Explanation : (1) Public fund means funds collected from public either by deposit or by issue of equity or loan instruments or through public investment in any scheme or the Government fund or any amount collected from public otherwise.

Explanation : (2) For the purpose of this section, serious financial fraud means if and only if, the case (i) involves a sum exceeding Rs.ten crore; or (ii) is likely to give rise to widespread public concern; or (iii) its investigation and prosecution are likely to require high specialized knowledge of financial market or of the behavior of banks or other financial institutions; or (iv) involves significant international dimensions; or (v) in the investigation of which there is requirement of legal, financial, investment and investigative skills to be brought together; or (vi) which appear to be complex to the regulators, banks, Union Government or any financial institution.

## Schedule II

Amendment to Indian Evidence Act, 1872

After Section 114A of the Indian Evidence Act, 1872 the following shall be inserted.

Section 114 B – **Presumption as to financial fraud** – When a financial fraud has been committed by a person or an abetment or criminal conspiracy made for such financial fraud, the Court shall presume intention of the party or parties committing act of abetment or criminal conspiracy or attempt for such financial frauds, of the parties committing such offence as the case may be unless such intention is disproved by the accused.

**Schedule III****Amendment to Code of Criminal Procedure, 1973**

1. After Chapter VII A of the code of Criminal Procedure, 1973, Chapter VII B shall be inserted as under.

**CHAPTER VII B**

Procedure for search, seize and attachment of properties, bank accounts & funds and forfeiture and restoration of such properties and funds under Financial Fraud

**Section 105 M – Right of the investigating officer to search**

Where the officer-in-charge of a Police Station, on the basis of information in his possession, has reason to believe that any person –

- (i) has committed any act which constitutes financial fraud, or
- (ii) is in possession of any proceeds of crime involved in financial fraud, or
- (iii) is in possession of any records relating to financial fraud,

then, subject to other provisions of the Code, he or any officer authorised by him may -

- (a) enter and search any building, place, vessel, vehicle or aircraft where he has reason to suspect that such records or proceeds of crime are kept;
- (b) break open the lock of any door, box locker, safe, almirah or other receptacle for exercising the powers conferred by clause (a) were the keys thereof are not available;
- (c) place marks of identification on such record or make or cause to be made extracts or copies therefrom;
- (d) make a note or an inventory of such record or property;
- (e) examine on oath any person, who is found to be in possession or control of any record or property, in respect of all matters relevant for the purposes of any investigation.

**Section 105 N – Right of the investigating officer to seize movable properties and documents**

- (1) An officer-in-charge of a Police Station or any officer authorised by him may seize any record, property or fund found as a result of any search under section 105 M.
- (2) Where the officer-in-charge of a Police Station is satisfied that any evidence of financial fraud may be or is likely to be concealed or tampered with, he may, for reasons to be recorded in writing, enter and search the building work place where such evidence is located and seize that evidence.
- (3) An officer-in-charge may seize any property or fund which may be alleged or suspected to be the proceeds of a financial fraud or which may be found under the circumstances which create suspicion of the commission of financial fraud .
- (4) The officer-in-charge of a police station seizing any record, property or fund under this section shall within a period of 30 days from such seizure, report to the court having jurisdiction to try the offence and may file an application, requesting for retention of such record, property or fund.

**Section 105 O – Right of the investigating officer to trace the properties and funds**

The officer-in-charge of a Police Station shall have the power to take all steps necessary for tracing and identifying any property or fund derived or obtained by any person, directly or indirectly, by such person from the commission of a financial fraud.

**Section 105 P – Right of the investigating officer to temporarily attach immovable properties and funds**

- (1) Where the officer-in-charge of a Police Station has reason to believe, that : -
- any person is in possession of any proceeds of financial fraud;
  - such person has been charged of having committed an offence stated in Section 513 of Indian Penal Code; and
  - such proceeds of financial fraud have either been invested in any immovable property or are likely to be concealed, transferred or dealt with in any manner which may result in frustrating any proceedings relating to confiscation of such proceeds of financial fraud, he may, by order in writing, provisionally attach such property or fund for a period not exceeding 30 days from the date of the order.

Provided that no such order of attachment shall be made unless, in relation to a financial fraud a report has been forwarded to a court of session under Section 173 of the Code.

- The officer-in-charge of a Police Station who provisionally attaches any property or fund under sub-section (1) shall, within a period of 30 days from such attachment, file a complaint, stating the fact of such attachment before the court having jurisdiction to try the offence and seeking direction of the court to hold custody of such property as may be stipulated by the court.
- Every order of attachment under sub-section (1) shall cease to have effect after the expiry of the period specified in that sub-section or on the date of confirmation by the court having jurisdiction to try the offence, whichever is earlier.

**Section 105 Q - Court's confirmation of attachment**

- When a complaint is submitted by the concerned officer-in-charge of a Police Station either under Section 105N or Section 105P, the court may confirm the attachment.
- The court may direct officer-in-charge of the Police Station to keep in custody all movable properties and documents seized and the District Collector of the District in whose jurisdiction any immovable property and funds attached lie, to administer the same until the court otherwise decides; or to transfer possession of all properties, movable and immovable, tangible or intangible and funds to the Court Receiver and Administrator, if any, to manage such property until the conclusion of the trial.

**Section 105 R - Court's order of forfeiture**

If as a result of the inquiry, investigation or search, the court trying the offence of financial fraud has reason to believe that all or any of the properties or funds are proceeds of financial fraud, it may forfeit such property or fund by following similar procedure prescribed under Section 105-G and Section 105-H of the Code.

**Section 105 S - Court's order for restoration**

When an inquiry or trial in any court having jurisdiction to try the offence of financial fraud is concluded, the court may make such order as it thinks fit for the restoration of the property to the institution from which the property had been fraudulently acquired or with the proceeds of which the property seized or attached had been acquired and in the event of such restoration is made impossible by intervening circumstances, the court may direct disposing the property or fund in such manner as the court deems fit.

2. In the First Schedule to the Act, after the last entry, the following shall be inserted, namely :

Section	Offence	Punishment	Cognizable or Non-cognizable	Bailable or Non-bailable	By what Court triable
513	Financial Fraud	Rigorous imprisonment	Cognizable	Non-bailable	Court of Session

		for seven years and also fine			
	If serious financial fraud	Rigorous imprisonment for ten years and fine up to double the amount	Ditto	Ditto	Ditto

<sup>1</sup>Section 17 of the Contract Act defines fraud as follows: "Fraud means and includes any of the following acts committed by a party to a contract, with his connivance, or by his agent, with intent to deceive another party thereto or his agent, or to induce him to enter into the contract: (a) suggestion as a fact, of that which is not true, by one who does not believe it to be true; (b) active concealment of a fact by one having knowledge of belief of that fact; (c) a promise made without any intention of performing it; (d) any other fact fitted to deceive; (e) any such act or omission as the law specifically describes to be fraudulent".

<sup>2</sup> Section 2 (14) of the Act provides as follows – "A person who, in purported compliance with a requirement under this section, (a) makes a statement which he knows to be false or misleading in a material particular; or (b) recklessly makes a statement which is false or misleading in a material particular shall be guilty of an offence". Section 2(16) even makes activities by the parties consequent upon the investigation, an offence. It stipulates, "Where any person, (a) knows or suspects that an investigation by the police or the serious fraud office into serious or complex fraud is being or is likely to be carried out; and (b) falsifies, conceals, destroys or otherwise disposes of, or causes or permits the falsification, concealment, destruction or disposal of documents which he knows or suspects are or would be relevant to such an investigation, he shall be guilty of an offence unless he proves that he had no intention of concealing the facts disclosed by the documents from persons carrying out such an investigation".

<sup>3</sup> However in the conversation with our delegates SFO informed that it may even investigate a fraud with the involvement of lesser amount if the SFO thinks it serious.

<sup>4</sup> See *supra* note. 1.

<sup>5</sup> As a matter of fact the Criminal Law (Second Amendment) Bill, 1995 was introduced in the Lok Sabha as Bill 65 of 1995 which *inter alia* included the provision for creation of Bank frauds in a separate Section under section 424 A of the Indian Penal Code, 1860 which provided as follows – "Whoever dishonestly or fraudulently, (a) removes or conceals, or transfers or causes to be transferred any property in his custody or control which is subject to any form of security interest created in favour of any bank without the express or implied consent or concurrence of such banks or he furnishes any statement which is false in any material particular, to any bank concerning any property which is in his custody or control and which is either subject to any form or security interest in favour of any bank or which is offered by him to any bank to be made subject to any security interest in favour of the bank, shall be punished with imprisonment of either description which may extend to two years or with fine or both".

<sup>6</sup> According to Section 2 (h) of the Criminal Procedure Code, 1973 investigation includes all the proceedings under this Code for the collection of evidence conducted by a police officer or by any person (other than a magistrate) who is authorized by a magistrate in this behalf.

<sup>7</sup> A part of the Lord Roskill Committee on which the Serious Fraud Office(SFO) was established, submitted in 1986 was quoted as follows by Robert Wardle, Assistant Director, SFO, London in the SFO information detailing the 'SFO Ten Years On' in press inquiries 0170-239 7003 published in April 1998, "the public no longer believes that the legal system in England and Wales is capable of bringing the perpetrators of serious frauds expeditiously and effectively to book. The overwhelming weight of the evidence laid before us suggests that the public is right. In relation to such crimes and to the skillful and determined criminals who commit them the present legal system is archaic, cumbersome and unreliable. "

<sup>8</sup> The Civil Law system is predominantly conceived on normative jurisprudence of Emanuel Kant. According to this philosophy the requirements of an effective legal systems are as follows, (1) heuristic conditions like (a) the legal propositions shall take into account the physical capacities of the persons to whom the propositions are applied; (b) the appropriate factual systems shall be taken into account in building the legal proposition; (c) average intelligence of the people must be taken into account in building



the legal proposition; (d) the proposition must be clear, distinct and easily understandable; (e) prioritized aims and objectives of legal propositions must be clear; (f) detailed procedures to achieve objectives; (g) effective institutional structure; (2) proper epistemological conditions for the participants and institutions for acquiring skills and systemic learning; (i) adequate hermeneutic conditions for appropriate teleological structure of sufficient abstraction of the principle of the legal proposition. [See, for details, Chhatrpati Singh, *Law from Anarchy to Utopia*(OUP, 1985, New Delhi)pp.40-62. On the other hand effective merit of Common Law is dependent on (a) clarity of legal proposition based on empirical behaviour on similar fact situation; (b) natural law principles as an extension to the principle of law of nature protecting individual rights and (c) ability of those who take decisions.

<sup>9</sup> Ms. Juhi Mehta & Ms. Deepa Bharathi Sharma, Research Scholars from NLSIU, Bangalore compiling and commenting on the issue.

<sup>10</sup> Abichandani, R.K., *Pollock and Mulla on Indian Contract and Specific Relief Acts*, Volume 1, N.M. Tripathi Pvt. Ltd., Bombay, 1994 at 241. English law also recognises the concept of 'constructive fraud'. This means that a court of equity will set aside a transaction entered into as a result of conduct, which though not amounting to actual fraud or deceit, is contrary to good conscience. Such conduct, which is described as constructive fraud includes the procurement of a gift or other benefit by the exercise of undue influence and the making of an unconscionable bargain. For details see: *Infra* n.2, para 838.

<sup>11</sup> (1889) 14 App. Cas 337 HC, *c.f. Halsburys Laws of England*, Volume 11(2), 4<sup>th</sup> edition, Reissue 1990, para 780.

<sup>12</sup> *Ibid*, para 755.

<sup>13</sup> *Ibid*, para 781.

<sup>14</sup> Aldridge, Anthony, Jacques Parry and Ian Gatt, *Aldridge and Parry on Fraud*, Sweet and Maxwell, London, 1996 at 33.

<sup>15</sup> Deception however is not an essential element of criminal fraud. In *Scott v. Metropolitan Police Commissioner*, [1974] 2 All.E.R. 204, the appellant had bribed cinema staff to make illicit copies of films. The appellant had not intended to defraud the owners, and therefore it was argued that there was no intention to defraud. Rejecting this argument, the court held that in order to constitute a conspiracy to defraud, what is important is that the purpose and the intended means of achieving the purpose must be dishonest. They need not involve fraudulent misrepresentation such as is needed to constitute the civil tort of deceit. Dishonesty of any kind is enough.

<sup>16</sup> *Supra* n. 5 at 34-35.

<sup>17</sup> *Supra* n. 5 at 35-36.

<sup>18</sup> *Att.-Gen.'s Reference (No. 1 of 1981)*, [1982] 2 All.E.R. 417.

<sup>19</sup> Section 12(3) of the Criminal Justice Act, 1987, *c.f. Aldridge and Parry on Fraud* at 45. Conspiracy to defraud is now a statutory offence under English law. It is defined as "...if a person agrees with any other person or persons that a course of conduct shall be pursued which, if the agreement is carried out in accordance with their intentions, either

- a) will necessarily amount to or involve the commission of any offence or offences by one or more of the parties to the agreement, or
- b) would do so but for the existence of facts which render the commission of the offence or any of the offence impossible, he is guilty of conspiracy to commit the offence or offences in question"(Section 1(1) of the Criminal Justice Act, 1977, *c.f. Aldridge and Parry on Fraud* at 45.)

<sup>20</sup> *Att.-Gen.'s Reference (No. 1 of 1982)*, [1983] 2 All.E.R. 721.

<sup>21</sup> *Supra* n. 5 at 52.

<sup>22</sup> *Somchai Liangsiraser v. Government of the U.S.A.* [1990] 2 All.E.R. 866; *R v. Sansom* [1991] 2 All.E.R.145.

<sup>23</sup> This is also a well-settled principle of private international law that courts will not enforce foreign criminal law.

<sup>24</sup> Section 25 of the Indian Penal Code, 1860.

<sup>25</sup> Section 415 of the Indian Penal Code, 1860.

<sup>26</sup> Section 416 of the Indian Penal Code, 1860.

<sup>27</sup> Section 408 of the Indian Penal Code, 1860.

<sup>28</sup> Section 409 of the Indian Penal Code states, "Whoever, being in any manner entrusted with the property, or with any domination over property in his capacity of a public servant or in the way of his

business as a banker, merchant, factor, broker, attorney or agent commits criminal breach of trust in respect of that property, shall be punished with imprisonment for life or with imprisonment of either description for a term which may extend to ten years and shall also be liable to fine”.

<sup>29</sup> Section 463 of the Indian Penal Code, 1860 which stipulates as follows, “whosoever makes any false document or false electronic record or a part of a document or electronic record with intent to cause damage or injury, to the public or to any person, or to support any claim or title, or cause any person to part with the property, or to enter into any express or implied contract, with the or intent to commit fraud or that fraud may be committed, commits forgery”.

<sup>30</sup> Section 464 of the Indian Penal Code, 1860.

<sup>31</sup> Section 467 of the Indian Penal Code, 1860.

<sup>32</sup> Section 468 of the Indian Penal Code, 1860.

<sup>33</sup> Section 474 of the Indian Penal Code, 1860.

<sup>34</sup> *Compendium of Instructions Relating to Frauds in Commercial Banks*, Department of Supervision, Reserve Bank of India, 1996.

<sup>35</sup> Kite flying stands for transactions where one party and its associate or two different parties having accounts in two branches indulge in availing of ‘withdrawal against clearing’ facility against instruments known to have been drawn without funds. Funds are obtained from banks wherein false cheques/bills drawn on sister concerns are submitted to banks for purchase/discounting. The bills/cheques are then sent to the concerned company’s bank for payment. After some time, the false bills/cheques are returned unpaid by the sister concern by which time the money has been utilised for purposes other than what it was intended for.

<sup>36</sup> *Report of the Study Group on Large Value Bank Frauds*, Board of Financial Supervision, Reserve Bank of India, 1999.

<sup>37</sup> Ms. Juhi Mehta & Ms. Deepa Bharathi Sharma, Research Scholars from NLSIU, Bangalore compiling and commenting on the issue.

<sup>38</sup> Hereinafter referred to as the “S.F.O.”.

<sup>39</sup> The S.F.O. finds its origins in various commissions and committee recommendations made to the UK government. In 1983, Lord Roskill as the chairman of a Fraud Trials Committee recommended the establishment of a unified organisation responsible for all the functions of detection, investigation and prosecution of serious fraud”. These recommendations gave rise to the Criminal Justice Act, 1987 which set up the S.F.O.

<sup>40</sup> *Supra* n. 5 at 419.

<sup>41</sup> Hereinafter referred to as “the Act”.

<sup>42</sup> *Supra* n.5.

<sup>43</sup> *Supra* n.5 at 421.

<sup>44</sup> These powers of the S.F.O. will be dealt with later.

<sup>45</sup> *Supra* n. 5 at 421-422. A senior lawyer usually undertakes the task of vetting. The S.F.O. aims to make a decision within 10 days, although this may be extended if additional information is required. The vetting officer prepares a discussion document for consideration by a vetting committee, which consists of the Director, the Deputy Director, the vetting officer and a senior from the appropriate police force. In certain cases other persons, e.g., an accountant or the person or organisation who made the complaint, may be invited to attend.

<sup>46</sup> *Serious Fraud Office: What it does and how it works*, <http://www.sfo.gov.uk/>, Visited on 9.12.2000.

<sup>47</sup> *Ibid.*

<sup>48</sup> *Ibid.*

<sup>49</sup> *Supra* n.5 at 424.

<sup>50</sup> [1992] 1 All.E.R. 730.

<sup>51</sup> [1988] Crim L.R.837, *c.f.* Aldridge and Parry on Fraud at 445.

<sup>52</sup> *Supra* n.5 at 433-434.

<sup>53</sup> The Financial Services Act, 1986 in Sections 177 and 178 while dealing with the offence of insider trading, defines the term reasonable excuse as [Section 178 (6)]:

“A person shall not be treated...as having a reasonable excuse for refusing to comply with a request or answer a question in a case where the contravention or suspected contravention being investigated

relates to dealing by him on the instructions or for the account of another person, by reason that at the time of the refusal-

- a) He did not know the identity of that other person; or
- b) He was subject to the law of a country or territory outside the United Kingdom which prohibited him from disclosing information relating to the dealing without the consent of that other person, *if he might have obtained that consent or exemption from that law.*"

<sup>54</sup> [1993] 3 All.E.R. 861.

<sup>55</sup> [1992] 1 All.E.R. 778.

<sup>56</sup> *Supra n.5* at 439.

<sup>57</sup> In *R v. Director of S.F.O., ex p. Johnson*, [1993] C.O.D.58. the Director served a Section 2 notice on the wife of the accused, requiring her to furnish information in relating to investigation against her husband. The wife filed for judicial review on the ground that as the wife of the accused she had a 'reasonable excuse' for not complying with the request, since under Section 80(3) of the Police and Criminal Evidence Act, 1984 she was not a compellable witness for the prosecution. Rejecting her argument it was held that even though she may not be a compellable witness, she could not refuse requests under Section 2, since Section 2 dealt with investigation of fraud rather than admissibility of evidence.

<sup>58</sup> *Ibid.*

<sup>59</sup> *Annual Report 1993-1994*, Serious Fraud Office, <http://www.sfo.gov.uk/>, Visited on 9.12.2000. The claim to such privilege is not outright. Usually the practice of the S.F.O. is to place the material in respect of which privilege is claimed into sacks that are sealed. They are subsequently opened in the presence of the solicitors advising the person entitled to claim privilege, and inspected by an S.F.O. lawyer who is not involved in the investigation or prosecution in question. Each document is then separately considered, and the claim for privilege resolved.

<sup>60</sup> *Supra n.5* at 434-438.

<sup>61</sup> Articles 6 and 8 of the European Convention on Human Rights, *c.f.* Janis, Mark, Richard Kay and Anthony Bradley, *European Human Rights Law-Text and Materials*, Clarendon Press, Oxford, Reprint 1996 at 468.

<sup>62</sup> <http://clea.org.uk/cases/ftext/Saunders/htm>, Visited on 10.12.2000.

<sup>63</sup> (No. 10828/84) (1993) 16 E.H.R.R. 297, *c.f.* Aldridge and Parry on Fraud at 447. In the present case customs officers accompanied by a police officer went to the Funke's house to seek details of his assets abroad. The applicant, a German national, admitted having, or having had, several bank accounts abroad for professional and family reasons and said that he did not have any bank statements at his home. The customs officers searched his home for some four and a half hours and discovered statements and chequebooks from foreign banks, together with some other items. These were all seized. The customs officers, pursuant to powers given to them by the Customs Code, also required the applicant to produce three years' statements for variety of bank accounts held outside France. Upon refusal, he was prosecuted and fined.

<sup>64</sup> *Supra n.39*. To quote the court in this context- "...It does not accept the Government's argument that the complexity of corporate fraud and the vital public interest in the investigation of such fraud and the punishment of those responsible could justify such a marked departure as that which occurred in the present case from one of the basic principles of a fair procedure. Like the Commission, it considers that *the general requirements of fairness contained in Article 6, including the right not to incriminate oneself, apply to criminal proceedings in respect of all types of criminal offences without distinction from the most simple to the most complex.* The public interest cannot be invoked to justify the use of answers compulsorily obtained in a non-judicial investigation to incriminate the accused during the trial proceedings."

<sup>65</sup> *Supra n.5* at 459.

<sup>66</sup> *Supra n.5* at 460.

<sup>67</sup> [1994] Crim.L.R. 374, *c.f.* Aldridge and Parry on Fraud at 461.

<sup>68</sup> *Supra n.5* at 464.

<sup>69</sup> In *Galbraith*, the Court of Appeal held that in case no evidence is available against the defendant the case must be dismissed. Where however there may be space for opposing views to be formed on the evidence, the judge should allow the case to be tried by the jury. [1981] 2 All.E.R. 1060 at 1062.

<sup>70</sup> [1993] 1 W.L.R. 949.

<sup>71</sup> Section 29(3) of the Supreme Court Act, 1981 provides: "in relation to the jurisdiction in matters relating to trial on indictment, the High Court shall have all such jurisdiction to make orders of mandamus, prohibition or certiorari as the High Court possesses in relation to the jurisdiction of an inferior court".

<sup>72</sup> *Supra* n. 5 at 482.

<sup>73</sup> *Ibid* at 484.

<sup>74</sup> *Ibid* at 485. A prosecution case statement sets out:

- i. The principal facts of the prosecution case;
- ii. The witnesses who will speak those facts;
- iii. Any exhibits relevant to those facts;
- iv. Any propositions of law on which the prosecution proposes to rely, and
- v. The consequences in relation to any of the courts in the indictment that appear to the prosecution to flow from the matters stated in pursuance of the above sub-paragraphs.

<sup>75</sup> *Ibid* at 485-490.

<sup>76</sup> *Supra* n.5 at 490-494.

<sup>77</sup> [1966] 1 Q.B. 589.

<sup>78</sup> *Supra* n. 5 at 511.

<sup>79</sup> *Greenfield [1973] 1 W.L.R.1151*. In *Greenfield*, the prosecution alleged a general agreement to cause 25 explosions. There was argument at the trial as to whether, even if it were shown that the defendants were involved in some explosions, there was sufficient proof that they were involved in all. The Court of Appeal endorsed the view that it was enough if there was a core of explosions for which they were all responsible.

<sup>80</sup> Wright, Rosalind, "The Investigation and Prosecution of Serious and Complex Fraud Towards the 21<sup>st</sup> Century", *Lecture Notes, ISCRL Commercial and Financial Fraud Conference, July 8<sup>th</sup>-12<sup>th</sup> 1999, Malta*, <http://www.sfo.gov.uk/malta.htm>, Visited on 12.12.2000.

<sup>81</sup> Electronic fund transfers entail a process whereby credit is extinguished from one bank account and a new account is opened in another account, with minimal human intervention. For details on online fraud see: Smith, Dr Russell G., "The Prevention of On-Line Financial Fraud", <http://www.isrcl.org/Smith.htm>, Visited on 5.12.2000.

<sup>82</sup> *Annual Report, 1998*, Serious Fraud Office, <http://www.sfo.gov.uk/>, Visited on 9.01.2001.

<sup>83</sup> Wright, Rosalind, *What Does the Future Hold for the SFO?*, April 1998, <http://www.sfo.gov.uk/>, Visited on 9.12.2000.

<sup>84</sup> *Supra* n. 58.

<sup>85</sup> Savona, Ernesto u., *Recent Trends of Economic Crime in Europe*, Paper presented to the Bank of Portugal meeting held on July 1, 1997, <http://www.jus.unintn.it/transcrime/papers/wp13.htm>, Visited on 15.12.2000. To look at these statistics sector wise-The most frequent type of fraud is the one involving tobacco and cigarettes. It occurs in Germany, Belgium, Spain, France, Ireland and Italy. Fraud concerning agricultural products is insistently carried out in most Union countries; specifically for beef (Belgium, Germany, France and the United Kingdom), cereals (Germany, Italy and Portugal), milk products (Germany, Spain, Italy and the United Kingdom), and olive oil (Spain, Italy and Portugal). Industrial goods are rarely used for fraud, with the exception of textiles. Customs offences receive the most frequent mention, with several reports dwelling on frauds affecting the Community or international transits (Belgium, Spain, France and Italy).

<sup>86</sup> *Ibid*.

<sup>87</sup> *Ibid*.

<sup>88</sup> *Ibid*.

<sup>89</sup> *Explanatory Report on the Convention on the protection of the European Communities' financial interests (Text approved by the Council on 26 May 1997)*, [http://europa.eu.int/eur-lex/en/com/pdf/2000/com2000\\_0358en01.pdf](http://europa.eu.int/eur-lex/en/com/pdf/2000/com2000_0358en01.pdf), Visited on 15.12.200.

<sup>90</sup> *Supra* n. 66. The convention also warrants criminal liability on heads of business, whose businesses are involved in the commission of a financial fraud.

<sup>91</sup> *Ibid*.

<sup>92</sup> *Protecting the Communities' Financial Interests the fight against fraud*, Annual Report 1999,

---

Commission of the European Communities, Brussels, 8.11.2000, [http://europa.eu.int/eur-lex/en/com/pdf/2000/act0718en02/com2000\\_0718en02\\_1.pdf](http://europa.eu.int/eur-lex/en/com/pdf/2000/act0718en02/com2000_0718en02_1.pdf) , Visited on 15.12.2000.

<sup>93</sup> *Report by the European Anti-Fraud Office*, First Report on Operational Activities, 1 June 1999-30 May 2000, European Anti-Fraud Office, Brussels, 23.5.2000, [http://europa.eu.int/comm/anti\\_fraud/documents/rapport\\_en.pdf](http://europa.eu.int/comm/anti_fraud/documents/rapport_en.pdf), Visited on 2.12.2000.

<sup>94</sup> *The criminal protection of the Community's financial interests: a European Prosecutor*, Additional Commission contribution to the Intergovernmental Conference on institutional reforms, Communication from the Commission, Brussels, 29.09.2000, [http://europa.eu.int/eur-lex/en/com/pdf/2000/com2000\\_0608en01.pdf](http://europa.eu.int/eur-lex/en/com/pdf/2000/com2000_0608en01.pdf), Visited on 15.12.2000.

<sup>95</sup> *Cited from* 37 Am Jur 2d, p.18.

<sup>96</sup> *Fuller v. Scarborough*, 239 Ala 196 So 875, *cited from Ibid*, p.19.

<sup>97</sup> <http://dictionary.lp.findlaw.com/scripts/results.pl?co=library.lp.findlaw.com&topic=30/30871e2ed1b1e92ab87cbd4c809d8c7c> visited on 9th January, 2001.

<sup>98</sup> *Warfield Natural Gas Co. v. Allen*, 91 ALR 890.

<sup>99</sup> *Crawford v. Crawford*, 134 GA 114 *cited from Supra* n. 1, p. 20.

<sup>100</sup> *Corabi v. Auto Racing, Inc.* 264 F2d 784

<sup>101</sup> fraud also needs to be distinguished from duress as in the latter there is an element of threat which is conspicuous in its absence from the first. Also in the latter the plaintiff is fully aware of the illegality of the transaction while fraud, by definition, is perpetrated without the knowledge of the plaintiff.

<sup>102</sup> *Supra* n.1, p.21.

<sup>103</sup> *Supra* n. 3.

<sup>104</sup> It is for this reason that equitable fraud is often equated to constructive fraud. There is a very fine, if any, distinction between constructive and legal fraud. While the former refers to fraud in case of breach of a fiduciary relationship or in a contract uberrimae fidae while a legal fraud characterises a misrepresentation made without the knowledge of its falsity