INDIA'S FINANCIAL SECTOR
AN ASSESSMENT

Volume V

Advisory Panel
on
Institutions and Market Structure

Committee on Financial Sector Assessment

March 2009

भारत सरकार
GOVERNMENT OF INDIA

भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA

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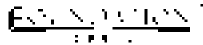

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Composition of the Advisory Panel on Institutions and Market Structure

Shri C. M. Vasudev	Former Secretary Department of Economic Affairs Ministry of Finance Government of India	Chairman
Shri C. B. Bhave	Chairman and Managing Director National Securities Depository Ltd. (up to February 15, 2008)	Member
Dr. K. C. Chakraborty	Chairman and Managing Director Punjab National Bank	Member
Dr. R. Chandrasekhar	Dean, Academic Affairs Institute for Financial Management and Research	Member
Dr. Ashok Ganguly	Chairman, Firstsource Solutions Ltd.	Member
Dr. Omkar Goswami	Chairman, CERG Advisory Pvt. Ltd.	Member
Shri Y. H. Malegam	Chartered Accountant	Member
Dr. Nachiket Mor	Deputy Managing Director, ICICI Bank Ltd.	Member
Shri T.V.Mohandas Pai	Member of the Board, Infosys Ltd.	Member
Shri Gagan Rai	Chairman and Managing Director National Securities Depository Ltd. (from February 25, 2008)	Member
Dr. Janmejaya Sinha	Managing Director Boston Consulting Group	Member
Special Invitees		
Shri Jitesh Khosla	Joint Secretary Ministry of Corporate Affairs Government of India	
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Dr. R. B. Barman	Executive Director Reserve Bank of India	
Shri Anand Sinha	Executive Director Reserve Bank of India	
Shri C. R. Muralidharan	Member Insurance Regulatory and Development Authority	
Shri Sandeep Parekh	Adviser (Legal) Securities and Exchange Board of India	

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List of Acronyms

AAS	Auditing and Assurance Standards
AASB	Auditing and Assurance Standards Board
ACH	Automated Clearing House
ADR	American Depository Receipt
AGMs	Annual General Meetings
AI	Approved Intermediary
AoA	Articles of Association
APC	Auditing Practices Committee
AR	Audited Results
AS	Accounting Standards
ASB	Accounting Standards Board
ASSOCHAM	Associated Chambers of Commerce and Industry of India
BCBS	Basel Committee on Banking Supervision
BIFR	Board for Industrial and Financial Reconstruction
BIS	Bank for International Settlements
BMC	Base Minimum Capital
BO	Beneficial Owners
BoD	Board of Directors
BOISL	Bank of India Shareholding Ltd.
BOLT	BSE Online Trading System
BPSS	Board for Regulation and Supervision of Payment & Settlement Systems
BR Act	Banking Regulation Act
BSE	Bombay Stock Exchange
CA	Companies Act
CAG	Comptroller and Auditor General of India
CASLB	Committee on Accounting Standards for Local Bodies
CBDT	Central Board of Direct Taxes
CBLO	Collateralised Borrowing and Lending Obligation
CC	Clearing Corporation
CCIL	Clearing Corporation of India Ltd.
CCP	Central Counterparty
CDR	Corporate Debt Restructuring
CDSL	Central Depository Services Limited
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CG	Corporate Governance
CGTSI	Credit Guarantee Fund Trust for Small Industries
CH	Clearing House
CIC Act	Credit Information Companies Act
CII	Confederation of Indian Industry
CLB	Company Law Board
CLS	Continuous Linked Settlement
CM	Clearing Members
CP	Custodial Participant
CPC	Civil Procedure Code
CPE	Continuing Professional Education
CPSIPS	Core Principles for Systemically Important Payment Systems
CPSS	Committee on Payment and Settlement Systems
CrPC	Criminal Procedure Code
C & S	Clearing and Settlement
CSD	Central Securities Depository
DBOD	Department of Banking Operations and Development
DBS	Department of Banking Supervision
DICGC	Deposit Insurance and Credit Guarantee Corporation

DIP	Disclosure and Investor Protection
DNS	Deferred Net Settlement
DP	Depository Participant
DRT	Debt Recovery Tribunal
DvP	Delivery Versus Payment
ECS	Electronic Clearing Services
ECGC	Export Credit Guarantee Corporation of India
EFT	Electronic Funds Transfer
EGM	Extraordinary General Meeting
ELM	Extreme Loss Margin
ESOP	Employee Stock Option Scheme
ESPS	Employee Share Purchase Scheme
EU	European Union
FASB	Financial Accounting Standards Board
FDR	Fixed Deposit Receipts
FICCI	Federation of Indian Chambers of Commerce and Industry
FII	Foreign Institutional Investors
F & O	Futures and Options
FRRB	Financial Reporting Review Board
FSAP	Financial Sector Assessment Programme
FSF	Financial Stability Forum
GAAP	Generally Accepted Accounting Principles
GASAB	Government Accounting Standards Advisory Board
GCC	General Credit Card
GDR	Global Depository Receipt
GIC	General Insurance Corporation
GoI	Government of India
GS Act	Government Securities Act
HLCCFM	High Level Co-ordination Committee on Financial Markets
HR	Human Resources
HVC	High Value Clearing
HVCCS	High Value Cheque Clearing System
IAASB	International Auditing and Assurance Board
IAPC	International Auditing Practices Committee
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IBA	Indian Banks' Association
ICA	Inter-credit Agreement
ICAI	Institute of Chartered Accountants of India
ICSI	Institute of Companies Secretaries of India
ICWAI	Institute of Cost and Works Accountants of India
IDL	Intra-day Liquidity
IEPF	Investors Education and Protection Fund
IFAC	International Federation of Accountants
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
IFTP	Inter-bank Funds Transfer Processor
INTOSAI	International Organisation of Supreme Audit Institutions
IPSAB	International Public Sector Accounting Standards Board
IMF	International Monetary Fund
IMS	Institutions and Market Structure

IMSS	Integrated Market Surveillance Systems
IOSCO	International Organisation of Securities Commission
IPC	Indian Penal Code
IPSASs	International Public Sector Accounting Standards
IPO	Initial Public Offer
IRDA	Insurance Regulatory and Development Authority
IS	International Standards
ISA	International Standards on Auditing
ISAE	International Standards on Assurance Engagement
ISIN	International Securities Identification Number
ISQC	International Standards on Quality Control
ISRE	International Standards on Review Engagement
ISRS	International Standards on Related Services Engagement
ISSA	International Securities Services Association
IT ACT	Information Technology Act
KCC	Kisan Credit Card
LA	Listing Agreement
LIC	Life Insurance Corporation of India
LoC	Line of Credit
MCA	Ministry of Corporate Affairs
MDA	Management Discussion and Analysis
MoU	Memorandum of Understanding
MF	Mutual Fund
MICR	Magnetic Ink Character Recognition
MMBCS	Magnetic Media-based Computer System
MNSB	Multilateral Net Settlement Batch
MTM	Mark-to-market
NABARD	National Bank for Agriculture and Rural Development
NACAS	National Advisory Committee on Accounting Standards
NBFC	Non-banking Financial Companies
NCIT	Non-custodial Institutional Trade
NCLAT	National Company Law Appellate Tribunal
NCLT	National Company Law Tribunal
NDS	Negotiated Dealing System
NDS-OM	Negotiated Dealing System Order Matching
NEAT	National Stock Exchange for Automated Trading
NECS	National Electronic Clearing Services
NEFT	National Electronic Funds Transfer
NGO	Non-governmental Organisation
NHB	National Housing Bank
NI Act	Negotiable Instrument Act
NPOs	Not-for-profit Organisations
NSCCL	National Securities Clearing Corporation Limited
NSDL	National Securities Depository Ltd.
NSE	National Stock Exchange
NSS	National Standards-setter
OECD	Organisation of Co-operation and Economic Development
O L	Official Liquidator
PAN	Permanent Account Number
PCM	Professional Clearing Member
PD	Primary Dealers
PDO	Public Debt Office

PI	Participant Interface
PU	Practice Unit
QRB	Quality Review Board
RBI	Reserve Bank of India
RoC	Registrar of Companies
ROSC	Report on the Observance of Standards and Codes
RRBs	Regional Rural Banks
RSE	Recognised Stock Exchange
RTGS	Real Time Gross Settlement
SARFAESI	Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests Act
SAST	Substantial Acquisition of Shares and Takeovers
SBI	State Bank of India
SCB	Scheduled Commercial Banks
SCM	Self-clearing Members
SCODA	SEBI Committee on Disclosures and Accounting Standards
SCOPE	Standing Conference of Public Enterprises
SCRA	Securities Contracts (Regulation) Act
SCRR	Securities Contracts (Regulations) Rules
SE	Stock Exchange
SEBI	Securities and Exchange Board of India
SEC	Securities and Exchange Commission
SHG	Self-help Group
SIC	Standing Interpretations Committee
SICA	Sick Industrial Companies (Special Provision) Act
SIPS	Systemically Important Payment Systems
SLB	Securities Lending and Borrowing
SMAC	Secondary Market Advisory Committee
SMCs	Small and Medium-sized Companies
SMEs	Small and Medium-sized Enterprises
SMP	Small and Medium Practitioners
SOX	Sarbanes Oxley Act
SQC	Standard on Quality Control
SR	Special Resolution
SRO	Self-regulatory Organisation
SSS	Securities Settlement System
STA	Share Transfer Agent
St CB	State Co-operative Bank
STP	Straight-through Processing
TMCM	Trading Member-cum-clearing member
TSR	Total Solution Release
UNCITRAL	United Nations Commission on International Trade Law
URRBCH	Uniform Regulations and Rules for Bankers' Clearing House
VaR	Value-at-Risk
VAT	Value-added Tax
WTD	Whole-time Director

Chapter I

Approach to Assessment

The Government of India in consultation with the Reserve Bank constituted the Committee on Financial Sector Assessment (CFSA) in September 2006, with a mandate to undertake a comprehensive assessment of the Indian financial sector focusing upon stability and development. The CFSA was chaired by Dr. Rakesh Mohan, Deputy Governor, Reserve Bank of India. The Co-chairmen were Shri Ashok Jha, Dr. D. Subbarao and Shri Ashok Chawla, Secretary, Department of Economic Affairs, Ministry of Finance, Government of India. The Committee also had officials from the Government of India as its members.

Taking into account the legal, regulatory and supervisory architecture in India, it was felt that there was a need for involving and associating closely all the major regulatory institutions, *viz.*, Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI) and Insurance Regulatory and Development Authority (IRDA), in addition to representatives from the Government for this exercise. In order to leverage the available expertise to the maximum possible extent, it was also deemed fit to involve, besides the regulatory authorities, other agencies as relevant to the work.

To assist the Committee in the process of assessment, the CFSA constituted four Advisory Panels for Financial Stability Assessment and Stress Testing, Financial Regulation and Supervision, Institutions and Market Structure and Transparency Standards, in August 2007. While the Panel on Financial Stability Assessment and Stress Testing conducted macro-prudential surveillance to assess the soundness and stability and developmental aspects of financial system, the other three Panels identified and evaluated the implementation of relevant standards and codes in different areas. All Panels have dealt with measures for strengthening the financial system from a medium-term perspective. The Panels were assisted by Technical Groups comprising mainly officials from relevant organisations to provide technical inputs and data support, as appropriate to the respective Advisory Panels. A Secretariat was constituted within the Monetary Policy Department in the Reserve Bank to provide logistical and organisational support to the Advisory Panels and Technical Groups.

Advisory Panel on Institutions and Market Structure

As part of the assessment of standards and codes, the terms of reference of the Advisory Panel on Institutions and Market Structure were to identify and consider the relevant standards and codes as currently prescribed and applicable for accounting, auditing, bankruptcy laws, corporate

governance and payment and settlement systems and evaluate their implementation in the Indian context; identify the gaps in adherence to these standards and codes and the reasons therefor; and suggest possible roadmaps addressing *inter alia* the developmental issues relating to these standards and codes, in a medium-term perspective. The Advisory Panel chaired by Shri C. M. Vasudev, comprised non-official experts as members and officials representing Government and other agencies as special invitees (**Annex A**).

Technical Group on Institutions and Market Structure

A Technical Group comprising officials drawn from government and other agencies who are directly associated with handling respective areas of work, assisted the Advisory Panel in preparing preliminary assessments and background material, which served as inputs to the Advisory Panel's work (See **Annex B** for the composition of the Technical Group and terms of reference). Apart from the officials indicated in Annex B**,** the Panel also benefited from the inputs of the officials indicated in **Annex C.**

Approach and Methodology

The Technical Group identified the standards issued by the International Accounting Standards Board (IASB) and the International Auditing and Assurance Standards Board (IAASB) as the relevant standards applicable to the assessment of the accounting and auditing standards, respectively.

The assessment of adherence to bankruptcy laws was based on the revised draft of the 'Principles and Guidelines for Effective Insolvency and Creditor Rights Systems' issued by the World Bank.

Likewise, the OECD principles for Corporate Governance were identified as the relevant international standard applicable to assess corporate governance.

The adherence to payment and settlement systems was assessed on the standards developed by the Committee on Payment and Settlement Systems (CPSS) and the International Organisation of Securities Commission (IOSCO).

The preliminary assessments made by the Technical Groups were considered by the Advisory Panel with closer involvement of four sub-panels (**Annex D**) in the areas of accounting and auditing, bankruptcy laws, corporate governance and payment and settlement systems. The Advisory Panel had a total of five meetings to consider the assessments and recommendations and to finalise its Report.

Peer Review

At the request of the CFSA, seven national and also international experts on areas relating to accounting, auditing, bankruptcy laws, corporate governance and payment and settlement systems peer reviewed the draft Reports on respective assessments and recommendations (**Annex E).**

The Advisory Panel considered in-depth the comments made by the peer reviewers and appropriately modified the Report after

incorporating the comments/suggestions. The Panel had also the option of not concurring with the peer reviewers' comments, if they were considered not appropriate, particularly in the Indian context. In the interest of transparency, the comments of the peer reviewers and the stance taken by the Panel are provided appropriately in respective parts of this Report.

Scheme of the Report

The Report is divided into seven chapters. After the 'Approach to Assessment' in this chapter, chapter II covers assessment of adherence to accounting standards. Chapter III covers assessment of adherence to auditing standards. Chapter IV covers assesment of adherence to corporate governance principles. Chapter V covers the assessment of adherence to standards pertaining to payment and settlement systems. Chapter VI covers the assessment of adherence to principles for effective insolvency and creditor rights systems and chapter VII gives the summary of recommendations of the Panel.

Annex A

RESERVE BANK OF INDIA
CENTRAL OFFICE
SHAHID BHAGAT SINGH ROAD
MUMBAI – 400 001, INDIA

DEPUTY GOVERNOR

MEMORANDUM

Constitution of Advisory Panel on Institutions and Market Structure

A Committee on Financial Sector Assessment (CFSA) has been constituted by the Government of India in consultation with the Reserve Bank, with the objective of undertaking a self-assessment of financial sector stability and development. One of the analytical components of Financial Sector Assessment would encompass a comprehensive assessment of the status and implementation of various international financial standards and codes.

2. In this connection, the CFSA has decided to constitute an Advisory Panel on Institutions & Market Structure comprising the following:

No	Name	Designation/Institution	
1.	Shri C. M. Vasudev	Former Secretary, Economic Affairs, Government of India	Chairman
2.	Shri C. B. Bhave	Chairman and Managing Director, National Securities Depository Ltd.	Member
3.	Dr. K. C. Chakraborty	Chairman and Managing Director, Punjab National Bank	Member
4.	Dr. R. Chandrasekar	Dean, Academic Affairs, Institute for Financial Management and Research	Member
5.	Dr. Ashok Ganguly	Chairman, Firstsource Solutions Ltd.	Member
6.	Dr. Omkar Goswami	Chairman, CERG Advisory Pvt. Ltd.	Member
7.	Shri Y. H. Malegam	Chartered Accountant	Member
8.	Dr. Nachiket Mor	Deputy Managing Director, ICICI Bank Ltd.	Member
9.	Shri T. V. Mohandas Pai	Member of the Board, Infosys Ltd.	Member
10.	Dr. Janmejaya Sinha	Managing Director, Boston Consulting Group	Member
11.	Shri Gagan Rai	Chairman and Managing Director, National Securities Depository Ltd.	Member

3. In addition, the Advisory Panel can utilise the expertise of the following *ex-officio* Special Invitees:

No.	Name	Designation/Organisation
1.	Shri Jitesh Khosla	Joint Secretary (Corporate Affairs), Ministry of Corporate Affairs, Government of India
2.	Dr. K.P.Krishnan	Joint Secretary (Capital Markets), Department of Economic Affairs, Ministry of Finance, Government of India
3.	Dr. R.B.Barman	Executive Director, Reserve Bank of India
4.	Shri Anand Sinha	Executive Director, Reserve Bank of India
5.	Shri C.R.Muralidharan	Member, Insurance Regulatory and Development Authority
6.	Shri Sandeep Parekh	Advisor (Legal), Securities and Exchange Board of India

4. The Advisory Panel will have the following terms of reference:

   (i) to identify and consider the relevant standards and codes as currently prescribed and applicable for institutions and market structure in terms of bankruptcy laws, accounting and auditing, payment and settlement systems and corporate governance policies and evaluate their implementation in the Indian context;

   (ii) to identify the gaps in adherence to the respective standards and codes and the reasons therefor; and

   (iii) to suggest possible roadmaps addressing, *inter alia*, the developmental issues relating to respective standards and codes, in a medium-term perspective.

5. The Advisory Panel would have the option of co-opting as Special Invitees any other experts as they deem fit.

6. The secretarial assistance to the Advisory Panel will be provided by the Reserve Bank of India. The Technical Group on Institutions and Market Structure constituted by the Reserve Bank at the instance of the Committee has already progressed with the technical work with regard to above terms of reference. The technical notes and background material prepared by these groups would *inter alia* form the basis for discussion by the Panel and in drafting of the Report.

7. The Advisory Panel will prepare a detailed Report covering the above aspects and the Government of India/Reserve Bank of India will have the discretion of making the Report public, after a peer review, as they may deem fit.

8. The Advisory Panel is expected to submit its Report in about three months from the date of its first meeting.

(Rakesh Mohan)
Deputy Governor and Chairman of the
Committee on Financial Sector Assessment

Mumbai
August 10, 2007

Annex B

RESERVE BANK OF INDIA
CENTRAL OFFICE
SHAHID BHAGAT SINGH ROAD
MUMBAI – 400 001, INDIA

DEPUTY GOVERNOR

MEMORANDUM

Constitution of Technical Group on Institutions & Market Structure

The Committee on Financial Sector Assessment (CFSA) will undertake a self-assessment of financial sector stability and development. One of the analytical components of Financial Sector Assessment would encompass a comprehensive assessment of the status and implementation of various international financial standards and codes. CFSA has decided to constitute a Technical Group on Institutions & Market Structure comprising the following:

No.	Name	Designation/Institution	
1.	Shri K. D. Zacharias	Legal Adviser-in-Charge, LD, RBI	Member
2.	Dr. Janak Raj	Advisor, DEAP, RBI	Member
3.	Shri Chandan Sinha	Chief General Manager, FMD, RBI	Member
4.	Shri A. P. Hota	Chief General Manager, DPSS, RBI	Member
5.	Shri P. K. Panda	General Manager, DBS, RBI	Member
6.	Shri P. R. Ravimohan	General Manager, DBOD, RBI	Member
7.	Shri D. Rajagopala Rao	General Manager, DNBS, RBI	Member
8.	Shri Amarjeet Singh	Regional Manager, SEBI	Member
9.	Shri Pawan Kumar	Director, Ministry of Corporate Affairs	Member
10.	Ms. Mamta Suri	Deputy Director, IRDA	Member
11.	Shri K. Kanagasabapathy	Secretary to CFSA	Convenor

2. The Group will have the following terms of reference:

(i) to identify the relevant standards and codes as currently prescribed by various standard-setting bodies in relation to bankruptcy laws, accounting, auditing, payment and settlement systems and corporate governance policies;

(ii) to compile relevant data and information on follow-up of earlier assessments and recommendations made by the earlier FSAP and also internally by the Standing

Committee on International Financial Standards and Codes on the relevant standards;

(iii) to contribute to technical work in the implementation of the remaining elements of standards and codes pertaining to bankruptcy laws, accounting, auditing, payment and settlement systems and corporate governance;

(iv) to identify the gaps in adherence to the respective standards and codes and the reasons therefor;

(v) to suggest possible roadmaps addressing, *inter alia*, the developmental issues, in the medium-term perspective; and

(vi) to provide a fair and independent assessment on bankruptcy laws, accounting, auditing, payment and settlement systems and corporate governance in the form required by Advisory Groups constituted by the Reserve Bank and other regulatory agencies.

3. The Group would function under the overall guidance of Shri V.K. Sharma, Executive Director, Reserve Bank of India.

4. The Group will also be directed by decisions taken by the Advisory Panel on Institutions and Market Structure.

5. A list of Special Invitees who could act as resource persons to the Group and whose expertise can be called upon by the Group while preparing inputs for the Advisory Panels is provided in Annex C. The Group may co-opt as special invitees, one or more of the identified officials, or any other officials from the Reserve Bank, Government or other agencies as they deem appropriate.

6. The Group is expected to complete its task in the minimum possible time which, in any case, would not go beyond three months from the date of its constitution.

(Rakesh Mohan)
Chairman
March 1, 2007

Annex C

List of Officials who Assisted the Advisory Panel

The Panel acknowledges the contributions made by the following officials in preparation of the Report.

No.	Name	Designation
1.	Dr. Janak Raj	Adviser, RBI
2.	Shri T. B. Satyanarayana	General Manager, RBI
3.	Shri R. N. Kar	General Manager, RBI
4.	Shri Arun Pasricha	General Manager, RBI
5.	Ms. Sudha Damodar	General Manager, RBI
6.	Dr. Mohua Roy	Director, RBI
7.	Shri S. Dhamodaran	Senior General Manager, ICICI Bank
8.	Shri Jaikant Singh	Director, Accounting and Auditing, MCA
9.	Shri O. N. Ravi	Senior Vice-President, CCIL
10.	Ms. Bhavna Doshi	Senior Adviser, KPMG
11.	Shri Vijay Kapur	Director, AASB
12.	Shri P. Rama Rao	Official Liquidator, Ministry of Corporate Affairs, GoI
13.	Shri Himanshu Mohanty	Deputy General Manager, RBI
14.	Shri Sunil T. S. Nair	Deputy General Manager, RBI
15.	Ms. Jyoti Jindgar	Deputy General Manager, SEBI
16.	Ms. Nilima Ramteke	Assistant General Manager, RBI
17.	Shri Puneet Pancholy	Assistant General Manager, RBI
18.	Shri K. Vijay Kumar	Assistant General Manager, RBI
19.	Shri D. Sathish Kumar	Assistant General Manager, RBI
20.	Shri Nishanth Gopinath	Assistant General Manager, RBI
21.	Shri L. M. Devare	Official Liquidator, Bank of Karad
22.	Ms. Vandana Jindal	Assistant General Manager, SEBI
23.	Shri A. Abhilash	Legal Officer, RBI
24.	Shri B. Bohra	Legal Officer, RBI

Annex D

Details of Sub-Panels formed by the Advisory Panel on Institutions and Market Structure

Subject Area	Members of Sub-Panel
Accounting and Auditing	Shri Y. H. Malegam*
Bankruptcy Laws	Dr. Omkar Goswami
	Dr. K. C. Chakraborty
Corporate Governance	Dr. Ashok Ganguly
	Dr. R. Chandrasekar
	Shri T. V. Mohandas Pai
Payment and Settlement Systems	Shri C. B. Bhave
	Dr. Janmejaya Sinha
	Dr. Nachiket Mor
	Shri Gagan Rai

* Commented on the Draft Report on Assessment of Adhrence to Corporate Governance Principles also.

Annex E

List of Peer Reviewers who Reviewed the Assessments

No.	Subject	Name/s of the Peer Reviewer/s
1.	Accounting	Mr. Ian Mackintosh, Chairman, Accounting Standards Board, UK Dr. Kamal Gupta, FCA
2.	Auditing	Mr. Ian Mackintosh, Chairman, Accounting Standards Board, UK Shri N. P. Sarda, Chairman, Deloitte, Haskins and Sells
3.	Bankruptcy Laws	Mr. Thomas Baxter, Jr. General Counsel and Executive Vice President Federal Reserve Bank of New York Shri T. R. Sridharan, Former Chairman, Canara Bank
4.	Corporate Governance	Sir Andrew Large, Former Deputy Governor, Bank of England
5.	Payment and Settlement Systems	Mr. Greg Johnston, Head of Banking, Reserve Bank of Australia

Chapter II

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Chapter II

Assessment of Accounting Standards

1. Introduction

1. Accounting Standards provide the basis for accurate financial reporting which is essential in a modern market corporate-driven economy. Robustness, reliability and transparency of financial reports determine the effectiveness of financial decision-making process, resource allocation and functioning of capital markets.

2. Accounting Standards harmonise different accounting policies and practices in use in a country, leading to reduction in accounting alternatives used in the preparation of financial statements, standardisation of presentation and disclosure norms to achieve comparability of financial statements of the different enterprises functioning in a country.

3. This chapter of the Report describes the current status of observance of International Accounting Standards in India and the initiatives taken in this regard by the Institute of Chartered Accountants of India (ICAI), the premier accounting body established under an Act of Parliament. ICAI operates in association with and with the support of the Ministry of Corporate Affairs, the Reserve Bank and various other regulatory bodies like Securities and Exchange Board of India (SEBI).

4. This assessment builds on the two immediately preceding assessment reports on the subject:

(i) The Report (January 2001) of the Advisory Group on Accounting and Auditing appointed by the Reserve Bank to evaluate and report on observance of international standards and codes in various areas impacting overall financial system (Advisory Group-2001); and

(ii) The Report on Observance of Standards and Codes (December 2004) (ROSC) issued as a part of joint initiative of the World Bank and the International Monetary Fund (IMF) for reviewing the strengths and weaknesses of corporate accounting and auditing practices in India (ROSC-2004).

5. After listing key findings and recommendations of Advisory Group-2001 and ROSC-2004, this chapter provides a brief description of the international initiatives for harmonisation of accounting practices and policies and the international benchmark used for this assessment. It then proceeds to provide the status of Indian Accounting Standards, the standard-setting process, legal and regulatory framework in this regard and a comparison of Indian Accounting Standards *vis-à-vis* International Accounting Standards. It then sets out the progress made in relation to the observations/recommendations made in the earlier reports, specifically, ROSC-2004. This is followed by recommendations of the Advisory Panel on the way forward.

1.1 Significant Findings and Recommendations of Advisory Group-2001

6. The Group compared the Indian Accounting and Auditing Standards with international standards, identified gaps and made recommendations to bridge the gaps. Its principal observations relating to Accounting Standards were:

(i) There is a significant gap between Standards issued by International Accounting Standards Committee (IASC) and ICAI, especially in respect of standards relating to financial institutions.

(ii) All standards issued by ICAI do not correspond to the standards issued by IASC.

Accordingly, it recommended that:

(i) ICAI must take steps to reduce the gaps between Indian and International Accounting Standards and take up, on emergency basis, issuance of standards for financial institutions in line with (a) IAS30, *Disclosures in Financial Statements of Banks and Similar Financial Institutions;* (b) IAS32, *Financial Instruments: Disclosure and Presentation*; and (c) IAS39, *Financial Instruments: Recognition and Measurement.*

(ii) It should be the endeavour of the Accounting Standards Board (ASB) that Indian Accounting Standards correspond, as far as possible with the International Accounting Standards and wherever there is departure, the Standard should identify the same and explain the reasons for departure.

(iii) ASB should be an autonomous body within ICAI with its own staff and independent funding.

(iv) There should be only one standard-setting authority in the country.

(v) ASB should set up a separate committee to address issues requiring immediate pronouncements.

(vi) There should be a mechanism in place to monitor compliance with the standards.

1.2 Significant Findings and Recommendations of Report on Observance of Standards and Codes-2004

7. ROSC-2004 reported as under:

'India's accounting profession was among the earliest to develop historically when the Indian Companies Act was enacted in the mid-1800s, giving the accounting profession its start. Since then, considerable efforts have been made to align India's accounting and auditing standards and practices with the internationally accepted standards and codes. However, there is room for improvement.

Indian accounting and auditing standards are developed on the basis of international standards; and the country has many accountants and auditors who are highly skilled and capable of providing international- standard services. However, in order to further improve the quality of corporate financial reporting in India, there is a need to improve the institutional framework and take steps for enhancing compliance with the applicable standards and rules.

Enhanced by significant inputs from stakeholders, this Report provides some

principles-based policy recommendations aimed at strengthening the corporate financial reporting regime in India. These recommendations specifically focus on strengthening the monitoring and enforcement arrangements. Moreover, suggestions have been made on some important elements of an independent oversight body for the auditing profession, from a public interest perspective. The objectives of the recommendations are to build on the existing system and promote a gradual process of improvement'.

8. The key policy recommendations of ROSC-2004, so far as they relate to accounting and auditing practices, are, accordingly focussed on strengthening of monitoring and enforcement mechanism and the role of each link in the monitoring and enforcement chain:

(i) the top management/preparers and issuers of financial statements;

(ii) the auditors reporting on the extent of compliance with Accounting Standards by the preparers of financial statements while conducting audit in accordance with applicable auditing standards; and

(iii) regulators preventing non-compliance with accounting and auditing standards through monitoring and enforcement of activities of both top management/ preparers of financial statements and auditors auditing and reporting on these financial statements.

The Report made the following key recommendations in relation to Accounting Standards/practices:

(i) Steps be taken to issue national standards for International Financial Reporting Standards (IFRSs) for which national standards are not yet issued.

(ii) Rationalise Companies Act, specifically, Schedule VI and the rates of depreciation, to bring it in line with Accounting Standards.

(iii) ICAI be recognised as single accounting standard-setting body.

(iv) Bring regulations and monitoring of financial reporting practice by all corporate banks under purview of the Reserve Bank.

(v) Scale up structured training programme for ICAI members.

(vi) Improve professional education and training arrangements.

2. Accounting Standards – The International Benchmark

9. The need for harmonising accounting practices and policies adopted in different countries was recognised by various accounting bodies of the world when, as result of an agreement between accountancy bodies in Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, UK, Ireland and the US, the International Accounting Standards Committee (IASC) was constituted in 1973 for harmonising global accounting policies and practices by developing International Accounting Standards (IASs). This initiative towards the harmonisation of accounting policies received a boost with the constitution of the International Federation of Accountants (IFAC) in 1977. IFAC was established by agreement among 63 professional accounting bodies from 51 countries with the objective of strengthening the accountancy profession by developing high quality international standards and supporting their adoption and use.

10. The Standards issued by IASC were described as International Accounting Standards (IAS). In April 2001, IASC was reconstituted as the International Accounting Standards Board (IASB) and took over the responsibility of setting Accounting Standards from IASC. The Standards issued by IASB are known as the IFRS. IASC had issued 41 Standards till 2001, when a process of restructuring was undertaken and the role of development of International Accounting

Standards was transferred to IASB. Since then, new IFRSs have been issued, many IASs have been revised and certain IASs have been withdrawn. As and when IASs are completely revised, they are issued as the IFRSs. As on date, 29 IASs are in force, the rest having been withdrawn. IASB has issued 8 IFRSs. IASs and IFRSs are collectively referred to as the IFRSs.

11. The interpretations of IASs and IFRSs are developed by the International Financial Reporting Interpretations Committee (IFRIC). IFRIC replaced the former Standing Interpretations Committee (SIC) in March 2002. IFRIC's mission is *'to interpret the application of International Accounting Standards (IASs) and International Financial Reporting Standards (IFRSs) and provide timely guidance on financial reporting issues not specifically addressed in IASs and IFRSs, in the context of the IASB framework, and undertake other tasks at the request of the IASB'.*

12. Besides the IFRSs, which are currently adopted or adapted by large number of countries, the Accounting Standards developed by United States of America (commonly referred to as US GAAPs – Generally Accepted Accounting Practices) have also assumed significance in the world of global financial reporting because of the increased number of global enterprises seeking listing in US capital markets. This has resulted in two widely recognised and used financial reporting standards; IFRSs and US GAAPs.

13. Recognising the influence of these two sets of financial reporting standards in establishing a benchmark in setting the world's financial reporting system, the Financial Accounting Standards Board (FASB) of the US and IASB felt that a sensible way to achieve a single set of the global financial reporting standards would be to move towards convergence of US GAAPs and IFRSs. A joint meeting between FASB and IASB held in October 2002 in Norwalk, USA formalised their commitment to the convergence of US GAAPs and IFRSs by issuing a memorandum of understanding ('Norwalk Agreement') and pledged to use their best efforts to make their existing financial reporting standards fully compatible as soon as is practicable, and to co-ordinate their future work programmes to ensure that once achieved, compatibility is maintained.

14. The Securities Exchange Commission (SEC) of the US announced on November 15, 2007 that non-US companies will be allowed to file their accounts based on the IFRSs without requiring to file the reconciliation statement between IFRSs and US GAAPs for the financial statements covering years ending after November 15, 2007 and 60 days after the relevant amendments to rule are published in the Federal Register.

15. The International Organisation of Securities Commission (IOSCO), recognising the need for standardisation of accounting practices followed globally in view of growing cross-border movement of capital, has propagated the use of the IFRSs as the uniform language of business.

16. The European Union (EU) has also adopted IFRSs as financial reporting standards for all EU- listed companies for preparing the consolidated financial statements from January 1, 2005. Australia has also adopted IFRSs from

2005 and New Zealand from 2007. Canada has announced that it will adopt IFRSs from 2011.

17. The Report of Advisory Group-2001 and ROSC-2004 used IFRSs as the benchmark for their assessment. Accordingly, IFRSs have been used as the benchmark for this Report.

3. Accounting Standards in India

18. The Indian accounting profession is among the oldest in the world. It was developed formally when the Indian Companies Act was enacted in the mid-1800s.

19. The process of codification of accounting practices in the form of Accounting Standards in India started with the establishment of the Accounting Standards Board (ASB) by ICAI in 1977. While formulating Indian Accounting Standards, ASB takes into consideration the applicable laws, customs, usages, level of development and business environment prevailing in the country and makes suitable modifications to International Accounting Standards.

3.1 Composition of the Accounting Standards Board

20. ICAI has established the ASB as a committee of the Council of ICAI. The composition of the ASB is broad-based with a view to ensuring the participation of all interest groups in the standard-setting process. These interest groups include industry, various departments of government and regulatory authorities, financial institutions, academic and professional bodies. Industry is represented on the ASB by their apex level associations, *viz.,* Associated Chambers of Commerce and Industry of India (ASSOCHAM), Federation of Indian Chambers of Commerce and Industry (FICCI) and Confederation of Indian Industries (CII). As regards government departments and regulatory authorities, the Reserve Bank, Insurance Regulatory Development Authority, Ministry of Corporate Affairs, Central Board of Direct Taxes, Comptroller & Auditor General of India, Controller General of Accounts, Securities and Exchange Board of India and Central Board of Excise and Customs are represented on the ASB. Besides these, representatives of academic and professional institutions such as universities, Indian Institutes of Management, Institute of Cost and Works Accountants of India and Institute of Company Secretaries of India are also represented on the ASB. Apart from these interest groups, members of the Central Council of ICAI are also nominated on the ASB.

3.2 The Accounting Standard-setting Process

21. Accounting standard-setting, by its very nature, involves an optimal balance of requirements of financial information for various interest groups having a stake in financial reporting. With a view to reaching consensus, to the extent possible, as to the requirements of the relevant interest groups and thereby bringing about general acceptance of Accounting Standards among such groups, considerable research, consultations and discussions with the representatives of the relevant interest groups at different stages of standard formulation becomes necessary.

The standard-setting procedure of the ASB, as briefly outlined below, is designed to ensure such consultation and discussions:

(i) Identification of the broad areas by ASB for formulating Accounting Standards.

(ii) Constitution of the study groups by ASB for preparing preliminary drafts of the proposed Accounting Standards.

(iii) Consideration of the preliminary draft prepared by the study group by ASB and revisions, if any, of the draft on the basis of deliberations by ASB.

(iv) Circulation of the draft, so revised, among Council members of ICAI and 12 specified outside bodies such as Standing Conference of Public Enterprises (SCOPE), Indian Banks' Association, apex-

level industry associations, SEBI, IRDA, Comptroller and Auditor General of India (C& AG) and Ministry of Corporate Affairs, for comments.

(v) Meeting with the representatives of specified outside bodies to ascertain their views on the draft of the proposed Accounting Standard.

(vi) Finalisation of the Exposure Draft of the proposed Accounting Standard on the basis of comments received.

(vii) Issuance of the Exposure Draft inviting public comments.

(viii) Consideration of the comments received on the Exposure Draft and finalisation of the draft Accounting Standard by ASB for submission to the Council of the ICAI for its consideration and approval for issuance.

(ix) Consideration of the draft Accounting Standard by the Council of ICAI, and if found necessary, modification of the draft in consultation with ASB.

(x) Issuance of the Accounting Standard, so finalised, under the authority of the Council of ICAI.

3.3 Recognition of Accounting Standards

22. Accounting Standards issued by ICAI received legal recognition in 1998 with the insertion of Sections 211(3A), (3B) and (3C) in the Companies Act, 1956. These sections require all companies (private or public) to prepare their financial statements in accordance with the Accounting Standards recommended by ICAI and prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards (NACAS), which was constituted by the Central Government on 29 August 2001 under authority of Section 210 A of the Companies Act, 1956 with its secretariat at the ICAI. Its constitution is given in **Appendix A**.

23. The Standards issued by ICAI are deliberated at length by NACAS and recommended to the Central Government for notification. The Ministry of Corporate Affairs vide its Notification dated December 7, 2006 notified Accounting Standards 1 to 7 and 9 to 29 as formulated by ICAI for adoption by companies.

24. SEBI, through the Stock Exchange listing agreements, requires listed companies to mandatorily comply with all the Standards as prescribed or deemed to be prescribed under the Companies Act, 1956 issued by ICAI from time to time.

25. IRDA requires insurance companies to follow the Standards issued by ICAI.

26. The Reserve Bank requires commercial banks to follow the Standards issued by ICAI through its binding circulars/guidelines. It also provides guidance to the banks on the application of Standards, where required.

27. Apart from the corporate bodies, the Council of ICAI has made various Accounting Standards mandatory in respect of certain non-corporate entities such as partnership firms, sole-proprietary concerns/individuals, societies registered under the Societies Registration Act,

trusts, associations of persons, and Hindu Undivided Families, where financial statements of such entities are statutorily required to be audited, for example, under Section 44AB of the Income-tax Act, 1961. The Council has cast a duty on its members to examine compliance with the Standards in the financial statements covered by their audit and in the event of any deviations therefrom, to make adequate disclosures in their audit reports so that the users of the financial statements are made aware of such deviations.

4. Present Status of Accounting Standards

4.1 Accounting Standards for Enterprises Engaged in Commercial, Industrial or Business Activities

28. Accounting Standards issued by the ICAI are applicable to enterprises engaged in industrial, commercial or business activities irrespective of the form of organisation (corporate, co-operative, partnership or even proprietorship concerns) and also irrespective of the objective for which it is established (charitable, religious or not-for-profit).

29. So far, 32 Indian Accounting Standards on the following subjects have been issued by ICAI:

AS 1 Disclosure of Accounting Policies

AS 2 Valuation of Inventories

AS 3 Cash Flow Statements

AS 4 Contingencies and Events Occurring after the Balance Sheet Date

AS 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

AS 6 Depreciation Accounting

AS 7 Construction Contracts (revised 2002)

AS 8 Accounting for Research and Development (withdrawn pursuant to the issuance of AS 26)

AS 9 Revenue Recognition

AS 10 Accounting for Fixed Assets

AS 11 The Effects of Changes in Foreign Exchange Rates (revised 2003)

AS 12 Accounting for Government Grants

AS 13 Accounting for Investments

AS 14 Accounting for Amalgamations

AS 15 Employee Benefits (Revised 2005)

AS 16 Borrowing Costs

AS 17 Segment Reporting

AS 18 Related Party Disclosures

AS 19 Leases

AS 20 Earnings Per Share

AS 21 Consolidated Financial Statements

AS 22 Accounting for Taxes on Income

AS 23 Accounting for Investments in Associates in Consolidated Financial Statements

AS 24 Discontinuing Operations

AS 25 Interim Financial Reporting

AS 26 Intangible Assets

AS 27 Financial Reporting of Interests in Joint Ventures

AS 28 Impairment of Assets

AS 29 Provisions, Contingent Liabilities and Contingent Assets

AS 30 Financial Instruments: Recognition and Measurement (Recommendatory from April 1, 2009 and mandatory from April 1, 2011) AS 31 Financial Instruments: Presentation (Recommendatory from April 1, 2009 and mandatory from April 1, 2011)

AS 32 Financial Instruments: Disclosures

All these standards use IFRSs as a base. A comparative statement setting out number and subject of IFRSs and IASs is given in **Appendix B**.

4.2 Accounting Standards for Small and Medium-sized Enterprises

30. Indian Accounting Standards are, in general, applicable to all entities whether there is public interest or not and irrespective of their form of organisation or size (share capital, turnover, number of employees). With the expansion in the coverage of Accounting Standards, it was felt that an application of all Accounting Standards to all entities (which includes even non-corporate entities who are required to get their financial statements audited by chartered accountants) would place too heavy a burden on small and medium enterprises in terms of cost and effort which would not be commensurate with the benefits.

31. Therefore, for the purpose of applying the standards, ICAI categorised enterprises into three levels, *i.e.,* Level I, Level II and Level III. Level II and Level III are considered to be SMEs. However, as per the notification of the Accounting Standards under the Companies Act, companies have been classified into two categories only, *i.e.*, Small and Medium Companies (SMCs) (Refer **Appendix C** for meaning of SMC) and other than SMCs. ICAI has recently harmonised its classification criteria with those under the Companies Act. Consequently, from accounting periods commencing on or after April 1, 2008 the position is as follows:

- The criteria for being categorised as a Level I company of ICAI and those of companies other than SMCs under the Rules are now identical. Similarly, the criteria for being categorised as a Level II company under ICAI's classification and those of SMCs under the Rules are the same.
- Entities that are bodies corporate but not companies (*e.g.* a corporation set up under a Central or State Act) would be classified under the revised scheme of classification of ICAI under Levels I and II only.
- Certain exemptions/relaxations have been given to enterprises falling in Levels II and III (*i.e.*, small and medium-sized enterprises). The exemptions/relaxations are primarily in respect of disclosure requirements. In general, the recognition and measurement principles to be applied by SMCs are the same as those to be applied by Level I enterprises. The exemptions/relaxations available to Level II non-company entities as per ICAI's classification would be the same as those available to SMCs under the Rules except that the aforesaid Level II entities that employ less than 50 employees during the accounting year will continue to enjoy certain exemptions/relaxations from AS 15, *Employee Benefits*, which are not available to SMCs under the Rules.
- AS18 (Related Party Disclosures) and AS24 (Discontinuing Operations) apply to Level II non-company entities also. The Rules too do not give any exemption to SMCs from AS18 or AS 24.

The harmonised criteria applicable to non-companies are in **Appendix D**.

4.3 Accounting Standards for Not-for-Profit Organisations (NPOs)/Non-governmental Organisations (NGOs)

32. Accounting Standards issued by ICAI do not apply to only those NPOs/NGOs who carry on activities that are not commercial, industrial or business in nature. The Research Committee of ICAI has issued a Technical Guide on Accounting and Auditing in NPOs/NGOs which recommends that the Standards issued by ICAI should be applied by even NPOs/NGOs engaged in purely non-commercial, non-business or non-industrial activities. The Technical Guide explains the manner in which the Accounting Standards should be applied by NPOs/NGOs to their activities.

4.4 Accounting Standards for Local Bodies

33. ICAI has been deeply involved in accounting reforms in government accounting, particularly, accounts of urban local bodies. It initially constituted a Sub-Committee of ASB for issuing Accounting Standards, for governments including urban local bodies in 1999. As a first step, it issued a Technical Guide on Accounting and Financial Reporting by urban local bodies, which contains recommendations relating to application of Accounting Standards, issued by ICAI, to urban local bodies. The purpose of this Technical Guide is to provide a broad framework for and directions to state governments and urban local bodies, ICAI members and others as they work to improve urban bodies' accounting and financial reporting systems. The recommendations contained in the Technical Guide have received a positive response from many urban local bodies that have shifted or are in the process of shifting from cash basis accounting to accrual basis accounting. The process has gained momentum as these bodies are increasingly going to the capital markets for raising funds. However, these bodies are still following diverse accounting policies and practices in the preparation of their financial statements. Therefore, a need was felt for formulating a single set of high quality financial reporting standards for local bodies setting out recognition, measurement, presentation and disclosure requirements dealing with transactions and events in general purpose financial statements of local bodies.

34. Recognising this need to harmonise and improve accounting and financial reporting among local bodies, ICAI constituted an independent Committee on Accounting Standards for Local Bodies (CASLB) in March 2005. The composition of the CASLB is broad-based and ensures the participation of all interest-groups in the standard-setting process. Apart from the members of the Council of the ICAI, the CASLB comprises representatives of the Ministry of Urban Development, the Comptroller and Auditor General of India, Controller General of Accounts, National Institute of Urban Affairs, Ministry of Panchayati Raj, directorates of major local bodies, directorates of local fund audit departments, academic institutions and other eminent professionals co-opted by the ICAI.

35. CASLB has been constituted primarily for formulating standards for local bodies. It can also take steps for improving the accounting methodology and systems of local bodies, and act as a forum to receive feedback from local bodies regarding the problems faced by them in the adoption of accrual accounting and in the application of the standards. While formulating standards for local bodies, CASLB gives due consideration to the International Public Sector Accounting Standards (IPSASs) prepared by the International Public Sector Accounting Standards Board (IPSASB) of IFAC and tries to integrate them, to the extent possible, with a view to facilitating global harmonisation.

36. The Committee's first publication, namely, 'Preface to the Accounting Standards for Local Bodies', sets out the objectives and operating procedures of CASLB and explains the scope and authority of the Standards for local bodies. Two Accounting Standards for local bodies (ASLB) are issued: ASLB3, *Revenue from*

Exchange Transactions and ASLB4, *Borrowing Costs.* The Exposure Draft of the 'Framework for Preparation and Presentation of Financial Reports by Local Bodies' is being finalised on the basis of the comments received on its limited exposure among the specified outside bodies. The drafts of the proposed standards for local bodies on *Presentation of Financial Statements* (ASLB1), *Property, Plant and Equipment* (ASLB5) and *Revenue from Exchange Transactions* (ASLB3) are being finalised for issuance for limited exposure[1] among specified outside bodies and Council Members. CASLB has also undertaken other projects for the preparation of standards for local bodies corresponding to IPSASs.

4.5 Accounting Standards for Governments

37. The Office of the Comptroller and Auditor General of India constituted the Government Accounting Standards Advisory Board (GASAB) in August 2002 *'in order to establish and improve standards of governmental accounting and financial reporting and enhance accountability mechanisms for Union and the State Government accounts'.* The recommendations made by GASAB will be considered by the Central Government for notification of the Standards to be adopted by governments. Amongst others, ICAI and the Reserve Bank are members of GASAB.

4.6 Accounting Standards for Business Enterprises Governed by Specific Acts of Parliament

38. Enterprises engaged in specified activities like banking, insurance or rate-regulated entities like electricity companies are governed by their specific statutes or regulations. These statutes or regulations, in general, set out the presentation and disclosure norms and, in specific cases, recognition and measurement principles. These norms and principles have an overriding effect over the norms and principles set out in the Indian Accounting Standards. These enterprises adopt Indian Accounting Standards in the absence of specific requirements or prescriptions under the statute or regulations governing an enterprise. Prescriptions under the statute or regulations are aimed at making more meaningful presentation of the financial information in the context of the activities of the concerned enterprise.

39. The banks in India, in addition to complying with the requirements of Indian Accounting Standards, are also required to adopt specific norms for certain items, *e.g.,* loan-loss provisioning. The Reserve Bank has adopted the core principles for effective banking supervision ennunciated by the Basel Committee on Banking Supervision (BCBS). BCBS has set out 25 core principles (CPs) in September 1997 and revised them substantially in October 2006. CP 22 relates to Accounting and Disclosures.

5. Divergences between Basel Committee Norms and IFRS and the Indian Position

40. There is a significant divergence between the Basel Committee norms and the stipulations under IFRSs. These are more pronounced in the case of treatment of impairment of loans and

[1] 'Limited exposure' is used when it is exposed to limited number of bodies – these are specified bodies. After comments are received from these bodies, they are considered by the Board, modifications, if required, are carried out and then the draft is sent for general exposure.

loan-loss provisioning. Attempts are being made to achieve convergence between IASB and BCBS on various contentious issues. However, AS30 corresponding to IAS39 has not yet been implemented in India. A Group has been formed by the Reserve Bank comprising members from the Reserve Bank, ICAI and bankers under the umbrella of Indian Banks' Association to iron out the differences and integrate the two approaches for smooth implementation by Indian banking system.

The insurance companies are required to adopt specific norms on income recognition, asset classification and provisioning as laid down by IRDA guidelines on the issue. Stipulations on insurance contracts as per the laws applicable to insurance companies in India and the one stipulated under IFRS4 on Insurance Contracts also have divergences from each other. Efforts have been initiated at ICAI and IRDA to integrate the two approaches and have a uniform standard. The ICAI has initiated steps to lay down the Accounting Standards with regard to insurance contracts.

6. Enforcing Compliance

6.1 The Companies Act

41. Companies governed by the Indian Companies Act, 1956 are required, by Section 211, to comply with Accounting Standards while preparing and presenting profit and loss account and balance sheet. The Section further requires that, in case of non-compliance, the company concerned shall disclose, in its profit and loss account and balance sheet, the deviation from the accounting standard, the reasons for such deviation, and the financial effect, if any, arising due to such deviation. Failure to comply with these requirements attracts fine upto Rs. 10,000 or imprisonment for a period up to six months or both.

6.2 Listing Agreement

42. The CEOs and CFOs of the companies, whose securities are listed on stock exchanges, are required to certify that the financial statements are in compliance with the Accounting Standards.

6.3 Disciplinary Action[2]

43. Auditors of companies are required to state whether, in their opinion, the profit and loss account and balance sheet comply with the accounting standards. This has been laid down in Section 227(3) of the Companies Act. Default by an auditor to report non-compliance invites disciplinary action. ICAI has a very robust system of dealing with complaints against members and it also takes *suo motu* action based on information relating to negligence or non-compliance of the provisions of the Companies Act and various other matters.

6.4 Financial Reporting Review Board

44. The Financial Reporting Review Board (FRRB) of the Institute undertakes a *suo motu* independent review of the published annual reports of the listed companies and certain other non-listed enterprises, as set out in the terms of reference of the FRRB, or based on any media reports and examines the same for any shortcomings in terms of financial reporting – compliance with the accounting standards, disclosures by the companies and also the adequacy of audit reports. Based on its findings, the FRRB can file a complaint with the relevant regulator, for example, SEBI, the Registrar of Companies or the Disciplinary Committee of the ICAI.

6.5 Peer Review Board

45. The Peer Review Board established by ICAI, in April 2002 aims at improving/enhancing the quality of service performed by members of

[2] Disciplinary action comprises investigation, which is a detailed process and opportunity is given to the member to explain the case. If found guilty, the punishment could range from reprimand to permanent removal of the name of the member from the list of members, depending on the nature of default.

ICAI, especially in relation to compliance with the technical standards by a firm (Practice Unit). In this process, the adequacy of the audit procedures and documentation for specific attest engagements are reviewed by the peer reviewer and a report is filed with the Peer Review Board. The peer review is repeated after six months or so in case of Practise Units found wanting/deficient in processes and documentation for attest engagements. The process of peer review has a persuasive influence in improving the quality of compliance with technical standards, including Accounting Standards.

6.6 Quality Review Board

46. Although not directly concerned with the enforcement of Accounting Standards, the Quality Review Board, newly constituted in June 2007, will also have a persuasive influence and will encourage reporting of non-compliance with Accounting Standards. The Board will perform the following functions:

(i) make recommendations to the Council with regard to the quality of services provided by the members of the Institute;

(ii) review the quality of services provided by the members of the Institute including audit services; and

(iii) guide the members of the Institute to improve the quality of services and adherence to various statutory and regulatory requirements.

47. The Board has ten members, excluding the Chairman. Five are nominated by the Central Government and five by the Council of ICAI. The Chairman to the Board is nominated by the Central Government.

7. Status of Progress on Recommendations of Reports of 2001 and 2004

7.1 Bridging Gap between Standards Issued by IASC/IASB & ICAI

48. The process of formulation of Accounting Standards commenced in India in 1977 but got a momentum after the amendment of the Indian Companies Act, 1956 [Section 211(3C)] in 1998 which gave legal recognition to the Accounting Standards. Prior to 1998, there was no specific legal mechanism to enforce compliance with Accounting Standards by the enterprises although, through the pronouncement of the ICAI, it was mandatory for the auditors to report on non-compliance, if any. The compliance with Accounting Standards was mandated for listed companies through Listing Agreements with Stock Exchanges by SEBI.

49. The gap, as observed by the Advisory Group-2001, has since been significantly bridged. This is also recognised in the ROSC-2004. There are Indian Accounting Standard/ Standards issued or in the process of formulation, corresponding to all the relevant International Accounting Standards or the subjects are covered by guidance notes.

50. ICAI has so far issued 32 ASs. Recently, it issued AS30, *Financial Instruments: Recognition and Measurement*, AS31, *Financial Instruments: Presentation*, AS32, *Financial Instruments: Disclosures* corresponding to IAS39, IAS32 and IFRS7, respectively. The Indian markets did not and even at present do not have sophisticated financial instruments as are referred to and dealt with in the concerned IFRSs. It, therefore,

has issued guidance notes that as and when a particular type of financial instrument is permitted, *e.g.,* options and futures, then the ASs would become applicable.

51. AS1 to 7 and AS9 to 29, formulated by ICAI, have been notified by the Ministry of Corporate Affairs, on December 7, 2006 to come into effect in respect of accounting periods commencing on or after the aforesaid date and consequently, it is now obligatory for companies, whether a private company or public, listed on any stock exchange or not, to adopt these Accounting Standards in preparation and presentation of financial statements. Some of the notified Standards provide exemptions/relaxations to SMCs as defined in the notification (Refer **Appendix C** for the meaning of SMCs).

52. Banking companies, coming within the purview of the Companies Act, are required to follow the ASs in preparation and presentation of their financial statements as per the provisions of Section 211 of the Companies Act, 1956. For listed public sector banks, the stock exchange Listing Agreements make applicability of ASs mandatory.

53. The Reserve Bank requires banks, which are not governed by the Companies Act, 1956, to follow the ASs issued by ICAI in preparation and presentation of financial statements through binding circulars/guidelines. Similarly, other regulatory bodies like IRDA also require compliance with ASs issued by ICAI.

7.2 Reducing Areas of Departures from IAS/IFRS

7.2.1 Reasons for Departures

54. IFRSs are adopted as a basis for formulation of Indian standards and due consideration is given to local customs, usage, practices, legal and regulatory environment. Departures have arisen:

- *On account of local legal and regulatory requirements – e.g.* AS21 and IAS27, *Consolidated Financial Statements* due to definition of 'control' in terms of Indian Companies Act, 1956; AS25 and IAS34, *Interim Financial Reporting* as regards requirement of disclosure and presentation of interim statements.
- *On account of local economic environment* – adoption of fair value – various IFRSs are based on fair value approach whereas markets in India were not considered to have necessary depth and breadth to provide reliable fair values for measurement purpose of accounting.
- *On account of conceptual differences* – There are few areas of conceptual differences, *e.g.,* recognition of provision on the basis of constructive obligation in IAS37, *Provisions, Contingent Liabilities and Contingent Assets.* As per this IAS, in case of restructuring, constructive obligation arises when an enterprise has detailed formal plan and the enterprise has raised valid expectation to those affected that it will carry out restructuring. ICAI feels that on aforesaid considerations, a liability does not crystallise and if a provision is required to be made on the aforesaid basis, it will be recognised at an early stage. In view of this aspect, AS29 does not specifically deal with constructive obligation. However, AS29 requires a provision to be created in respect of obligations arising from normal business practice, custom and a desire to maintain good business relation or act in an equitable manner. Hence, in such cases, general criteria for recognition of provision are required to be applied.
- *On account of level of preparedness* – Accounting Standards in India, in general, apply to non-corporate entities as also to small and medium-sized enterprises. Further, Indian economy is in the developmental stage and, therefore, it

was felt that the economy was not at a level that could have directly adopted International Standards; implementation of these Standards would have caused serious challenges.

55. A statement containing major departures in Indian Accounting Standards from the corresponding IFRSs is given in **Appendix E.**

7.2.2 Steps taken to Reduce Departures

Differences on account of local, legal and regulatory environment

56. India has gained experience in applying Accounting Standards and as businesses are globalising, the ASB has taken a decision to include accounting treatments in accordance with IFRSs in the corresponding Indian Standards even though they may be inconsistent with legal or regulatory requirements on the basis that until the law is amended, the relevant legal requirement would prevail. For example, as per IAS32, redeemable preference shares, based on their substance, may be considered as a debt instrument instead of equity instrument. In the Indian legal framework, the settled position is to consider these as part of equity. ICAI has decided to retain the IAS32 position in AS31, *Financial Instruments: Presentation*, corresponding to IAS32. However, it is recognised in the standard itself that until the law is amended, legal position will prevail over the position set out in the AS.

Differences on account of local economic environment

57. In the context of changing economic environment, the ASB has now decided to adopt fair value basis for valuation adopted in IAS39 in AS30, *Financial Instruments:Recognition and Measurement*, corresponding to IAS39.

58. The development and growth of the economy has led to more maturity and stability in the Indian businesses, leading to an enhancement of the ability of businesses to absorb structural changes, *e.g.*, accounting for employee benefits, AS15, *Employee Benefits*, (Revised 2005) is now generally in consonance with the corresponding IAS19, despite complexities in the recognition and measurement requirements in relation to employee benefits.

7.3 Mention of Deviation from IFRS and Reason Therefor in AS

59. ICAI has started the practice of including an Appendix in all new/revised Accounting Standards which brings out major deviations, if any, from the corresponding International Standards (now IFRSs) and the reasons therefor.

7.4 Convergence with IFRSs

60. Although convergence with IFRSs has always been the endeavour and changes made in ASs are only minimal, recently, the Council of ICAI considered whether there should be total convergence with IFRSs, especially since more than 105 countries in the world have either adopted or permit the adoption of IFRSs in their countries and many more are expected to follow suit soon. The Council felt that convergence with IFRSs is an important policy decision and will significantly affect not only the status of accounting discipline in the country but also its economy. Therefore, it decided that before taking any decision, it would be useful to develop a concept paper laying down the

strategy for convergence with IFRS. For this purpose, the ASB constituted a Task Force for developing a concept paper with the objective of exploring the approach for achieving convergence with the IFRSs and laying down a road-map for achieving convergence with IFRSs, with a view to make Indian standards IFRS-compliant. Composition of the Task Force is enclosed at **Appendix F**.

61. Accounting Standards are considered IFRS-compliant if a country adopts IFRSs in full. However, as per IASB's Statement of Best Practices: Working Relationship between IASB and Other Country Standard-setters, adding disclosure requirements or removing optional treatments does not create non-compliance with IFRSs.

62. The Task Force considered the nature of IFRSs considering their complexity, interface with various legal and regulatory requirements and conceptual differences, if any, and the types of entities in respect of which the IFRSs can be adopted. The Task Force submitted the Concept Paper to the ASB which was accepted by the ASB and it submitted the same to the Council for its approval. The Council approved the Concept Paper, including its recommendation to fully adopt IFRSs issued by the IASB from the accounting periods commencing on or after April 1, 2011 for the listed entities and other public interest entities,such as banks, insurance companies and large-sized entities subject to its confirmation from the government and other legal and regulatory authorities. In respect of entities other than public interest entities, [termed as 'small and medium-sized entities' (SMEs)], it has been recommended that a separate standard for SMEs may be formulated based on the IFRS for Small and Medium-sized Enterprises when finally issued by the IASB, after modifications, if necessary. Compliance with this IFRS for SMEs is not necessary to make India IFRS-compliant. For a smooth transition to the IFRSs from April 1, 2011 ICAI has taken up the matter of convergence of IFRSs with NACAS, and various regulators such as the Reserve Bank, SEBI and IRDA. ICAI has also formulated its work-plan to ensure that IFRSs are effectively adopted from April 1, 2011. The Ministry of Corporate Affairs, has issued a statement that India would converge with IFRSs by April 1, 2011.

63. ASB has constituted a Group on Implementation of Convergence with IFRSs, broadly with the following objectives:

- To approach various ministries and agencies such as NACASand regulators for seeking their co-operation for this purpose, particularly, in changing various laws and regulations, where appropriate, with a view to achieve convergence.
- To liaise with the industry associations, such as, ASSOCHAM, FICCI, CII, IBA, *etc.*, for getting the industry ready for convergence with the IFRSs.
- To prepare the work plan for the ASB regarding fixing the priority for revising certain existing Standards and issuing new Standards corresponding to IFRSs prior to 2011.
- To look into the requirements of training the preparers and auditors and to formulate ways to meet the requirements.
- To consider any other aspect, such as, liaising with IASB, where required, to settle conceptual issues.

64. In summary, the gap between Indian and International Accounting Standards has been narrowing and is expected to reach full convergence with IFRSs in 2011 when IFRSs are expected to be adopted in India for listed and other public interest entities.

7.5. Single Standard-setting Authority

65. There are several regulators for different sectors in India, *e.g.*, the Reserve Bank for banking sector, SEBI for listed companies, IRDA for insurance companies, with each one having

authority for setting Accounting Standards for the entities regulated by them. However, in practice, all these regulators have accepted the standards formulated by ICAI and do not issue separate standards. The income tax department issued two standards based on AS1, *Disclosure of Accounting Policies* and AS5, *Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies for Taxation Purposes* but discontinued it. Thus, ICAI is now the single standard-setting body for establishing standards for all entities other than Central and State Governments.

66. So far as Accounting Standards for preparation of financial statements of Central and State Governments are concerned, as stated earlier, the Standards are being developed by the Comptroller and Auditor General of India in terms of Article 150 of the Constitution. The Standards so developed are recommended for implementation of the Government. The process is in a nascent stage.

7.6 Emerging Issues Task Force

67. The Research Committee of the ICAI considers on a regular basis emerging issues and makes pronouncements on these issues on a timely basis. It is generally assisted by specifically constituted Task Forces comprising members having experience and expertise in relevant areas.

7.7. Monitoring Compliance with Accounting Standards

68. ICAI has established the **Financial Reporting Review Board** which reviews financial statements from compliance perspective and recommends appropriate action to Ministry of Corporate Affairs, SEBI and other regulators. The Ministry, too, has started the process of considering recommendations and initiating inquiry.

7.8 Rationalisation of Provisions of Companies Act with Accounting Standards

69. The process has started as observed by ROSC-2004 and a number of suggestions of the Naresh Chandra Committee have been implemented. The work relating to revision of Schedule VI with inputs from ICAI is nearing completion. Certain other modifications suggested by ROSC-2004, especially relating to depreciation rates, are under evaluation.

8. The Way Forward

8.1 Convergence with IFRSs

70. ICAI should make its best efforts to achieve convergence with IFRSs by April 1, 2011 as far as listed entities and other public interest entities are concerned. Apart from seeking the co-operation of regulatory and other authorities, ICAI should create awareness about the requirements of IFRSs amongst preparers, auditors and others, particularly, to ensure that entities get sufficient time to put in place the systems and procedures to be able to comply with IFRSs. At the same time, ICAI should continue with its efforts to issue new as well as revised standards to bridge the existing gap between the two sets of standards. This will smoothen the process of transition to IFRSs and also ensure that Indian standards are largely IFRS-compliant even if full convergence with IFRSs cannot be achieved due to any reason by April 1, 2011.

8.2 Greater Participation in the International Standard-setting Process

71. If, as proposed by the Council of the ICAI, there is to be total convergence with IFRSs in India by April 1, 2011 it is essential that India should have a more significant influence, both in the agenda-setting of the IASB as also in its technical output. ICAI, therefore, needs to identify individuals within the country who can play a more active role in various organisations of IASB. ICAI also needs to constitute a group of academicians and professionals which would be more pro-active in suggesting items for the agenda of IASB and IFRIC as also for consideration of exposure drafts issued by these bodies.

8.3 Development of Accounting Standards

72. Currently, the Standards issued by ICAI are anchored in the standards issued by IASB. Its work programme, therefore, follows the work programme of IASB. But situations may arise when India finds that there is no international standard on a subject of importance for the country and there is imminent need to have one, *e.g.*, on emission rights. ASB ought to consider the development of a standard on such subjects if the work programme of IASB does not permit taking up development of standard on that subject. If and when ICAI commences work of development of a new standard, it ought to keep IASB informed and seek their comments on the basic principles being enunciated in the standard. Such standard(s) ought to be replaced by the standard on the subject, as and when issued by IASB.

8.4 Sector-specific Application Guidance

73. Accounting Standards issued by ICAI and IASB are general purpose Accounting Standards and the principles enunciated in the standards apply across the board to all industries alike. Typical issues, specific to an industry, do arise in application of these standards, *e.g.,* the insurance sector or the banking sector. ICAI needs to consider providing sector-specific guidance in application of these standards. Such guidance, in a sense, is rule-based guidance in the application of principle-based standard(s). Such an approach will lead to uniformity in application of standards in specific, complex and typical issues relating to a sector/industry segment. Care and caution must, however, be excercised in issuing such a guidance to ensure that the guidance does not travel beyond the principles set out in standards. It should not lead to establishment of new principles.

8.5 Interpretations

74. Current Indian Standards are based on international standards and, therefore, in an ideal scenario, all issues relating to interpretations ought to be referred to IFRIC. This is necessary since, if each country which has adopted or adapted international standards starts issuing interpretations, it could frustrate the very objective of convergence and global adoption of a common set of Accounting Standards. Having said that, one should also bear in mind that IFRIC may not be able to provide a timely response to each of the issues referred to it for interpretation.

75. ICAI will need, therefore, as an interim measure, an institution for providing interpretations/address issues relating to interpretations, on need basis. The issues requiring interpretation, ought to be brought to the notice of IFRIC and the interpretations that are issued also ought to be brought to the attention of IFRIC. The interpretations issued by India may need to be modified if interpretations, as and when issued by IFRIC, are different from the ones issued by the ICAI. It is, therefore, necessary that an independent 'Interpretation Committee' be constituted by ICAI and that the same 'due process' be followed before an 'interpretation' is issued. Interpretations issued by IFRIC or its predecessor, Standing Interpretations Committee (SIC), may be adopted by the 'Interpretations Committee' of the ICAI where the issue relates to a matter on which Indian Accounting Standard is identical or substantively similar to corresponding IFRS.

8.6 Authority for Issuance of Standards

76. The ASB is a committee of ICAI and the standards are issued by the Council of ICAI and not by the ASB. Though it has representation from outside, it is not truly autonomous. It is true that insofar as companies are concerned, the Standards issued by the Council of ICAI are only recommendatory and have to be prescribed by the Central Government in consultation with NACAS. This lends some degree of outside review. Nonetheless, the autonomy of the ASB would be greatly enhanced if it is given the authority to issue the standards and if the Council of ICAI confines itself to administrative, but not the functional, control of ASB. Also, codifying the constitution of ASB, total number of members, number of members to be nominated by ICAI, representatives of regulators, trade, industry, academics as also independent professionals will add to the transparency of the process adopted by ICAI.

8.7 Accounting Standards for Government

77. The Government Accounting Standards Advisory Board (GASAB), set up by the C&AG, should accelerate its activities and have a time-bound program to:

(a) have research conducted to identify and articulate reforms in government accounting in countries like the US, the UK, Canada, New Zealand, Australia, *etc.*,

(b) lay down a time-bound program for reforms in the existing system, such as:

- Sharper distinction between revenue and capital receipts and disbursements in the existing cash-based accounting system.
- Accounting for indirect subsidies.
- Transition towards modified accrual-based or full accrual-based accounting system. Depending upon the experience of other countries, the extent and the manner in which elements of accrual-based system can be introduced in India should be determined and introduced.
- Issue standards that improve the usefulness of financial reports based on the needs of financial report users. The attempt should be to enhance the primary characteristics of understandability, relevance and reliability and the qualities of comparability and consistency.
- Keep standards current to reflect changes in Governmental environment.
- Provide guidance on implementation of standards.
- Consider significant areas of accounting and financial reporting that can be improved through the standard-setting process.
- Improve the common understanding of the nature and the purpose of information contained in government financial reports.

8.8 Co-operative Banks

78. There is need for scheduled co-operative banks to adopt the same principles as applicable to commercial banks. Similarly, even large non-scheduled co-operative banks need to adopt the

same accounting principles as applicable to commercial banks.

79. Smaller co-operative banks may, however, be given some concessions in the application of accounting principles just as concessions are given to medium and small-sized enterprises. The government, in consultation with the Reserve Bank, should consider taking steps that require scheduled co-operative banks to immediately adopt the accounting principles being adopted by commercial banks.

80. The same may be required of the large non-scheduled co-operative banks gradually and a time-bound programme should be drawn up. More time may be given to smaller co-operative banks to apply duly modified accounting principles, but a time-bound implementation programme should be drawn up at the earliest.

8.9 Harmonisation of Legal and Regulatory Positions with Accounting Standards

81. The ICAI should also continuously hold dialogues with regulatory bodies and take early action for formulation or implementation of standards in developing areas and work with such agencies to bring about change in policy or legal provisions leading to robust accounting, presentation and disclosure norms and to remove disparities, if any, between legal provisions, policies and recommended accounting treatment. These agencies should also provide early responses and facilitation in this direction.

8.10 Compliance Monitoring Programme

82. The Financial Reporting Review Board established by ICAI has commenced the process of monitoring compliance by reporting entities. It has recommended action to the authorities who need to initiate action where gross non-compliances are brought to their notice by the FRRB.

83. Monitoring of compliance with Accounting Standards by the Reserve Bank in respect of banks and financial institutions regulated by it and IRDA in respect of insurance companies regulated by it would be useful and needs to be continued. Where there are interpretational issues in respect of any standard or in matters where there are no standards, the regulator should take up such issues with the ICAI on an on-going basis.

8.11 Compliance Guidance/Training Programme

84. ICAI has been conducting training programmes for its members and also for accountants in the industry. It should continue to do so and take steps to enhance and broaden the scope, possibly together with regulators, to impart more formalised training to preparers of financial statements.

85. As the standards become more complex, the need will arise for guidance, both for the preparers of financial statements as also for those who audit them, on the application of the standards. It is, therefore, necessary that ICAI increases the scope and frequency of its training programmes on the implementation of Accounting Standards.

86. ICAI should consider focussing more on the practical aspects of applying standards. Some of the Standards are of recent origin and may require more guidance in implementation. ICAI should establish a mechanism where members who implement standards can approach for advice. ICAI has different mechanisms to address issues, such as the Expert Advisory Committee, but a more informal approach ought to be encouraged. ICAI should also conduct special programs for educating members on IFRSs and their applications as also US GAAPs to provide broader outlook to its members.

Appendix A

Composition of NACAS

Section 210A of the Companies Act, provides for composition of the NACAS as under:

(i) a chairperson who shall be a person of eminence and well-versed in accountancy, finance, business, administration, business law, economics or similar discipline;

(ii) one member each nominated by the ICAI constituted under the Chartered Accountants Act, 1949 (38 of 1949), the Institute of Cost and Works Accountants of India constituted under the Cost and Works Accountants Act, 1959 (23 of 1959) and the Institute of Company Secretaries of India constituted under the Company Secretaries Act, 1980 (56 of 1980);

(iii) one representative of the Central Government to be nominated by it;

(iv) one representative of the Reserve Bank to be nominated by it;

(v) one representative of the Comptroller and Auditor General of India to be nominated by him;

(vi) a person who holds or has held the office of professor in accountancy, finance or business management in any university or deemed university;

(vii) the Chairman of the Central Board of Direct Taxes constituted under the Central Boards of Revenue Act, 1963 (54 of 1963) or his nominee;

(viii) two members to represent the chambers of commerce and industry to be nominated by the Central Government; and

(ix) one representative of SEBI to be nominated by it.

Appendix B

Comparative Statement of International Accounting Standards/International Financial Reporting Standards and Indian Accounting Standards (As on October 31, 2008)

I. Indian Accounting Standards already issued by the Institute of Chartered Accountants of India (ICAI) corresponding to the International Accounting Standards/International Financial Reporting Standards

Sr. No.	International Accounting Standards (IASs)/International Financial Reporting Standards (IFRSs)[3]		Indian Accounting Standards (ASs)	
	No.	Title of the Standard	AS No.	Title of the Standard
	1	2	3	4
1.	IAS1	Presentation of Financial Statements	AS 1	Disclosure of Accounting Policies Statements
2.	IAS 2	Inventories	AS 2	Valuation of Inventories
3.		Corresponding IAS has been withdrawn since the matter is now covered by IAS 16 and IAS 38	AS 6	Depreciation Accounting
4.	IAS 7	Cash Flow Statements	AS 3	Cash Flow Statements
5.	IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors	AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
6.	IAS 10	Events After the Balance Sheet Date	AS 4	Contingencies and Events Occurring after the Balance Sheet Date
7.	IAS 11	Construction Contracts	AS 7	Construction Contracts
8.	IAS 12	Income Taxes	AS 22	Accounting for Taxes on Income
9.	IAS 14	Segment Reporting[4]	AS 17	Segment Reporting
10.	IAS 16	Property, Plant and Equipment	AS 10	Accounting for Fixed Assets
11.	IAS 17	Leases	AS 19	Leases
12.	IAS 18	Revenue	AS 9	Revenue Recognition
13.	IAS 19	Employee Benefits	AS 15	Employee Benefits
14.	IAS 20	Accounting for Government Grants and Disclosure of Government Assistance	AS 12	Accounting for Government Grants

[3] It may be noted that International Accounting Standards nos. 3, 4, 5, 6, 9, 13, 15, 22, 25, 30 and 35 have already been withdrawn by the International Accounting Standards Board (IASB).

[4] IAS14 will be withdrawn on IFRS8, *Operating Segments*, coming into effect, from 1-1-2009. Since it has still to come into effect, it has not been included for reconciliation purposes.

15.	IAS 21	The Effects of Changes in Foreign Exchange Rates	AS 11	The Effects of Changes in Foreign Exchange Rates
16.	IAS 23	Borrowing Costs	AS 16	Borrowing Costs
17.	IAS 24	Related Party Disclosures	AS 18	Related Party Disclosures
18.	IAS 27	Consolidated and Separate Financial Statements	AS 21	Consolidated Financial Statements
19.	IAS 28	Investments in Associates	AS 23	Accounting for Investments in Associates in Consolidated Financial Statements
20.	IAS 31	Interests in Joint Ventures	AS 27	Financial Reporting of Interests in Joint Ventures
21.	IAS 32	Financial Instruments: Presentation	AS 31	Financial Instruments: Presentation (AS 31 will come into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years)
22.	IAS 33	Earnings Per Share	AS 20	Earnings Per Share
23.	IAS 34	Interim Financial Reporting	AS 25	Interim Financial Reporting
24.	IAS 36	Impairment of Assets	AS 28	Impairment of Assets
25.	IAS 37	Provisions, Contingent Liabilities and Contingent Assets	AS 29	Provisions, Contingent Liabilities and Contingent Assets
26.	IAS 38	Intangible Assets	AS 26	Intangible Assets
27.	IAS 39	Financial Instruments: Recognition and Measurement	AS 30	Financial Instruments: Recognition and Measurement (AS 30 will come into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years)

28.		Corresponding IAS has been withdrawn since the matter is now covered by IAS 32, 39, 40 and IFRS 7	AS 13	Accounting for Investments (AS 13 shall also stand withdrawn on the date, AS 30, AS 31 and AS 32 becoming mandatory except to the extent it relates to accounting for investment properties)
29.	IFRS 3	Business Combinations	AS 14	Accounting for Amalgamations
30.	IFRS 5	Non-current Assets Held for Sale and Discontinued Operations	AS 24	Discontinuing Operations[5]. Further, AS 10 deals with accounting for fixed assets retired from active use.
31.	IFRS 7	Financial Instruments: Disclosures	AS 32	Financial Instruments: Disclosures (AS 32 will come into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years)

II. Accounting Standards Presently Under Preparation Corresponding to the International Accounting Standards/International Financial Reporting Standards

Sr. No.	International Accounting Standards/ International Financial Reporting Standards		Indian Accounting Standards (ASs)
	No.	**Title of the Standard**	**Status**
	1	2	3
1.	IAS 40	Investment Property	Under preparation. At present, covered by Accounting Standard (AS) 13, Accounting for Investments.
2.	IFRS 2	Share-based Payment	Under preparation. At present, Employee-Share based Payments, are covered by a Guidance Note issued by the ICAI, which is based on IFRS 2. Further, some other pronouncements deal with other share-based payments, *e.g.*, AS 10, *Accounting for Fixed Assets.*
3.	IFRS 6	Exploration for and Evaluation of Mineral Resources	Under preparation. At present, Guidance Note on Accounting for Oil and Gas Producing Activities issued by the ICAI.

[5] IASB has issued IFRS 5 and withdrew IAS 35, *Discontinuing Operations*, on which AS 24 is based. An Indian Accounting Standard corresponding to IFRS 5 is under preparation. After the issuance of this Indian AS, AS 24 is proposed to be withdrawn.

4.	IAS 26	Accounting and Reporting by Retirement Benefit Plans	Under preparation.
5.	IAS 29	Financial Reporting in Hyper-inflationary Economies	Under preparation.
6.	IAS 41	Agriculture	Under preparation.
7.	IFRS1	First-time Adoption of International Financial Reporting Standards	Under preparation.
8.	IFRS 4	Insurance Contracts	Under preparation.

Reconciliation of the International Accounting Standards/International Financial Reporting Standards with the Indian Accounting Standards (As on October 31, 2008)

A) International Accounting Standards/International Financial Reporting Standards issued by the International Accounting Standards Board

Number of International Accounting Standards (IASs) issued by the International Accounting Standards Board	41
Number of International Financial Reporting Standards issued by the IASB	7
Less: Number of IASs since withdrawn	(11)
Add: IAS 4 and IAS 25 have been withdrawn, but, included here for reconciliation purposes because corresponding Accounting Standards of the ICAI (*i.e.*, AS 6 and AS 13) are still in force	2
	39

B) Accounting Standards (ASs) and other documents issued by the Institute of Chartered Accountants of India

1. Number of Indian Accounting Standards issued (excluding AS 8 which is withdrawn pursuant to AS 26 becoming mandatory)	31
2. Number of Accounting Standards under preparation	8
	39

Appendix C

Definition of Small and Medium-sized Company as per Clause 2(f) of the Companies (Accounting Standards) Rules, 2006

'Small and Medium Sized Company' (SMC) means, a company –

(i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

(ii) which is not a bank, financial institution or an insurance company;

(iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

(iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

(v) which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

Explanation: For the purpose of the above clause, a company shall qualify as a Small and Medium-sized Company, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

Appendix D

Harmonised Criteria for Classification of Non-corporate Entities as Decided by the Institute of Chartered Accountants of India

Level I Entities

Non-corporate entities which fall in any one or more of the following categories, at the end of the relevant accounting period, are classified as Level I entities:

(i) Entities whose equity or debt securities are listed or are in the process of listing on any stock exchange, whether in India or outside India.

(ii) Banks (including co-operative banks), financial institutions or entities carrying on insurance business.

(iii) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees fifty crore in the immediately preceding accounting year.

(iv) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year.

(v) Holding and subsidiary entities of any one of the above.

Level II Entities (SMEs)

Non-corporate entities which are not Level I entities but fall in any one or more of the following categories are classified as Level II entities:

(i) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees forty lakh but does not exceed rupees fifty crore in the immediately preceding accounting year.

(ii) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees one crore but not in excess of rupees ten crore at any time during the immediately preceding accounting year.

(iii) Holding and subsidiary entities of any one of the above.

Level III Entities (SMEs)

Non-corporate entities which are not covered under Level I and Level II are considered as Level III entities.

Appendix E

Major Departures in Indian Accounting Standards from the Corresponding IFRSs

The present position of Indian Accounting Standards has been depicted in the following comparative statements of International Financial Reporting Standards and Indian Accounting Standards.

I. Indian Accounting Standards Already Issued by the Institute of Chartered Accountants of India (ICAI) Corresponding to the International Financial Reporting Standards

Sr. No.	International Financial Reporting Standards (IFRSs)[6]		Indian Accounting Standards (ASs)[7]		Major Differences
	No.	**Title of the Standard**	**No.**	**Title of the Standard**	
1.	IAS 1	Presentation of Financial Statements	AS 1	Disclosure of Accounting Policies	AS 1 is based on the pre-revised IAS 1. AS 1 is presently under revision to bring it in line with IAS 1. The draft of the revised AS 1 has been prepared and the same will be considered by the ASB for circulation amongst specified outside bodies and council members.
2.	IAS 2	Inventories	AS 2	Valuation of Inventories	AS 2 is based on IAS 2 (revised 1993). IAS 2 has been revised in 2003 as a part of the IASB's improvement project. Major differences between AS 2 and IAS 2 (revised 2003) are as follows: **Differences due to level of preparedness** 1. IAS 2 specifically deals with costs of inventories of an enterprise providing services. However, keeping in view the level of understanding that was prevailing in the country regarding the treatment of inventories of an enterprise providing services at the time of last revision of AS 2, the same are excluded from the scope of AS 2. 2. Keeping in view the level of preparedness in the country at the time of last revision of AS 2, AS 2 requires lesser disclosures as compared to IAS 2.

[6] It may be noted that International Accounting Standards nos. 3, 4, 5, 6, 9, 13, 15, 22, 25, 30 and 35 have already been withdrawn by the International Accounting Standards Board (IASB).

[7] It may be noted that the existing ASs are in the process of revision to converge with IFRSs, where they are not presently converged with IFRSs.

					3. IAS 2 specifically provides that the measurement requirements of the Standard do not apply to the measurement of inventories held by commodity broker-traders who measure their inventories at fair value less costs to sell. AS 2 does not contain any exclusion or separate provisions relating to inventories held by commodity broker-traders. (Broker-traders are those who buy or sell commodities for others or on their own account. The inventories are principally acquired by a broker-trader with the purpose of selling in the near future and generating a profit from fluctuations in price or broker-traders' margin.) By implication, the measurement basis laid down in the Standard, *viz.*, lower of cost and net realisable value, applies to inventories of commodity broker-traders. **Conceptual differences** 4. AS 2 specifically excludes 'selling and distribution costs' from the cost of inventories and provides that it is appropriate to recognise them as expenses in the period in which they are incurred. However IAS 2 excludes only 'Selling Costs' and not 'Distribution Costs'. 5. AS 2 does not deal with the issues relating to recognition of inventories as an expense including the write-down of inventories to net realisable value and any reversal of such write-down. 6. AS 2 provides that the cost of inventories of items other than those

					which are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by using the first-in, first-out (FIFO) principle, or weighted average cost formula. It is specifically required by AS 2 that the formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition. However, IAS 2 does not require the same for the choice of the formula to be used, rather it requires that same cost formula should be used for all inventories having a similar nature and use to the entity. **There is no difference between the ED and IAS 2.**
3.		Corresponding IAS has been withdrawn since the matter is now covered by IAS 16 and IAS 38.	AS 6	Depreciation Accounting	AS 6 was formulated on the basis of IAS 4, *Depreciation Accounting* which has since been withdrawn. The corresponding Indian Accounting Standard (AS) 10, *Accounting for Fixed Assets,* has been revised to bring it in line with IAS 16. The Council has approved the draft of the revised AS 10 and the same will be issued shortly. Upon issuance of the revised AS 10, AS 6 would be withdrawn.
4.	IAS 7	Cash Flow Statements	AS 3	Cash Flow Statements	AS 3 is based on the current IAS 7. The major differences between IAS 7 and AS 3 are as below: **Differences due to removal of alternatives** 1. In case of enterprises other than financial enterprises, unlike IAS 7, AS 3 does not provide any option with regard to classification of interest paid. It requires interest paid to be classified as financing cash flows. 2. In case of enterprises other than financial enterprises, AS 3 does not provide any option with regard to

					classification of interest and dividend received. It requires interest and dividend received to be classified as investing cash flows. 3. AS 3 also does not provide any option regarding classification of dividend paid. It requires dividend paid to be classified as financing cash flows.
5.	IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors	AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies	AS 5 is based on the earlier IAS 8. AS 5 is presently under revision to bring it in line with the current IAS 8.
6.	IAS 10	Events After the Balance Sheet Date	AS 4	Contingencies and Events Occurring after the Balance Sheet Date	AS 4 is based on the pre-revised IAS 10 which dealt with the contingencies as well as the events occurring after the balance sheet date. On the lines of IAS 37, the ICAI has issued AS 29. Pursuant to the issuance of AS 29, the portion of AS 4 dealing with the contingencies, except to the extent of impairment of assets not covered by other Accounting Standards, stands superseded. AS 4 now deals with the events after the balance sheet date. AS 4 is presently under revision to bring it in line with the corresponding IAS 10. **Difference due to legal and regulatory environment** 1. As per IAS 10, proposed dividend is a non-adjusting event. However, as per the Indian law governing companies, provision for proposed dividend is required to be made, probably as a measure of greater accountability of the company

					concerned towards investors in respect of payment of dividend. While attempts are made at various levels, from time to time, to persuade the Government for changes in law, it is a time-consuming process. 2. As per IAS 10, non-adjusting events, which are material, are required to be disclosed in the financial statements. However, as per AS 4, such disclosures are required to be made in the report of the approving authority and not in the financial statements.
7.	IAS 11	Construction Contracts	AS 7	Construction Contracts	AS 7 is based on the current IAS 11. There is no difference between AS 7 and IAS 11.
8.	IAS 12	Income Taxes	AS 22	Accounting for Taxes on Income	**Differences due to level of preparedness** ● Keeping in view the level of preparedness in the country at the time of issuance of AS 22, AS 22 was based on the Income Statement Approach. ● ICAI is revising AS 22 to bring it in line with IAS 12.
9.	IAS 14	Segment Reporting	AS 17	Segment Reporting	AS 17 is based on the current IAS 14. The major differences between IAS 14 and AS 17 are described below. **Differences due to removal of alternatives** 1. IAS 14 encourages, but does not require, the reporting of vertically integrated activities as separate segments. However, under AS 17, in case a vertically integrated segment meets the quantitative norms for being a reportable segment, the relevant disclosures are required to be made. 2. As per IAS 14, a segment identified as a reportable segment in the immediately preceding period on satisfying the relevant 10 per cent threshold, shall be reportable

					segment in the current period also if the management judges it to be of continuing significance. However, as per AS 17, this reporting is mandatory without considering the management's judgement. **Differences due to level of preparedness** 3. IAS 14 prescribes certain additional disclosure requirements regarding enterprise's share of profit or loss of associates and joint ventures and regarding restatement of prior year information, *etc.* At the time of issuance of AS 17, there were no Accounting Standards in India dealing with accounting for investments in associates and joint ventures, *etc.* Accordingly, these disclosures are not specifically covered in AS 17. 4. As per IAS 14, for a segment to qualify as a reportable segment, it is required for it to earn the majority of its revenue from external customers in addition to meeting the 10 per cent threshold criteria of revenue, operating results or total assets required in AS 17.
10.	IAS 16	Property, Plant and Equipment	AS 10	Accounting for Fixed Assets	AS 10 is based on the earlier IAS 16. AS 10 is being revised to bring it in line with the current IAS 16. The draft revised AS 10 has been approved by the Council and the same has also been cleared by the NACAS. The following is the major difference between IAS 16 and the revised AS 10:

					Differences due to legal and regulatory environment In India, the law governing the companies prescribes minimum rates of depreciation. Keeping this in view, the revised AS 10 recognises that depreciation rates prescribed by the statute would be the minimum rates of depreciation.
11.	IAS 17	Leases	AS 19	Leases	AS 19 is based on IAS 17 (revised 1997). IAS 17 has been revised in 2004. The major differences between IAS 17 and AS 19 (revised 2004) are described below. **Conceptual differences** 1. Keeping in view the peculiar land lease practices in the country, lease agreements to use lands are specifically excluded from the scope of AS 19 whereas IAS 17 does not contain this exclusion. 2. IAS 17 specifically provides that the Standard shall not be applied as the basis of measurement for: (a) property held by lessees that is accounted for as investment property; (b) investment property provided by lessors under operating leases; (c) biological assets held by lessees under finance leases; or (d) biological assets provided by lessors under operating leases. However, AS 19 does not exclude the above from its scope. 5. AS 19 specifically prohibits upward revision in estimate of unguaranteed residual value during the lease term. However, IAS 17 does not prohibit the same. 6. As per IAS 17, initial direct costs incurred by a lessor other than a manufacturer or dealer lessor have to

					be included in the amount of lease receivable in the case of finance lease resulting in reduced amount of income to be recognised over lease term and in the carrying amount of the asset in the case of operating lease as to expense it over the lease term on the same basis as the lease income. However, as per AS 19, these can be either charged off at the time of incurrence in the statement of profit and loss or can be amortised over the lease period.
12.	IAS 18	Revenue	AS 9	Revenue Recognition	AS 9 is based on the earlier IAS 18. AS 9 is presently under revision to bring it in line with the current IAS 18.
13.	IAS 19	Employee Benefits	AS 15	Employee Benefits	AS 15 is based on the current IAS 19. The major differences between IAS 19 and AS 15 are described below. **Difference due to removal of alternatives** 1. Unlike IAS 19, AS 15 does not provide any option with regard to recognition of actuarial gains and losses. It requires such gains and losses to be recognised immediately in the statement of profit and loss. **Conceptual Difference** 2. Regarding recognition of termination benefits as a liability, it is felt that merely on the basis of a detailed formal plan, it would not be appropriate to recognise a provision since a liability cannot be considered to be crystallised at this stage. Accordingly, AS 15 provides criteria for recognition of a provision for

					liability in respect of termination benefits on the basis of the general criteria for recognition of provision as per AS 29, *Provisions, Contingent Liabilities and Contingent Assets* (corresponding to IAS 37). It may be noted that the IASB had issued an Exposure Draft of the proposed Amendments to IAS 19 whereby the criteria regarding recognition of termination benefits as a liability are proposed to be amended. The Exposure Draft proposes that voluntary termination benefits should be recognised when employees accept the entity's offer of those benefits. ICAI in its comments on the Exposure Draft, have pointed out that in a country such as India, such a requirement would give erroneous results since the schemes generally have the following characteristics in terms of the steps involved in implementing the scheme: (i) Announcement of the scheme by an employer, which is considered as an 'invitation to offer' to the employees rather than the offer to the employees for voluntary termination of their services. (ii) Employees tender their applications under the scheme. This does not confer any right to the employees under the scheme to claim termination benefits. In other words, tendering of application by an employee is considered as an 'offer' in response to 'invitation to offer', rather than acceptance of the offer by the employee. (iii) The acceptance of the offer made by the employees as per (ii) above by the management. Keeping in view the above, ICAI has suggested that as per the above

					scheme, liabilities with regard to voluntary termination benefits should be recognised at the time when the management accepts the offer of the employees rather than at the time the employees tender their applications in response to the 'invitation to offer' made by the management. If ICAI's comments on the Exposure Draft are accepted, the amended criteria in IAS 19 would result in the recognition of the liability broadly at the same time as under the criteria prescribed in AS 15. Incidentally, it may be mentioned that the treatment prescribed in AS 15 is also in consonance with the legal position in India.
14.	IAS 20	Accounting for Government Grants and Disclosure of Government Assistance	AS 12	Accounting for Government Grants	AS 12 revised corresponding to IAS 20 has been approved by the Council and has been cleared by NACAS and is likely to be issued shortly. There is no difference between the Draft of the standard and IAS 20.
15.	IAS 21	The Effects of Changes in Foreign Exchange Rates	AS 11	The Effects of Changes in Foreign Exchange Rates	**Difference due to level of preparedness** 1. AS 11 is based on the integral and non-integral foreign operations approach, *i.e.,* the approach which was followed in the earlier IAS 21 (revised 1993). 2. The current IAS 21, which is based on 'Functional Currency' approach, gives similar results as that under pre-revised IAS 21, which was based on integral/non-integral foreign operations approach. Accordingly, there are no significant differences between IAS 21 and AS 11.

					3. The current AS 11 has recently become effective, *i.e.,* from April 1, 2004. It is felt that some experience should be gained before shifting to the current IAS 21. However, AS 11 is under revision to bring it in line with revised IAS 21.
16.	IAS 23	Borrowing Costs	AS 16	Borrowing Costs	There is no major difference between AS 16 and IAS 23 (revised 2007).
17.	IAS 24	Related Party Disclosures	AS 18	Related Party Disclosures	AS 18 is based on IAS 24 (reformatted in 1994) and following are the major differences between the two. **Conceptual differences** 1. According to AS 18, as notified by the Government, a non-executive director of a company should not be considered as a key management person by virtue of merely his being a director unless he has the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise. However, IAS 24 provides for including non-executive director in key management personnel. 2. In AS 18, the term 'relative' is defined as 'the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be influenced by, that individual in his/her dealings with the reporting enterprise' whereas the comparable concept in IAS 24 is that of 'close members of the family of an individual' who are 'those family members who may be expected to influence, or be influenced by, that individual in their dealings with the entity. They may include: (a) the individual's domestic partner and children; (b) children of the individual's domestic partner; and (c) dependants of the individual or the individual's domestic partner.'

18.	IAS 27	Consolidated and Separate Financial Statements	AS 21	Consolidated Financial Statements	AS 21 is based on IAS 27 (revised 2000). **Difference due to legal and regulatory environment** Keeping in view the requirements of the law governing the companies, AS 21 defines control as ownership of more than one-half of the voting power of an enterprise or as control over the composition of the governing body of an enterprise so as to obtain economic benefits. This definition is different from IAS 27, which defines control as 'the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities'. **Conceptual Differences** Goodwill/capital reserve is calculated by computing the difference between the cost to the parent of its investment in the subsidiary and the parent's portion of equity in the subsidiary in AS 21 whereas in IAS 27 fair value approach is followed.
19.	IAS 28	Investments in Associates	AS 23	Accounting for Investments in Associates in Consolidated Financial Statements	AS 23 is based on the IAS 28 (revised 2000).
20.	IAS 31	Interests in Joint Ventures	AS 27	Financial Reporting of Interests in Joint Ventures	**Conceptual Differences** The conceptual differences, explained in relation to IAS 27, are relevant in this case also. AS 27 is based on the IAS 31 (revised 2000). **Difference due to removal of alternatives** 1. Unlike IAS 31, AS 27 does not provide any option for accounting of interests in jointly controlled entities

					in the consolidated financial statements of the venturer. It requires proportionate consolidation to be followed and venturer's share of each of the assets, liabilities, income and expenses of a jointly controlled entity to be reported as separate line items. **Conceptual Differences** 2. The conceptual differences, explained in relation to IAS 27, are relevant in this case also.
21.	IAS 32	Financial Instruments: Presentation	AS 31	Financial Instruments: Presentation	ICAI has recently issued AS 31 corresponding to IAS 32 and which will come into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years. There is no difference between AS 31 and corresponding IAS 32.
22.	IAS 33	Earnings Per Share	AS 20	Earnings Per Share	AS 20 is based on the IAS 33 (issued 1997). AS 20 is being revised to bring it in line with IAS 33. **Differences due to level of preparedness** 1. As per IAS 33 (revised), basic and diluted amounts per share for the discontinued operation are required to be disclosed. However, AS 20 does not require such disclosures. 2. IAS 33 (revised) requires the disclosure of antidilutive instruments also which is not required by AS 20.
23.	IAS 34	Interim Financial Reporting	AS 25	Interim Financial Reporting	AS 25 is based on the current IAS 34. The major differences between IAS 34 and AS 25 are described below. **Differences due to legal and regulatory environment** 1. In India, at present, the statement of changes in equity is not presented in the annual financial statements since, as per the law, this information

					is required to be disclosed partly in the profit and loss account below the line and partly in the balance sheet and schedules thereto. Keeping this in view, unlike IAS 34, AS 25 presently does not require presentation of the condensed statement of changes in equity. However, as a result of proposed revision to AS 1, limited revision to AS 25 has also been proposed, which requires the presentation of the condensed statement of changes in equity as part of condensed financial statements and limited exposure for the same has been made. 2. Keeping in view the legal and regulatory requirements prevailing in India, AS 25 provides that in case a statute or a regulator requires an enterprise to prepare and present interim information in a different form and/or contents, then that format has to be followed. However, the recognition and measurement principles as laid down in AS 25 have to be applied in respect of such information.
24.	IAS 36	Impairment of Assets	AS 28	Impairment of Assets	AS 28 is based on IAS 36 (issued in 1998). At the time of issuance of AS 28, there was no major difference between AS 28 and IAS 36. IASB, pursuant to its project on Business Combinations, has made certain changes in IAS 36.
25.	IAS 37	Provisions, Contingent Liabilities and Contingent Assets	AS 29	Provisions, Contingent Liabilities and Contingent Assets	AS 29 is based on the current IAS 37. The major differences between IAS 37 and AS 29 are described below.

					Difference due to level of preparedness 1. AS 29 requires that the amount of a provision should not be discounted to its present value since financial statements in India are prepared generally on historical cost basis and not on present value basis. However, a limited revision is being proposed to bring it in line with IAS 39 insofar as this aspect is concerned. **Conceptual Differences** 2. IAS 37 deals with 'constructive obligation' in the context of creation of a provision. The effect of recognising provision on the basis of constructive obligation is that, in some cases, provision will be required to be recognised at an early stage. For example, in case of a restructuring, a constructive obligation arises when an enterprise has a detailed formal plan for the restructuring and the enterprise has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it. It is felt that merely on the basis of a detailed formal plan and announcement thereof, it would not be appropriate to recognise a provision since a liability cannot be considered to be crystallised at this stage. Further, the judgment whether the management has raised valid expectations in those affected may be a matter of considerable argument. In view of the above, AS 29 does not specifically deal with 'constructive obligation'. AS 29, however, requires a provision to be created in respect of obligations arising from normal business practice, custom and a desire to maintain good business relations or act in an equitable

					manner. In such cases, general criteria for recognition of provision are required to be applied. Incidentally, it may be mentioned that the treatment prescribed in AS 29 is also in consonance with the legal position in India. 3. Unlike IAS 37, as a measure of prudence, AS 29 does not require contingent assets to be disclosed in the financial statements.
26.	IAS 38	Intangible Assets	AS 26	Intangible Assets	AS 26 is based on IAS 38 (issued 1998). IASB, as a part of its project on Business Combinations, has revised IAS 38. Following are the major differences between AS 26 and IAS 38: **Conceptual Differences** 1. An intangible asset is defined as an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes whereas IAS 38 defines an intangible asset 'as an identifiable non-monetary asset without physical substance'. 2. AS 26 is based on the assumption that the useful life of the intangible asset is always definite. In regard to assets with definite life also there is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Whereas IAS 36 recognises that an intangible asset may have an indefinite life, in respect of

					intangible assets having a definite life, the Standard does not contain rebuttable presumption about their useful life. 3. As per AS 26, if control over the future economic benefits from an intangible asset is achieved through legal rights that have been granted for a finite period, it is required that the useful life of the intangible asset should not exceed the period of the legal rights unless: (a) the legal rights are renewable; and (b) renewal is virtually certain. However, IAS 38 requires 'evidence to support renewal' instead of virual certainty for renewal.
27.	IAS 39	Financial Instruments: Recognition and Measurement	AS 30	Financial Instruments: Recognition and Measurement	ICAI has recently issued AS 30 corresponding to IAS 39 and which will come into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years. There is no difference between AS 30 and IAS 39.
28.		Corresponding IAS has been withdrawn since the matter is now covered by IAS 32, 39, 40 and IFRS 7.	AS 13	Accounting for Investments	AS 13 was formulated on the basis of IAS 25, *Accounting for Investments.* Pursuant to the issuance of IAS 32, IAS 39, IAS 40 and IFRS 7, IAS 25 has been superceded. AS 13 shall also stand withdrawn on the date, with AS 30 and AS 31 becoming mandatory except to the extent it relates to accounting for investment properties.
29.	IAS 40	Investment Property	–	Dealt with by Accounting Standard 13	The proposed Indian Accounting Standard corresponding to IAS 40 is under preparation.
30.	IFRS 3	Business Combinations	AS 14	Accounting for Amalgamations	i. AS 14 was formulated on the basis of earlier IAS 22, *Business Combinations.* ii. Pursuant to the issuance of IFRS 3, *Business Combinations*, IAS 22 has been superseded.

					iii. AS 14 is presently under revision to bring it in line with the IFRS 3.
31.	IFRS 5	Non-current Assets Held for Sale and Discontinued Operations	AS 24	Discontinuing Operations. Further, AS 10 deals with accounting for fixed assets retired from active use.	i. AS 24 is based on the IAS 35, *Discontinuing Operations*, which has been superseded pursuant to the issuance of IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations.* ii. An Indian Accounting Standard corresponding to IFRS 5 is under preparation.
32.	IFRS 7	Financial Instruments: Disclosures	AS 32	Financial Instruments: Disclosures	ICAI has recently issued AS 32 corresponding to IFRS 7 which will come into effect in respect of accounting periods commencing on or after 1-4-2009 and will be recommendatory in nature for an initial period of two years. There is no difference between AS 32 and IFRS 7.

II. Accounting Standards Presently Under Preparation Corresponding to the International Financial Reporting Standards

Sr. No.	International Financial Reporting Standards		Status of the Corresponding Indian Standard
	No.	**Title of the Standard**	
1.	IAS 40	Investment Property	Under preparation. At present, covered by Accounting Standard (AS) 13, *Accounting for Investments.*
2.	IFRS 2	Share-based Payment	Under preparation. At present, Employee-Share based Payments are covered by a Guidance Note issued by the ICAI, which is based on IFRS 2. Further, some other pronouncements deal with other share-based payments, *e.g.*, AS 10, *Accounting for Fixed Assets.*
3.	IFRS 6	Exploration for and Evaluation of Mineral Resources	Under preparation. At present, Guidance Note on Accounting for Oil and Gas Producing Activities, issued by the ICAI, which is comprehensive as it deals with all accounting aspects and is based on the corresponding US GAAP.
4.	IAS 26	Accounting and Reporting by Retirement Benefit Plans	Under preparation.
5.	IAS 29	Financial Reporting in Hyper-inflationary Economies	Under preparation.
6.	IAS 41	Agriculture	Under preparation.
7.	IFRS1	First-time Adoption of International Financial Reporting Standards	Under preparation.
8.	IFRS 4	Insurance Contracts	Under preparation.

Appendix F

Composition of the Task Force

The Accounting Standards Board in consultation with the then President of the ICAI, constituted the Task Force on October 15, 2006 with the following members:

1.	CA. S. C. Vasudeva	(The then Chairman, ASB, as the Convenor of the Task Force)
2.	CA. Jayant Gokhale	(The then Vice-Chairman, ASB)
3.	CA. N. P. Sarda	Past President, ICAI
4.	CA. V. Rajaraman	Past President, ICAI
5.	CA. T. V. Mohandas Pai	Member of Trustees of the International Accounting Standards Committee Foundation (IASCF)
6.	CA. Shailesh Haribhakti	Member – Standards Advisory Council of the International Accounting Standards Board
7.	CA. Uday Phadke	Nominee on the ASB from Confederation of Indian Industries (CII)
8.	CA. Dolphy D'Souza	Alternate Nominee on the ASB from Federation of Indian Chambers of Commerce & Industry (FICCI)
9.	Shri P. R. Ravi Mohan	Nominee of the Reserve Bank of India on the ASB
10.	Dr. Kamal Gupta	Former Technical Director, ICAI
11.	Prof. S. Sundararajan	Indian Institute of Management, Bangalore
12.	CA. Amal Ganguli	Senior Chartered Accountant

Appendix G

Accounting Standards[8]
A Peer Review of the Advisory Panel Report

By Dr. Kamal Gupta

Para 30 in the Report

At the beginning of this para, the words 'In general' may be added since, in respect of some specific Accounting Standards, exemptions/relaxations have been given to enterprises based on size, *e.g.*, AS 3 and AS 17 do not apply to small and medium enterprises.

Para 31 in the Report

This para may be redrafted to bring out the following facts more clearly:

(a) It may be clarified that entities that are bodies corporate but not companies (*e.g.*, a corporation set up under a Central or State Act) would be classified under the revised scheme of classification of ICAI under Levels I and II only. In other words, Levels I and II would cover (i) bodies corporate that are not companies and (ii) non-corporate bodies that meet Level I/II criteria.

(b) ICAI's announcement relating to classification of enterprises into three levels refers to exemption from disclosure requirements, though in the case of AS 15, there are some exemptions even from recognition and measurement requirements.

The following is a suggestive redraft of para 31:

For the purpose of the application of Accounting Standards, ICAI has categorised the enterprises into three levels, i.e., Level I, Level II and Level III enterprises. Level II and Level III are considered to be SMEs. However, as per the notification of the Accounting Standards under the Companies Act, companies have been classified into two categories only, i.e., Small and Medium Companies (SMCs) (Refer Appendix C for meaning of SMC) and other than SMCs. The ICAI has recently harmonised its classification criteria with those under the Companies Act. Consequently, from accounting periods commencing on or after 1 April 2008, the position would be as follows:

- *The criteria of Level I of the ICAI and those of companies other than SMCs under the Rules are now identical. Similarly the criteria of Level II under ICAI's classification and those of SMCs under the Rules are the same.*
- *Entities that are bodies corporate but not companies (e.g., a corporation set up under a Central or State Act) would be classified under the revised scheme of classification of ICAI under Levels I and II only.*
- *Certain exemptions/relaxations have been given to enterprises falling in Levels II and III (i.e., small and medium-sized enterprises). The exemptions/relaxations are primarily in respect of disclosure requirements. In general, the recognition and measurement principles to be applied by SMCs are the same as those to be applied by Level I enterprises. The exemptions/relaxations available to Level II non-company entities as per ICAI's*

[8] The response of the Advisory Panel *vis-à-vis* the observations made by the Peer Reviewer are indicated in bold and italics.

classification would be the same as those available to SMCs under the Rules except that the aforesaid Level II entities that employ less than 50 employees during the accounting year will continue to enjoy certain exemptions/relaxations from AS 15, Employee Benefits, which are not available to SMCs under the Rules.

- *AS 18, Related Party Disclosures, and AS 24, Discontinuing Operations, would apply to Level II non-company entities also. In this regard, it may be noted that the Rules too do not give any exemption to SMCs from AS 18 or AS 24.*

*The harmonised criteria applicable to non-companies have been provided in **Appendix D.***

Stance of the Panel: Accepted. The suggestions have been incorporated in the Report.

Para 38 in the Report

A slight modification of this para may be necessary to bring out the position that recognition and measurement principles laid down in the statute or regulations governing an entity override those prescribed in an accounting standard. This is clearly recognised in the Preface to the Statements of Accounting Standards, according to which 'the Accounting Standards by their very nature cannot and do not override the local regulations which govern the preparation and presentation of financial statements in the country.'

Stance of the Panel: Accepted. The suggestions have been incorporated in the Report.

Para 51 in the Report

- The expression 'Ministry of Company Affairs' may be replaced by the expression 'Ministry of Corporate Affairs'.
- The word 'corporate entities' may be replaced by the word 'companies' in view of the fact that notified Accounting Standards apply only to companies and not other bodies corporate.

Stance of the Panel: Accepted. The suggestions have been incorporated in the Report.

Para 54 in the Report

ICAI's official paper on convergence with IFRSs also cites 'level of preparedness' as another reason for departures from IFRSs in the past. Its inclusion may be considered, specially in view of the fact that in **Appendix E**, this has been cited as a reason in respect of some of the standards.

Stance of the Panel: Accepted. The suggestions have been incorporated in the Report.

Section 18 – The Way Forward (Section 8 in the Report)

- This section may start with convergence with IFRSs as the first point, since this arguably is the single most important step towards improved financial reporting.

- Another point that may be made is that while striving to achieve the goal of convergence, the ICAI should continue with its process of issuing new standards and revising the existing ones in line with IFRSs. This process will create a greater awareness and understanding about the requirements under IFRSs among preparers, auditors, *etc.*, in the intervening period. Also, it would ensure that even if wholesale adoption of IFRSs is delayed (say, due to the number of regulatory changes which are required in this regard), the process of convergence still goes on.
- As far as issuance of interpretations is concerned, it may be added that in respect of issues where the Indian Accounting Standards are similar to corresponding IFRSs, the interpretations issued by IFRIC/Standing Interpretation Committee (SIC) may be adopted.

The following suggestive draft may be considered.

'8.1 Convergence with IFRSs

ICAI should make its best efforts to achieve convergence with IFRSs by 1.4.2011 as far as listed entities and other public interest entities are concerned. Apart from seeking the co-operation of regulatory and other authorities, ICAI should create awareness about the requirements of IFRSs amongst preparers, auditors, etc., particularly to ensure that entities get sufficient time to put in place the systems and procedures to be able to comply with IFRSs. At the same time, ICAI should continue with its efforts to issue new as well as revised standards to bridge the existing gap between the two sets of standards. This will smoothen the process of transition to IFRSs and also ensure that Indian standards are largely IFRS-compliant even if full convergence with IFRSs cannot be achieved due to any reason by 1.4.2011.'

The following may be added towards the end of existing para 75.

'————' interpretation' is issued. Interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) or its predecessor, the Standing Interpretations Committee (SIC) may be adopted by the 'Interpretation Committee' of the ICAI where the issue relates to a matter on which Indian Accounting Standard is identical or substantively similar to the corresponding IFRS.'

Stance of the Panel: Accepted. The suggestions have been incorporated in the Report.

Appendix H

Accounting Standards[9]
A Peer Review of the Advisory Panel Report

By Mr. Ian Mackintosh,

I have reviewed both documents[10]. In both cases I cannot comment on the accuracy of the reporting of the history and the present situation. I have no personal knowledge of these matters. My comments are therefore contained to the situation going forward.

Accounting

I would firstly say that I agree with the actions for convergence in paragraphs 60 to 64 in the Report. I think this plan, if implemented, will be a major step forward for financial reporting in India.

Also, the items mentioned in paragraphs 65 to 69 in the Report.

I would call for caution in the development of country-specific Accounting Standards, sector-specific guidance and interpretations. Taking them one at a time,

- One should be very certain that standards labelled as country-specific are indeed country-specific. The example given of accounting for emission rights is not a country-specific issue and guidance on this matter is needed all over the world. In such a case, it is not for a national standard-setter to pre-empt the international standard-setter. The preferred solution is to get the IASB to act on the matter and to provide an international solution for national application. I would see country-specific matters as being very rare.
- I would also advise that care should be taken with sector-specific guidance, so that you are not seen as setting standards in conflict with international standards. It is not something to be precluded entirely, but to be handled with great care.
- Interpretations should generally be referred to IFRIC and only in the very rare circumstances of a purely Indian issue should the standard-setter be involved.

Stance of the Panel: As regards the country and sector-specific standards, the Panel observed that there may be areas where IASB may not come out with a standard but it could be an area of importance for India. Accordingly, ICAI could come out with sector or country-specific guidance in respect of these areas. However, as and when the IASB comes out with IFRSs in these areas, the standards issued by ICAI would be replaced by the IFRSs.

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[9] The response of the Advisory Panel *vis-à-vis* the observations made by the peer reviewer are indicated in bold and italics.

[10] Mr. Mackintosh had reviewed both accounting and auditing documents. His comments relating to auditing are in the separate Chapter on auditing standards.

I agree that, as recommended in paragraph 76, the standard-setter should have sole authority over technical matters.

In relation to paragraphs 78 to 80, I agree that banks across sectors should use the same accounting principles.

I also agree with the sentiments in paragraph 81.

I agree in general with the paragraphs on monitoring and training, but care will need to be taken that the ICAI is not seen as interpreting the standards. While advice can be given on general principles, the accounting treatment will depend on the nature of the transaction involved and professional judgement will be required.

Stance of the Panel: Accepted. This has been incorporated in the report

The way forward section might also give some consideration as to how the standard-setter might be organised and operate to influence the IASB both as to its agenda and as to the technical output it produces. How is the voice of India to be heard in the global situation going forward? I see this as a very major role for the board.

Chapter III

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Chapter III

Assessment of Auditing Standards

1. Introduction

1. Credible auditing of accounts is critical to modern economies. This Report begins by giving a brief description of the international scenario with respect to auditing and goes on to give a brief history of the evolution of the auditing profession in India as well as how auditing standards are implemented and enforced. It then reviews the findings of the World Bank's ROSC-2004 Report as well as the initiatives taken by the ICAI to bridge the gap between the international and national auditing standards. The Report contains an assessment of the international standards *vis-à-vis* auditing standards in India. There is also an overview of the developments and major trends in auditing since the ROSC-2004 about the shape of things to come in future. Finally, having regard to comparative assessment and current trends around the world, the Report makes recommendations as to the way forward.

2. Auditing – the International Benchmark

2.1 The International Federation of Accountants

2. Sixty-three professional accountancy bodies from 51 nations came together in 1977 to form the International Federation of Accountants (IFAC). The ICAI was one of the founding members. IFAC has four-fold objectives; developing high quality international standards and supporting their adoption and use; facilitating collaboration and co-operation among its member bodies; collaborating and co-operating with other international organisations; and serving as the international spokesperson for the accountancy profession. The Federation is headed by a Council with a term of three years. The ICAI, too, had its representatives on the Board of the IFAC Council since its inception in 1977 through 1995, from 1997 to 1998 and then from 2001 to 2008.

2.2 The International Auditing Practices Committee

3. To achieve its objectives, IFAC, over a period of time, constituted several boards/ committees to work in several areas of professional interest. The International Auditing Practices Committee (IAPC) was constituted in October 1977 with the prime objective of enhancing the quality and uniformity in practice throughout the world and strengthening public confidence in the global auditing and assurance profession. Towards this end, the IAPC, which was renamed as the International Auditing and Assurance Standards Board (IAASB) in 2002, is entrusted with the task of developing standards on auditing and review of historical financial information, as also standards on other types of assurance engagement carried out in the context of

information other than historical financial information. The IAASB also develops related practice statements. English is the official language of the IAASB.

4. The Standards and Practice Statements issued by the IAASB are the benchmarks for high quality auditing and assurance practices. They are designed to help professional accountants meet the changing expectations of users. In addition, IAASB also develops the quintessential quality control standards for the auditors. From the first International Auditing Guideline[1], *Objective and Scope of the Audit of Financial Statements,* issued by the IAPC in 1979, to the first International Standard on Auditing (ISA) issued in 1991, as on date, the tally of IAASB Standards has risen to 39[2], covering an array of important aspects of auditing and other assurance services. Based on the functional classification, the International Standards on Auditing have been classified in seven categories, *viz.*, introductory matters, general principles and responsibilities, risk assessment and response to assessed risks, audit evidence, using the work of others, audit conclusions and reporting, and specialised areas.

2.3 International Auditing Standards and the Indian Contribution

5. ICAI represented India on the IAPC (later known as IAASB) during the latter's early years, spanning the period 1980 to 1986.

6. In addition to helping draft the international standards, the ICAI's representation on the IAPC helped in rooting the international standards as the anchor in the formulation of the auditing standards in India.

7. Since 2002, the Chairman and Secretary of the Auditing and Assurance Standards Board (AASB) also participate as representatives of the Institute in the meetings of the National Auditing Standard-Setters[3] [comprising ten countries including India], organised by the IAASB annually. The purpose of these meetings is to share knowledge on matters affecting international convergence and on international and national developments affecting the priority of topics on future standard-setting agendas, to optimise the process of bringing the strengths of IAASB and the national standard-setter (NSS) to bear on reaching consensus and convergence in standards at an early stage, to achieve closer co-operation and strengthened communication for identifying opportunities for closer collaboration on projects, leveraging of resources, further development of staff skills, minimisation of duplication, and to achieve wider involvement of NSS in IAASB task forces. For the purpose of these annual NSS meetings, only those standard-setters are invited by IAASB that:

- are significantly active in the development of national auditing standards, or by way of contributing to the development of International Standards on Auditing (ISAs);

[1] The nomenclature was changed to International Standard on Auditing (ISA) in 1991.

[2] The number of Standards issued by IAASB is 39 (excluding those which are the revised versions of the earlier Standards issued under the Clarity Project) as on January 1, 2008.

[3] IAASB constituted a National Standard-setters (NSS) Group comprising of eight countries in 2001. India was invited to become its member in 2002.

- have adopted or plan to adopt ISAs, or are demonstrably committed to the achievement of convergence of international and national standards;
- are sufficiently strong in terms of resources to participate actively in collaborative efforts identified through the activities of the liaison group; or
- represent the world's largest economies.

2.4 International Auditing and Assurance Board – The Clarity Project

8. The IAASB embarked upon its Clarity Project in 2004 with the twin objectives of greater use of its International Standards and ease of their translation. Until then, the Standards issued by the IAASB were written in a format wherein the principles or the fundamental requirements of the Standards were given in the bold text, the mandate being indicated by the use of the word **'should',** followed by its explanation in the normal type face, as a running text. Besides, the ISAs were quite concise and the explanation to the principles also did not contain any guidance aimed specifically at application of these Standards to audit of small entities. The Clarity Project, as the name suggests, was aimed at improving the clarity of the IAASB's pronouncements, making the ISAs easy to understand and implement. The IAASB is, therefore, also in the process of revising and/or redrafting its entire suite of Standards and hopes to complete the project by the end of 2009.

9. Till December 2003, all the Standards issued by the IAASB were known as the International Standards on Auditing. However, pursuant to its Clarity Project, the IAASB, with effect from January 2008, has categorised its International Standards as under, on the basis of type of assurance provided by different types of engagements:

- *International Standards on Auditing (ISAs)* – to be applied in the audit of historical financial information (100 – 999).
- *International Standards on Review Engagements (ISREs)* – to be applied in the review of historical financial information (2000 – 2699).
- *International Standards on Assurance Engagements (ISAEs)* – to be applied in assurance engagements dealing with subject matters other than historical financial information (3000 – 3699).
- *International Standards on Related Services (ISRSs)* – to be applied to compilation engagements, engagements to apply agreed upon procedures to information and other related services engagements as specified by the IAASB (4000 – 4699).

The above four categories of International Standards are collectively known as the Engagement Standards.

10. The Standards written under the Clarity Project have the following distinct features:

(i) The principles and the relevant application guidance in the Standard do not appear as running text. Instead, a Standard is now divided into two distinct sections. The first section contains the Requirements (*i.e.*, the principles) apart from the Introduction, Scope and Objectives, whereas the second section contains the Application and Explanatory Material (*i.e.,* the application guidance) in respect of the principles enunciated in the Requirements section. A Standard, therefore, now does not make a distinction between the principles and application guidance in the format of a bold type *vis-à-vis* normal text, rather the mandate is reflected in the Requirements paragraphs through the use of the word 'shall'.

(ii) Recognising the fact of existence of large number of small and medium enterprises

across the world, the Standards provide appropriate guidance to the auditors in respect of application of these Standards to such entities without diluting the principal requirements of the Standard. The Application and Explanatory Material Section of the Standard issued under the Clarity format, accordingly, contains separate guidance on application of the principles enunciated in the requirements section to the audit of small entities.

(iii) Prior to the Clarity Project, the IAASB had a separate Standard on audit in a computerised information systems environment. But now the different aspects of information technology environment have also been embedded in all the relevant Standards written under the Clarity Project. The said erstwhile Standard has been withdrawn pursuant to the issuance of its two Standards, ISA 315, *Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatements,* and ISA 330, *Auditor's Procedures in Response to Assessed Risks,* focusing on risk-based auditing.

(v) The Application and Explanatory Material section, at relevant places, also contains guidance on application of the principles laid down in the Standard to the audit of public sector entities. It is pertinent to note that the IAASB defines 'public sector' as 'national governments, regional (for example, state, provincial, territorial) governments, local (for example, city, town) governments and related governmental entities (for example, agencies, boards, commissions and enterprises)'.

11. In July 2006, IAASB issued a policy paper for national standard-setters (NSS) outlining the extent and manner of modification that a NSS could make to the corresponding International Standard (IS). A gist of these criteria is as follows:

(i) National Standard (NS) cannot be in conformity with the corresponding International Standard (IS) unless the standard-setter has in place a Standard conforming to the IAASB's International Standards on Quality Control.

(ii) NS cannot be in conformity with the corresponding International Standard unless the NS includes all the requirements and guidance contained in the corresponding ISA, except as provided in (iii) and (iv) below.

(iii) Limited additions permitted to an IS:
   - (a) National legal/regulatory requirements.
   - (b) Other requirements/guidance that are not inconsistent with the current requirements/guidance in IS.

(iv) Limited deletions from the ISs are:
   - (a) Elimination of options.
   - (b) Requirement/guidance which the law/regulation does not permit.
   - (c) Requirement/guidance where the IS recognises different practices may exist in different jurisdictions.

(v) All the ISs of a particular category have been included.

3. International Acceptance of International Standards on Auditing

12. ISAs are widely accepted now. The global acceptance of ISAs is confirmed by the 2006 survey by the IFAC Compliance Advisory Panel which indicates that more than 100 countries are using ISAs, either adopted as written or locally adapted, or as a basis for preparing their national standards. The 2006 Survey also revealed that 40 per cent of the countries adopt ISAs without any amendment; 35 per cent of the countries adopt ISAs and amend as necessary; and, 25 per cent of the countries compare National Standards with ISAs to eliminate differences. India falls in the category of those countries which adopt ISAs and make amendments subject to local laws, customs and usages. ISAs are also accepted as the basis for the audit of the financial statements of foreign listed entities by many of the world's major capital markets for the public sector, the International Organisation of Supreme Audit Institutions (INTOSAI)[4] uses ISAs as a basis for its Financial Audit Guidelines.

4. Auditing Standards in India

4.1 Legislative History

13. The history of auditing in India can be traced back to the period of the Mauryan empire[5], *i.e,* the period between 4th century BC and 150 AD. The mercantile legislations passed in 1857 contained a provision for annual audit of company's accounts. The Indian Companies Act of 1866 not only required the directors of the company to keep true accounts of the stock in trade and sums of money received and expended as well as credits and liabilities of the company, it also contained detailed provisions in respect of audit of accounts of companies. The 1866 Act embedded the need for an auditor to be independent and, accordingly, contained a number of provisions in respect of ensuring the auditor's independence, *viz.,* those relating to remuneration, eligibility for re-election, filling of casual vacancy, right of access to books and accounts of the company, report to the members, *etc.* The other important legislations were the Joint Stock Companies Acts of 1850, 1857, 1860, 1882 and the Indian Companies Act, 1913. The Companies Act, 1956 has also had far-reaching implications for the auditing profession in India[6].

14. Today, the audit of a company is carried out in terms of the provisions laid down in sections 224 to 227 of the Companies Act, 1956. Only a member of the ICAI who holds a certificate of practice can act as an auditor of a company. Whereas section 224 contains provisions relating to appointment and remuneration of the auditors, section 225 contains provisions relating to resolutions for appointment/removal of auditors. Section 226 of the said Act lays down requirements aimed at ensuring and protecting the independence of the auditors. To ensure fair and objective audit as also independence of auditors, it disqualifies the following persons from appointment as auditors of a company:

(i) a body corporate,

(ii) an officer/employee of the company,

(iii) a person who is a partner, or who is in the employment, of an officer or an employee of the company,

(iv) a person who is indebted to the company for an amount exceeding one thousand rupees, or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding one thousand rupees, and

(v) a person holding any security of that company after a period of one year from

[4] INTOSAI is the representative organisation of supreme audit institutions, which are central government auditors.

[5] In Kautilya's *Arthashastra.*

[6] Source: *The History of Accountancy Profession in India, Vol.I*, The Institute of Chartered Accountants of India.

the date of commencement of the Companies (Amendment) Act, 2000.

4.2 The Emergence of the Institute of Chartered Accountants of India

15. The passing of the Chartered Accountants Act, 1949 led to the creation of the ICAI. It has been entrusted with the task of regulation of the accountancy profession in India. For this purpose, the Council of the Institute has established a number of Committees and Boards, each to address an aspect critical to such regulation, for example, students' registration, education and training, auditing standards, accounting standards, ethical issues, continuing professional education, disciplinary aspects, *etc.* Some of these Committees and Boards are as follows:

Disciplinary Committee	1949
Examination Committee	1949
Board of Studies[7]	1954
Research Committee	1955
Continuing Professional Education Committee[8]	1956
Committee on Ethical Standards	1975
Accounting Standards Board	1977
Auditing and Assurance Standards Board[9]	1982

At present, there are more than 35 Committees/ Boards constituted by the Council of the Institute.

16. In 1955, the Council of the Institute set up the Research Committee 'for providing necessary guidance with a view to ensuring the highest traditions and technical competence in the discharge of the duties by the Chartered Accountants'[10]. During 1952-1982, when the AASB was not in existence, the Research Committee brought out more than 20 publications dealing with some critical issues faced by the auditors. A list of these publications is given in **Appendix A**.

5. Formation of the Auditing Practices Committee

17. The research work undertaken by the Research Committee comprised both accounting and auditing, the auditing aspects being looked into primarily by the Auditing Practices Committee (APC), a sub-committee of the Research Committee, formed during the late 1970s. However, in September 1982, the Council of the Institute transformed that sub-Committee into a full-fledged non-standing Committee of the Council, independent of the Research Committee. The primary objective of the Committee was to review existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute. In 2002, the nomenclature of the APC was changed to Auditing and Assurance Standards Board (AASB) in conformity with the developments at the international level. In 2007, the nomenclature and categorisation of the Auditing and Assurance Standards was changed when the AASB issued the revised Preface in

[7] Earlier known as the Coaching Board.
[8] Earlier known as the Post Graduate Courses Committee.
[9] Prior to September 1982, Auditing and Assurance Standards Board was a part of the Research Committee.
[10] Source: *History of Accountancy Profession in India, Volume I,* pp 361, The Institute of Chartered Accountants of India.

line with the IAASB's revised Preface under the Clarity Project. This aspect has been discussed in subsequent paragraphs. A table showing the new categorisation and re-numbering of the auditing standards and reconciliation are given in **Appendix B.**

5.1 Composition of Auditing Practices Committee

18. Till 2002, the membership of APC comprised members of the Council of the Institute as well as co-opted members. As per the provisions of the Chartered Accountants Act, 1949 only chartered accountants, either from industry or practice can be co-opted on the Board. In July 2002, to bring in greater transparency and efficiency in the working of the APC, the Council of the Institute opened up the meetings of the APC to regulators, industry representatives as well as academicians as special invitees. Such representatives need not be chartered accountants. The regulators invited were the Reserve Bank and the SEBI. One special invitee was sought from the apex industry associations, *viz.*, Federation of Indian Chambers of Commerce and Industry, Confederation of Indian Industry and the Associated Chambers of Commerce, on an annual rotation basis. Similarly, a representative was requested from leading management institutes of India, e.g., the Indian Institute(s) of Management – Ahmedabad, Lucknow, Indore, Kolkata, Kozikode, Bangalore, on an annual rotation basis.

5.2 Auditing Standard-setting – Considerations and Process

19. India is one of the founder members of the IFAC. Its responsibility in respect of the International Standards, therefore, emerges from one of the IFAC membership obligations whereby the Institute is required to promote the Standards promulgated by the IFAC. Accordingly, while formulating these Standards, the APC was also required to give due consideration to the corresponding standard(s) issued by the International Federation of Accountants as well as applicable laws, customs, usages and business environment in India. Though, periodically, IFAC undertakes assessment of the membership obligations by the member bodies, there is more to convergence with the international best practices than a mere need for compliance with a membership obligation, namely, *conviction and commitment.*

20. Auditing standards in India are formulated following a due process approved by the Council of the ICAI. This due process[11] is set out in the Preface to the Statements on Standard Auditing Practices issued in June 1983. In terms of the 1983 Preface, a Standard passes through the following stages:

Stage I:	At the first stage, the AASB determines the broad areas in which Standards need to be formulated and the priority in regard to the selection thereof.
Stage II:	AASB constitutes study groups to write the Standards.
Stage III:	The draft of the Standard prepared by the study group is discussed by the AASB and subject to necessary changes, if any, is issued as an Exposure Draft of the Standard for public comments.
Stage IV:	AASB considers the comments received on the Exposure Draft on the basis of which the draft of the proposed Standard is finalised and submitted for the consideration of the Council of the Institute.
Stage V:	The Council considers the draft of the proposed Standard and, if necessary, modifies it in

[11] The due process has been revised in 2007 and made more rigorous. The revised due process is discussed elsewhere in the Report.

consultation with the AASB. The final Standard is then issued under the authority of the Council.

21. As a matter of policy, as laid down in the Preface to Statements on Standards on Auditing Practices issued in 1980, the Standards issued by the AASB are anchored on the corresponding standards issued by the IAASB. Changes to the latter are made only as warranted by the local conditions.

5.3. Standards, Statements and Guidance Notes

22. The Auditing Practices Committee, in addition to the Standards, has also brought out Statements on a number of auditing issues. The Statements, normally, provided guidance to the members on issues of contemporary relevance and were issued primarily when auditing standards were either not yet in place or were in evolutionary stages. For example, the Statement on Auditing Practices, issued in 1964, a period when the concept of Standards had yet to take a concrete form, provided extensive guidance to the members on issues such as true and fair, materiality, comparative study, accounting policies, internal controls, auditor's approach, *etc.* The Statement on Manufacturing and Other Companies (Auditor's Report) Order, 1975 provided detailed guidance to the members for effective discharge of their reporting requirements under the said Order. The Statement on Qualifications in Auditor's Reports was published as far back as in 1970 to provide guidance to members regarding the form, purpose and manner of qualifications and thereby improving the overall standards of reporting on the financial statements by chartered accountants.

23. Both the Standards as well as the Statements on auditing codify the best practices in the area of auditing and are regarded by the Council as being critical and are, therefore, mandatory in nature. If, for any reason, a member has not been able to perform an audit in accordance with the applicable Standard or Statement, he is required to draw attention to the material departures therefrom. It is, however, important to note that there can be situations in which certain matters are covered both by a 'Statement' and by a 'Standard'. In such a situation, the 'Statement' prevails till the time the relevant 'Standard' becomes mandatory. Once a 'Standard' becomes mandatory, the concerned 'Statement' or the relevant part thereof automatically stands withdrawn.

24. The APC was also entrusted with bringing out Guidance Notes on auditing. Guidance Notes are designed primarily to provide guidance to members on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature. A member is required to ordinarily follow recommendations in a Guidance Note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so. Till date, the AASB has issued a number of Guidance Notes on auditing, including four industry-specific Guidance Notes. A list of Statements and Guidance Notes is given in **Appendix C.**

5.4 Developments at the Auditing and Assurance Standards Board Pursuant to the International Auditing and Assurance Board's Clarity Project

25. In May 2007, the Council of the Institute, as a part of its strategy to fall in line with the best practices followed at the AASB, approved a revised due process for the issuance of auditing standards. The revised due process is a necessary companion to the revised Preface and the new/revised Standards to be issued by the AASB is in line with the corresponding International Standards issued by the IAASB pursuant to its Clarity Project. The Revised Preface issued pursuant to the Clarity Project also paved the way for a new format of writing the Standards, *i.e.,* dividing the Standards in two parts, *viz.*, Requirement Section and Application and Explanatory Section. (The new Standards issued by the AASB corresponding to the ISs issued under the Clarity project have been discussed subsequently in this Report.) Though the principles of transparency and fairness lie at the heart of the revised due process, some critical modifications have been introduced to further strengthen the working of the AASB, especially, its standard-setting process. A brief summary of the significant changes made is given below:

5.4.1 Composition of Auditing and Assurance Standards Board

26. In respect of the composition of the AASB, the Revised Preface and the Due Process has introduced the following changes:

(i) IRDA (apart from the existing Reserve Bank and SEBI) has been added as another regulator from which a special invitee to AASB would be requested.

(ii) The academicians would now, in addition to the Indian Institute(s) of Management, be represented by any other prominent academic and/or research organisation.

(iii) Public interest would be represented on the AASB, for example, by a representative of a not-for-profit organisation.

(iv) Term of the Chairman of the AASB would be at least three years to ensure continuity and consistency in policy decisions and approach.

5.4.2 Standard-setting Process

27. The standard-setting process has been modified for the following requirements by the Revised Preface and Due Process:

(i) The AASB meeting where a Standard/ Statement is to be considered, requires the presence – in person or through telecommunication link – of at least two-thirds of the membership of AASB.

(ii) Absence of a member for a consecutive period of three AASB meetings needs to be brought to the notice of the Council of the Institute.

(iii) The AASB has been authorised to undertake joint projects with regulators and others.

(iv) The draft of the Standard/Statement to be considered by the AASB is to be hosted on the website of the Institute at least twenty one days before the said AASB meeting.

(v) The period of exposure has been increased from 45 days to at least 60 days.

(vi) Comments of the respondents are to be hosted on the website of the AASB.

(vii) The manner of disposal of these comments by AASB is also required to be hosted on the website of the AASB.

(viii) Members of the public can attend the AASB meetings where a particular Standard is to be considered, subject to the specified conditions.

(ix) The final Standard for submission to the Council would be cleared by the AASB after a voting process.

28. Some of the other significant changes brought in by the revised Preface and the Due Process are:

(i) Guidance Notes, clarifications on Standards, technical guides, practice manuals, studies and other papers have been formally listed as documents that can be issued by the AASB.

(ii) The AASB has been given a formal authority to issue technical guides, practice manuals, studies and other papers, *etc.*, under its own authority.

(iii) Procedure for issuance of the documents mentioned in (i) above has also been formalised.

6. Encouraging Implementation and Enforcing Compliance of Standards

29. The criticality of the Standards issued by the Institute is further underlined by clause 9 of Part I of the Second Schedule to the Chartered Accountants Act, 1949, which states that a chartered accountant in practice will be guilty of professional misconduct, if he '*fails to invite attention to any material departure from the generally accepted procedures of audit applicable to the circumstances.*' As a regulator of the accountancy profession and the custodian of public trust in the financial reporting system in the country, the task of the Institute extends both to *encouraging* implementation as well as *enforcing* compliance with the Standards.

6.1 Encouraging Implementation

6.1.1 Continuing Professional Education

30. *The History of Accountancy Profession in India* states that 'The Institute has always recognised the significance of continuing professional education (CPE) for its members and pursued it as one of the avowed objectives so as to ensure that its members attain and maintain the quality of knowledge and service expected of them. Continuing education is a joint responsibility of both the individual members as well as the professional body to which they belong. A professional Institute holds out a generalised promise of proficiency with regard to its members and it cannot absolve itself of the responsibility regarding their continued technical proficiency. It is with this end in view that the Institute has taken upon itself the task of providing continuing education to its members on a regular and systematic basis'[12]. Accordingly, the Council of the Institute constituted the Continuing Professional Education Committee in 1956.

31. As a part of the continuing professional education, the Committee, through its various programme organising units, conducts a number of seminars, workshops, conferences, *etc.*, on various areas of professional interest, including auditing. During 2007-2008, the CPE Committee organised audit related programmes on topics such as service tax audit, bank audit, VAT audit, the Sarbanes-Oxley Act, 2002 the overall set of auditing standards, audits in public sector, forensic audit, audit of members of stock exchanges, audit of charitable institutions, audit of insurance companies, *etc.*, allocating more

[12] Source: The *History of Accountancy Profession in India, Vol.* II,The Institute of Chartered Accountants of India,

than 5000 CPE hours in total. In the year 2008-09, the CPE Committee has till October 31, 2008 held many learning programmes in the area of audit, generating more than 3,500 CPE hours. The Committee also brings out non-authoritative publications on various subjects. As on date, CPE is mandatory for the practicing members. However, from 2008, the CPE has become mandatory for the members in industry as well.

6.1.2 Peer Review Board

32. The Institute also has in place a system of peer review of audit firms (*i.e.*, practice units), done under the aegis of the Peer Review Board of the ICAI, established in April 2002. The Board consists of ten members appointed by the Council of the ICAI of whom at least six are from amongst the members of the Council. The Board also has representatives from the Ministry of Corporate Affairs, the CAG, SEBI and the industry (as represented by FICCI/CII).

33. The review process involves an evaluation of the process followed by the Practice Units (PUs) in performing attestation engagements. Under a peer review, the reviewer examines the adequacy of the founding pillars of quality control system in an audit firm, *viz.*, compliance with technical standards, audit procedures and documentation, quality of reporting, office systems and procedures and training of the staff and makes a report thereon. The report, rather than being a fault-finding weapon, is aimed at helping the reviewee to improve its performance. Importantly, the PUs found wanting/deficient by the peer reviewer are again subjected to a peer review process after a period of about six to twelve months to assess the improvements made by them.

34. Peer review was introduced in three stages to cover all types of PUs – sole proprietors, partnerships, *etc.* Stage I of the peer review process covered all such PUs which carry out audits of enterprises involving large amounts of funds – Government/public (paid-up capital above Rs. 5 crore and annual turnover of more than Rs. 50 crore), central statutory auditors of banks, insurance companies, central co-operative societies, asset management companies, mutual funds, *etc.* Stage II covered firms carrying out audits of branches of public sector banks/private sector and foreign branches, regional rural banks, co-operative banks, NBFCs listed on stock exchanges and not covered in Stage I. Stage III covered all the rest of the firms. As per the statistics available, 1,188 PUs fall under Stage I while Stage II covers 16,478 PUs and Stage III covers all residuary 38,356 firms including members that practice in individual name. The process of review is also cyclical since PUs covered under Stage I are reviewed mandatorily after every three years while in respect of Stage II and Stage III PUs, a four-year and a five-year cycle, respectively, has been decided by the Board. So far more than 11,000 PUs have been selected for review under different stages. As on date, 1,479 certificates have been issued to different PUs while follow-up reviews have been ordered in respect of about 248 PUs.

35. Peer review being an instrument of encouraging compliance with standards and improving the overall quality of work by audit firms, it is essential that the peer reviewers are themselves strong technically and are experienced enough to understand the intricacies of practice. The Institute has, therefore, till date empanelled more than 3,900 peer reviewers and has provided extensive training to 3,100 reviewers at 79 programmes organised so far throughout the country. The training, incidentally, also ensures consistency and uniformity in the peer review process. The Institute has also developed a strong trainer base for the training of the peer reviewers.

36. A move that can be seen as supporting the peer review process is the recommendation of the SEBI's Committee on Disclosures and Accounting Standards (SCODA) that, in view of the public funds involved, audit of listed

companies should be carried out by only those auditors who have themselves been subject to the peer review. The said recommendation of SCODA has, in principle, been accepted by the Council of the Institute.

6.1.3 Quality Review Board

37. Section 28A of the Chartered Accountants Act, 1949 as amended by the Chartered Accountants (Amendment) Act, 2006 envisages establishment of a Quality Review Board (QRB) by the Central Government to perform the following functions:

(i) to make recommendations to the Council with regard to the quality of services provided by the members of the Institute;

(ii) to review the quality of services provided by the members of the Institute including audit services; and

(iii) to guide the members of the Institute to improve the quality of services and adherence to various statutory and regulatory requirements.

38. The Central Government, through its notification issued in June 2007, has constituted the QRB. The Board has a total of ten members, excluding the Chairman, whereof five members are nominated by the Central Government and five by the Council of the Institute. The Chairman to the Board is also nominated by the Central Government.

6.2 Enforcing Compliance – Disciplinary Mechanism

39. A member of ICAI is subject to its disciplinary jurisdiction. The Chartered Accountants Act, 1949 (hereinafter the Act unless specified otherwise) gives authority to the Central Council of ICAI to enquire into cases of professional or other misconduct on the part of members of ICAI and to take disciplinary action.

40. The Act, as amended by the Amendment Act of 2006, provides for the constitution of the Board of Discipline consisting of a presiding officer who has knowledge of disciplinary matters and of the profession and of two members, one of whom shall be a member of the Central Council and the other a person to be nominated by the Central Government out of persons of experience having eminence in the field of law, economics, business, finance or accountancy. The Board looks into complaints which fall under the First Schedule to the Act.

41. There is also a Disciplinary Committee which consists of the President or Vice-President of ICAI as the presiding officer and of two members who are members of the Central Council of ICAI and two members to be nominated by the Central Government from amongst persons of eminence having experience in the field of law, economics, business, finance or accounting. The Disciplinary Committee looks into complaints against members falling under both the First Schedule as well as the Second Schedule to the Chartered Accountants Act, 1949.

42. To a large extent, the First Schedule covers professional and other misconduct related to non-observance of the internal regulations of the Institute. It has four parts, namely:

- Part I – applicable to professional misconduct by members in practice;
- Part II – applicable to professional misconduct by members in service;

- Part III – applicable to professional misconduct by members generally (whether in practice or not); and
- Part IV – applicable to other misconduct by members generally.

43. The Second Schedule generally covers professional misconduct in areas where public interest is involved. It has three parts, namely:

Part I – applicable to professional misconduct by members in practice. This includes *inter alia* disclosure of confidential information, failure to disclose material facts or misstatements in financial statements, failure to exercise due diligence or grossly negligent conduct, failure to obtain sufficient information to warrant the expression of an opinion and failure to invite attention to material departures from generally accepted audit procedures;

Part II – applies to professional misconduct by members generally (whether in practice or not); and

Part III – applies to other misconduct by members generally.

44. The First and Second Schedules to the Chartered Accountants Act, 1949 are reproduced in **Appendix D**.

45. The Chartered Accountants Act, 1949 provides for the appointment by the Central Government of an Appellate Authority consisting of a person who is or has been a judge of a High Court as the Chairperson and two past members of the Central Council and two persons to be nominated by the Central Government from amongst persons having knowledge and practical experience in the field of law, economics, business, finance or accountancy.

46. Appeals to the Appellate Authority against an order of the Board of Discipline or the Disciplinary Committee can be made by an aggrieved member and/or the Director (Discipline).

6.3 Enforcing Compliance – Supervisory Mechanism

6.3.1 Financial Reporting Review Board

47. The Financial Reporting Review Board (FRRB) was constituted by the Council of the ICAI in July 2002, comprising of the members of the Council of the Institute (including a nominee of the Central Government on the Council) as well as representatives of IRDA and the CAG as special invitees. The primary function of the FRRB is to review the compliance *inter alia* with the reporting requirements of various applicable statutes, Accounting Standards and Auditing and Assurance Standards issued by the ICAI.

48. The Board reviews general purpose financial statements and the auditors' reports thereon of certain randomly selected enterprises with a view to determine, to the extent possible:

- Compliance with the generally accepted accounting principles in the preparation and presentation of financial statements;
- Compliance with the disclosure requirements prescribed by regulatory bodies, statutes and rules and regulations relevant to the enterprise; and
- Compliance with the reporting obligations of the auditor.

49. The FRRB can review the general purpose financial statements of the enterprise and the auditor's report thereon either *suo motu* or on a reference made to it by any regulatory body like, the Reserve Bank, SEBI, IRDA, Ministry of Corporate Affairs, *etc.* The FRRB may also review general purpose financial statements of the enterprises and the auditor's report thereon relating to which serious accounting irregularities in the general purpose financial statements have been highlighted by the media reports.

50. The enterprises within the purview of the FRRB include:

- enterprises whose debt or equity securities are listed on a recognised stock exchange in India;
- public financial institutions and banks;
- non-listed and other commercial enterprises having a turnover of Rs. 50 crore or more; and
- such other category of enterprises which in the opinion of the Board make the public interest vulnerable due to susceptibility to non-compliance of generally accepted accounting principles in the preparation and presentation of financial statements, non-compliance of the disclosure requirements prescribed by regulatory bodies, statutes and rules and regulations relevant to the enterprise and non-compliance of the reporting obligations of the enterprise and the auditor.

51. For *suo motu* reviews, the FRRB decides every year, the number of companies to be reviewed in each Council year. The companies are short-listed on the basis of the criteria decided by the Board, using the company database available from a nationally renowned source. After short-listing, the companies are sorted in the ascending order of turnover. From this list, the required number of companies are selected using scientific methods such as random sampling. In its reviews, the FRRB is assisted by its various Financial Reporting Review Groups (FRRGs). The members of the FRRGs are adequately trained by the FRRB and work under strict confidentiality requirements.

52. In case the FRRB finds any non-compliance with the factors stated above, it refers the case to the Secretary to the Council of the Institute of Chartered Accountants of India[13] for initiating action against the auditor under the Chartered Accountants Act, 1949. Insofar as the management of the enterprise is concerned, pending the grant of relevant powers to the FRRB by the Central Government, the FRRB informs irregularity to the regulatory body relevant to the enterprise.

53. In cases where no material non-compliance and/or non-compliance affecting the true and fair view of financial statements are observed by the FRRB, and only immaterial non-compliance and/or non-compliance, which do not affect the true and fair view of financial statements are observed, the FRRB may not refer the case to the Secretary[14] to the Council of the ICAI for initiating action against the auditor under the Chartered Accountants Act, 1949. In such cases, the FRRB would appropriately bring the non-compliance to the attention of the auditor and/or the enterprise concerned. Till 2007, the FRRB has taken up the review of 245 companies, out of which 74 cases have been referred to the Secretary to the Council of the Institute and 76 cases have been referred to the relevant regulators.[15]

[13] Pursuant to the amendments introduced by the Chartered Accountants (Amendment) Act 2006, the cases now need to be referred to the Director (Board of Discipline).

[14] See footnote 4.

[15] The Institute has its own disciplinary mechanism, as prescribed under the Chartered Accountants Act, 1949 (amended by the 2006 Amendment Act), to deal with the complaint cases filed against the members of the Institute. This disciplinary mechanism has been discussed in this Report subsequently.

54. With a view to apprising the members of the Institute and others concerned about the major non-compliance observed during the review, the FRRB compiles information on instances of such non-compliance from time to time and publishes the same in the Journal of the Institute and also hosts them on the website of the Institute, without mentioning the names of the enterprises concerned and/or their auditors. The FRRB does not have any power to impose any kind of penalty on the concerned enterprise/auditor.

7. India and the World – Report on the Observance of Standards and Codes-2004

7.1 Report on the Observance of Standards and Codes' Evaluation Process

55. The Financial Stability Forum (FSF) of the World Bank, established following the East Asian crisis,1997 enunciated twelve core principles of financial stability, with accounting and auditing being one of them. The Report on Standards and Codes (ROSC), a joint initiative of the World Bank and the IMF is aimed at assessing the level of compliance in the member countries of the twelve core principles enunciated by FSF, comprising assessment of actual practices as well as the effectiveness of the monitoring and enforcement mechanisms. For the purpose of collecting relevant information, diagnostic templates have been developed by the World Bank.

56. Insofar as auditing is concerned, the International Standards on Auditing (ISAs) issued by the IAASB of IFAC were taken as the benchmarks for the assessment and comparison. The diagnostic tool for the purpose evaluated the audit standard-setting framework as well as the position of each Auditing and Assurance Standard[16] *vis-a-is* the corresponding International Standard on Auditing. The aspects evaluated include:

- Existence of auditing standards;
- Legal backing for these standards;
- Existence of a national standard-setter;
- Legal authority of the national standard-setter;
- Composition of the standard-setting body;
- Accountability of the standard-setting body;
- Due process of standard-setting; and
- Issuance of practical implementation guidance on auditing standards.

57. In respect of the individual standards, the following specific aspects were evaluated:

- Standards gap and compliance assessment;
- Whether standard has been adopted;
- Whether the national standard-setters address certain specific aspects of each of the ISAs;
- Standards as practiced;
- the extent to which the practice differs from the written requirements of the national standards; and
- difficulties faced by the professional accountants in public practice to fully comply with the standard.

7.2 Significant Findings of the Report on the Observance of Standards and Codes-2004

58. The ROSC-2004 was finalised by the representatives of the World Bank through a participatory process involving various stakeholders such as the Ministry of Corporate Affairs, the Reserve Bank, the ICAI, IRDA, SEBI, the Bombay Stock Exchange, the National Stock Exchange, the CAG, the Central Board of Direct Taxes, the Federation of Indian Chambers of

[16] Now known as the Engagement Standards.

Commerce, the Confederation of Indian Industries, and the Associated Chambers of Commerce. Some of the significant findings of the ROSC-2004 are as follows:

- ICAI follows a due process in formulating and issuing standards.
- AASs generally replicate the ISAs, modifications being made to adapt to the local circumstances
- Lesser audit alternatives as compared to ISAs.

59. The ROSC-2004 identified the following differences in the AASs issued by the ICAI *vis-a -vis* the ISAs.

I. No AAS corresponding to the following ISAs:

   (i) ISA 100, *Assurance Engagements*

   (ii) ISA 501, *Audit Evidence – Additional Consideration for Specific Items*

   (iii) ISA 720, *Other Information in Documents Containing Audited Financial Statements*

   (iv) ISA 910, *Engagements to Review Financial Statements*

II. Significant differences in Standards related to audit planning, management representations, audit sampling and quality control.

III. Inability of the incoming auditor to access the working papers of the outgoing auditor.

IV. No requirement for assessment of the professional competence of another auditor.

V. Quality of audit practices differs significantly among audit firms.

VI. Improper use of the expression 'subject to/except for' audit opinions in audit reports.

7.3 Institute of Chartered Accountants of India's Response to Report on the Observance of Standards and Codes' Findings

60. Pursuant to observations made by the ROSC, ICAI took several steps including expediting the issuance of updated Standards. Such response, along with the Panel's response, are discussed below:

7.3.1 Auditing Standards Corresponding to ISAs

61. Subsequent to the issuance of the ROSC-2004, the ISA 100 was withdrawn by the IAASB and in its place a document titled *Framework for Assurance Engagements* was issued. In 2007, the ICAI issued a document titled *Framework for Assurance Engagements* corresponding to the IAASB document.

62. Though the ICAI did not have an auditing standard corresponding to ISA 501, it did have Guidance Notes on some of the topics covered in ISA 501 namely, guidance notes on 'Audit of Inventories' and on 'Audit of Liabilities'. A full-fledged Standard on 'Audit Evidence – Additional Consideration for Specific Items' (AAS 34[17]) was issued in March 2005.

[17] Now known as the Standard on Auditing (SA) 501.

63. The AASB has already issued the Exposure Draft of the SA 720 corresponding to ISA 720.

64. Insofar as ISA 910 is concerned, ICAI had issued a Guidance Note on 'Engagements to Review Financial Statements' which was substantially on the lines of ISA 910. In March 2005, it has issued a standard (AAS 33[18]) on the subject.

8. On the Road to Convergence – Ironing Out the Standard-specific Differences

65. Subsequent to ROSC-2004, the IAASB, pursuant to its Clarity Project, has till date issued twenty Revised/Redrafted International Standards on Auditing and thirteen exposure drafts of revised/redrafted ISAs which are yet to be finally issued by IAASB. In addition, IAASB had also issued a 'mother standard' on quality control by the nomenclature of ISQC 1, *Quality Control for Audit Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.* One of the major implications of ISQC for the IFAC member bodies is that having a Standard corresponding to ISQC 1 is an essential pre-requisite for the national standard-setters to claim compliance with the International Standards. The Institute has already issued a Standard (SQC 1) corresponding to ISQC 1. The IAASB has recently issued an Exposure Draft of the Redrafted ISQC 1 under the Clarity Project.

8.1 Access to Working Papers

66. The inability of the auditors to share working papers among themselves in the Indian context has given rise to differences *vis-à-vis* a number of ISAs, for example, in the Standard dealing with audit of group financial statements. This inability seems to have stemmed from the requirements of clause (1) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 which states that, '*a chartered accountant in practice will be guilty of professional misconduct if he discloses information acquired in the course of his professional engagement to any person other than his client so engaging him, without the consent of his client or otherwise than as required by any law for the time being in force*'. Even in the case of an audit of a branch of a company, though section 228 of the Companies Act, 1956 empowers the principal auditor to visit the branch and inspect the documents maintained thereat but does not empower him to seek the working papers of the branch auditor. It shall, however, be well within the ambit of the legal provisions that an outgoing auditor may share his working papers subject to the permission of the client. Therefore, the principal auditor, both in the case of a branch or a subsidiary of the client company, may have access to the working papers of the latter if the parent company (client) so permits the branch/subsidiary auditor. The auditor may, however, at his discretion make copies of his working papers available to the client.

67. The Panel, however, reaffirms the recommendation of the SEBI Committee on Disclosures and Accounting Standards (SCODA) that, where a company has a material subsidiary whose audit has not been done by the principal auditor, the principal auditor should have the obligation to review the working papers of the other auditors who have audited the financial statements of such subsidiaries. To give effect to the ability of the principal auditor to fulfil this obligation, specific authority should be given to the auditor of the subsidiary in the engagement letter to allow such access.

8.2 Assessment of Professional Competence

68. The International Standards on Auditing, envisaging situation where an auditor uses the work of another auditor, requires the former,

[18] Now known as the Standard on Review Engagements (SRE) 2400.

in all cases, to assess the professional competence of the other auditor whose work he intends to use/rely upon. Such a requirement in ISAs, perhaps, has been incorporated to cover twin situations, *viz.*, a multinational corporation may have several branches or subsidiaries operating in different parts of the world or probably on account of the fact that in some countries, for example, the United Kingdom, there may be more than one professional accounting body recognised under the law whose members can carry out the audit of the financial statements. In such jurisdictions, where there is only one professional accounting body recognised by law whose members can carry out the audits of financial statements, (for example, in India, this would comprise the members of ICAI), the need to assess the professional competence of the other chartered accountant on whose work the main auditor wishes to rely/relies, may still be necessary. The need arises on account of the fact that in today's complex economic environment involving the highly specialised nature of industry and financial services sector, professional accountants are required to deal with several intricate issues pertaining to a particular industry. Therefore, one may come across a situation wherein an auditor having adequate experience and standing in the profession may not have relevant experience of the particular industry. Thus, it may be imperative for an auditor assuming the ultimate responsibility for the audit opinion to assess the professional competence of the other auditor in the context of the particular assignment before relying upon the latter's work.

8.3 Quality of Audit Practices

69. A large number of audit firms in India – more than 80 per cent according to the statistics maintained by ICAI – are sole proprietors, most of them having limited resources and small entities as their clients for audit and taxation work. This, however, cannot be a reason to compromise on the audit quality. The Institute has, therefore, undertaken rigorous steps such as the mandatory Continuing Professional Education for one and all practicing chartered accountants, peer reviews as well as training programmes throughout the nook and corner of the country. It is hoped that these initiatives of the ICAI, some of which have been elaborated in earlier paragraphs, coupled with the recent issuance of a comprehensive standard on quality control, corresponding to the ISQC 1 of the IAASB, would go a long way in ensuring a uniformly high quality among audit firms.

8.4 Manner of Making Qualified Reports

70. ICAI has always been conscious of the fact that quality of reporting is the ultimate test of true professional and, thus, has taken several steps from time to time to bring in better practices in reporting by the auditors. As a measure to bring in uniformity in the reporting practices among the statutory auditors of companies under the Companies Act, 1956 the Institute, issued the Statement on Section 227(1A) of the Companies Act, 1956 in 1965. This Statement was subsequently merged with the Statement on Qualifications in Auditor's Report, issued by the ICAI in 1970-71. This publication of the ICAI was a benchmark of sorts in the sense that it contained fundamental

principles on when and how to qualify the audit reports. To provide a greater and clearer understanding to the readers as to how the auditor's qualifications have affected the financial statements of the entity, the Statement was revised in 2000 to incorporate a significant provision to the effect that the auditor must give the aggregate impact of his quantifiable qualifications on the net profit/loss of the auditee. In 2002, the ICAI also issued a prescribed format of an audit report. Thereafter, in 2003, ICAI issued the AAS 28, *The Auditor's Report on Financial Statement*, corresponding to the then existing ISA 700. Through this AAS, for the first time, the ICAI laid down the basic elements of the auditor's report. The Standard also introduced the concept of an 'emphasis of matter paragraph' and also laid down guiding principles as to situations warranting a qualified/adverse or a disclaimer of opinion.

71. The ICAI, through its CPE and other training programmes on auditing as well as the peer review process, has provided guidance to members on the appropriate use of the expression 'subject to/except for' in audit reports. In fact, the quality of reporting is one of the main focus areas in the process of peer review. In addition, the ICAI's seriousness on the quality of audit reports is also reflected by the fact that the FRRB has referred to the Secretary, ICAI, more than 74 cases against auditors due to shortcomings in their audit reports on the financial statements of the companies reviewed by the FRRB.

9. 2008 – Four Years After Report on the Observance of Standards and Codes-2004

72. The ICAI being a founder member of the IFAC, has followed a conscious policy of harmonisation with the international Standards, which, accordingly, form the basis for the national auditing standards (i.e, AASs) subject to any modifications arising out of the requirements of laws and regulations or customs and usage of trade. Since 2004, the AASB has also started the practice of giving a separate section on material departures from the corresponding ISA at the end of the Standard for better understanding of the users of financial statements. Beginning with the new/revised Standards, being issued corresponding to the ISAs issued under the Clarity Project, there is a conscious move on the part of the Institute to keep the departures from the ISAs at the bare minimum, having regard to the IAASB's policy paper on compliance with the International Standards by the National Standard-Setters. Moreover, the information on the material departures from the corresponding ISAs is also being presented in a format which is more informative. The additions/deletions are now being given separately.

73. Another important difference between the IAASB Standards and the auditing Standards issued by the ICAI is that whereas the international standards contain separate guidance on application of the principles laid down in the Standard to public sector entities, the auditing standards issued by the ICAI do not contain any such separate guidance. The reason for this approach is the difference in the definition of 'public sector entities' as adopted by the IAASB and that adopted by the AASB of the ICAI. In India, public sector generally refers to public sector enterprises which are now working on commercial principles like any other business enterprise. The AASB, therefore, does not make any distinction in application of the auditing standards to public *vis-à-vis* non-public sector entities. Moreover, to the extent practicable, the guidance relating to public sector in ISAs has been retained in generic manner. Further, in India, government companies are subject to a supplementary audit by the C&AG in addition to the normal statutory audit conducted by a chartered accountant. In its Report of May 2005, the Expert Committee on Company Law noted that 'since statutory audit is conducted by the statutory auditor appointed by the C&AG in the manner directed by him,

the test/supplementary audit is superfluous since it would duplicate the work already done by statutory auditor.'

74. Significant changes have taken place the world over in the environment in which the audit is carried out today, the technology used by the clients for their business operations and, most importantly, the changing expectations of the various stakeholders, especially the regulators. Appropriate refinements in the auditing methodologies and technology were, therefore, imperative to match these changes and to help the profession maintain continued relevance in the society. The following paragraphs give a snapshot of the initiatives of the ICAI to match the pace of the economic developments taking India by storm.

9.1 Towards Risk-based Auditing

75. In order to make the audit more efficient and effective as also a value-adding proposition for the client, there was a conscious move globally towards developing a risk-based approach in auditing. Though the IAASB began its Clarity Project in 2004, a major boost to the auditing process came in 2003 when the IAASB issued two new standards, ISA 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and ISA 330, *The Auditor's Procedures in Response to Assessed Risks*, and revised two of its existing Standards, *viz.*, ISA 200, *Objective and General Principles Governing an Audit of Financial Statements*, and ISA 500, *Audit Evidence.* These four Standards were collectively known as the *Audit Risk Standards.* These Standards were effective in respect of audits of financial statements for periods beginning on or after December 15, 2004. Issuance of these four standards gave rise to conforming amendments/revision to almost the entire suite of the International Standards on Auditing. The accordingly revised International Standards on Auditing were issued by the IAASB during the period 2004 and were effective for all audits of financial statements for the periods beginning on or after December 15, 2004.

9.2 On the Road to Convergence with International Standards on Auditing – the Strategy

76. The Institute has again reiterated its commitment to bring out internationally benchmarked auditing standards. For this purpose, ICAI's Auditing and Assurance Standards Board has not only initiated an ambitious project of revising all its existing Auditing and Assurance Standards in the light of the various ISAs being issued by IAASB under its Clarity Project to achieve total convergence with the same but is also looking forward to meeting the dateline set by IAASB for winding up the Clarity Project. AASB has also charted out a strategy for successfully finishing this project. According to this strategy, the standard-setting process would be accelerated without compromising on the consultations with the various stakeholders and deliberations required in formulation of a standard. For this, the AASB issues exposure drafts of the revised Standards on Auditing co-terminus with the exposure drafts of the revised/new ISAs issued under the Clarity Project. The AAS are being given shape only after the final ISA has been issued by the IAASB. The Board, in association with the Continuing Professional Education Committee of the Institute, is also holding a number of

training programmes and workshops, *etc.* on auditing standards for members.

9.3 On the Road to Convergence with the International Standards on Auditing – the Progress

77. As the first and the most fundamental step towards convergence, AASB in 2007 issued the Revised Preface in line with the Preface issued by the IAASB. The Revised Preface paves way for the introduction of Standards written in a format which is in harmony with that adopted by the IAASB for its ISA under the Clarity Project. The Preface, which is effective April 1, 2008 categorises auditing standards into the following five categories, based on the types and levels of assurance that an engagement aims to provide:

(i) Standards on Auditing (SAs) – to be applied in the audit of historical financial information.

(ii) Standards on Review Engagements (SREs) – to be applied in the review of historical financial information.

(iii) Standards on Assurance Engagements (SAEs) – to be applied in assurance engagements, engagements dealing with subject matters other than historical financial information.

(iv) Standards on Related Services (SRSs) – to be applied to engagements to apply on agreed-upon procedures to information and other related services engagements such as compilation engagements.

78. Pursuant to the Revised Preface, therefore, the AASs, have been re-named as above and also re-numbered and re-categorised on the pattern followed by the IAASB for its Standards. The Revised Preface also provides for an SA to have two sections – the requirements section containing the basic principles and the application guidance section containing the implementation guidance.

79. In terms of a recent policy of IAASB, no National Standard-Setter (NSS), like the ICAI, can claim to have achieved convergence with the International Standards unless, among other things, it has a Standard equivalent to the International Standard on Quality Control (ISQC). The ISQC issued by the IAASB ranks highest in the hierarchy of the structure of IAASB pronouncements, preceding all the Standards issued by the IAASB. Therefore, as mentioned in earlier paragraphs, it is a mother Standard laying down extensive guidelines in respect of the quality control practices to be established and maintained by the accounting firms for the audits, reviews and other assurance engagements undertaken by them. The ICAI has also issued a mother standard on quality control corresponding to the ISQC.

80. In addition, the ICAI has also issued the revised Framework for Assurance Engagements corresponding to that issued by the IAASB. The Framework is a basic document, explaining the concept of assurance and the elements involved therein in the details.

81. A list of the final SAs issued by the ICAI under the Clarity Project is as follows:

240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* – Effective for audits of financial statements for periods beginning on or after April 1, 2009.

250 *Consideration of Laws and Regulations in an Audit of Financial Statements* – effective for audits of financial statements for periods beginning on or after April 1, 2009.

260 *Communications of Audit Matters with Those Charged with Governance* – effective for audits of financial statements for periods beginning on or after April 1, 2009.

300 *Planning and Audit of Financial Statements* – Effective for audits of financial statements for periods beginning on or after April 1, 2008.

315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment* – effective for audits of financial statements for periods beginning on or after April 1, 2008.

330 *The Auditor's Responses to Assessed Risks* – Effective for audits of financial statements for periods beginning on or after April 1, 2008.

570 *Going Concern* – Effective for audits of financial statements for periods beginning on or after April 1, 2009.

580 *Written Representations* – Effective for audits of financial statements for periods beginning on or after April 1, 2009.

A gist of the major differences between the AASB's Standards and ISAs is given in **Appendix E.**

10. The Way Forward

82. From the above, it is clear that the strength and future of auditing in India hinges delicately, among other things, on the commitment of the various players in the auditing environment, essentially the government and the ICAI, to certain fundamental aspects. It is hoped that the following recommendations of the Advisory Panel would act as a catalyst in taking the auditing profession in the India to the next level of change.

10.1 Convergence with International Standards on Auditings

83. Notwithstanding the efforts being made by AASB to achieve full convergence with the international standards at the earliest, the road to convergence is difficult. Whereas the extensive requirements of the new Standards could have implications in terms of escalation in the costs of audit, some firms might find it difficult to persuade their clients for increasing the audit fees. Further, a big effort would also be required both at the level of the Institute as well at the level of these individual firms to not only equip the latter with the requirements of the new Standards but also give up their old methodologies and fall in line with the new audit techniques. This is also aggravated by the fact that at the international level also, the auditing standards are undergoing changes very frequently. The difficulties notwithstanding, convergence with the international standards has to be pushed forward and in future, EDs must be issued co-terminus with the EDs issued by IAASB.

84. The omission of a specific reference to 'Public Sector' in Standards on Auditing issued by AASB under the Clarity format needs reconsideration, particularly in view of the significant development that the INTOSAI is using ISAs as a basis for its Financial Audit Guidelines. Though generic guidance regarding specific aspects of public sector has been incorporated in the standard itself, but explicit reference to public sector would go a long way because ultimately these standards would also form the basis for auditing public sector by C&AG of India in the larger context.

10.2 Implementation of Auditing Standards

85. As discussed earlier, the Indian auditing scene is marked by the presence of a large number of small and medium practitioners. Given their limited resources and need to provide service in multiple aspects of the

practice, these practitioners are bound to face difficulties in keeping pace with the fast-changing auditing literature and the resultant changes to the audit methodology. A seamless integration of these small and medium practitioners in the Institute's efforts to make the auditing profession in India truly benchmarked with international practices is, therefore, quintessential for success of these efforts. For this purpose, the Institute needs to adopt a three-pronged strategy. The first part of the strategy being bringing out more technical guidance and other literature to help the practitioners not only understand the new auditing standards and aspects relating to their practical implementation but also appropriately appreciate the need for these changes. AASB has already initiated projects on bringing out implementation guides for its proposed Standards on risk-based audits and quality control in audit firms. The second part would be organising training programmes, conferences and such other programmes on the new auditing literature and methodology, which would help practitioners not only unlearn the old concepts and learn new ones, but also provide a platform for the Institute and the members to interact and understand the problems, apprehensions and expectations from each other and possible solutions thereto. However, with the Institute being the second largest accountancy body in the world with a membership of nearly 1,50,000 spread out over an extensive geographical area, reaching out to them and overcoming their professional, social, cultural and age prejudices and pre-conceptions, would require concerted, well-planned and, above all, patient efforts on the part of the Institute. The third and the final part would be to send a strong message among the practitioners that there is no option but to comply with the new requirements if they really want to contribute to as also share the fruits of the economic growth of the country. It should be clearly demonstrated that the delinquents and the errant would not be let off lightly. This can be ensured by strengthening the quality review and the disciplinary process.

10.3 Strengthening Peer Review

86. As mentioned in the preceding paragraphs, the peer review process is aimed at encouraging compliance with the auditing standards. A closer look at the data available with the Institute makes it clear that even for a significant proportion of Stage I and Stage II Practice Units, the actual peer review remains to be completed. ICAI needs to examine the causes of these delays to ensure the continuous efficacy of the process.

87. The Institute should also not lose sight of the Stage III Practice Units, which comprise auditors of small and medium enterprises. The importance of the Stage III auditors and their clientele in economic development of the country should not be underrated. The small and medium enterprises can also be said to involve public interest given the fact that they also use public funds and other resources in the form of loans from banks, *etc.,* Further, gaps in their accounting concepts and systems, existence of a large number of related parties in the form of individuals, weaker internal control systems, and above all, a fairly free operating environment, without much legal and regulatory oversight, *etc.,* make it all the more important that their audits are done carefully. Another reason for keeping a close watch on the quality of audits of small and medium enterprises is the fact that their audits are done mainly by small and medium audit firms (SMPs), a segment of auditors which is typically plagued by issues such as inability to keep up with the technical pronouncements of the Institute on a regular basis, inadequate staff and failure to provide them proper training and mentor them, over-familiarity with/financial over-dependence on a few clients leading to potential independence threats, *etc.* Moreover, attestation services performed by a chartered accountant holding certificate of practice ought to be a

subject matter of review in the larger public interest. While these are valid considerations, until the resources of the ICAI are significantly enhanced, it may be desirable to give priority to Stage I and Stage II Practice Units where large public interest is involved.

88. There is a feeling that in some cases because of restrictions on cost, the time devoted to the peer review is inadequate. Some alternative method of financing the cost has to be examined so that the adequacy of the peer review is not compromised.

10.4 An Independent Oversight Mechanism

89. As stated earlier in the Report, the Chartered Accountants Act, 1949 has recently been amended to set up the QRB with the Central Government having a majority (six out of eleven members including the Chairman to the Board) representation thereon and the representation of the Council of the ICAI being lesser than that. Such a constitution of the QRB has definitely sent positive signals all across as to the Board's commitment to a fair and transparent quality review process of audit firms. It is, therefore, essential that the government and the Institute ensure that the Board starts functioning at the earliest.

90. The main issue in the above context is clarifying the exact role of the QRB, whether it would be advisory or regulatory in nature. It is felt that to be really effective, it would be essential for the QRB to play a more proactive role as an independent oversight body for the auditing profession in India, as has become the norm in most of the developed countries. Such an independent oversight body would increase the credibility of the work done by the Indian audit firms, at the global level.

10.5 The Board of Discipline and the Disciplinary Committee

91. With a two-layer disciplinary process, and with the Disciplinary Committee, (having Government nominees on board in terms of the provisions of the Chartered Accountants Act, 1949) being bestowed with more powers than the Board of Discipline, it is believed that the process of reining in errant members would be more rigorous and strict and would also cut down on the time factor. Since the nominations to the Board of Discipline and the Disciplinary Committee have already been made by the Institute and the Government, they should now accelerate the process of making the Board and the Committee functional. It is also suggested that until the current backlog of disciplinary cases is eliminated, complaints received from regulatory authorities and government entities like banks, where greater public interest is involved, be dealt with on a fast-track basis.

10.6 Enforcing Stricter Reporting Requirements for Listed Companies

92. The Listing Agreement of the SEBI, has been instrumental in improving and strengthening the reporting and disclosure practices among the listed entities. It requires the companies to furnish details regarding audit qualifications, *viz.*, the reason for the audit qualification in their accounts, the reason for the company failing to publish accounts without audit qualifications, and the time within which the company will remove the qualification and publish accounts without qualification. Further,

SEBI's Committee on Disclosures and Accounting Standards (SCODA) in August 2002 also recommended three things. First, that the stock exchanges should be required to inform SEBI in cases where companies fail to remove audit qualifications; second, that SEBI may constitute an Advisory Committee to examine the cases reported by the stock exchanges where the companies have failed to remove audit qualifications, and, third, that SEBI may refer the matter to the Department of Company Affairs (now the Ministry of Corporate Affairs) to initiate necessary action under the Companies Act, 1956 and also to the ICAI in cases where actions are required against the auditors of the company. With this kind of a requirement in the Listing Agreement, SEBI has tried to build in a regulatory framework akin to the SEC in the US, wherein the SEC does not accept qualified audit reports of companies.

93. The path of 'no qualified audit reports' approach is, however, like a double-edged sword and, therefore, needs to be tread cautiously. Whereas, on the one hand, it would act as a strong deterrent to the companies indulging in what is called 'earnings management' and 'creative accounting', on the other hand, the inability of the auditor to issue qualified audit reports can lead to deadlocks with managements in case of genuine differences of opinion, which normally results in resignation of the auditors without the issuance of the audit report. In the extreme cases, such inability may also lead to impairment of auditor's independence. It may also be noted despite SEC's refusal to accept qualified reports, there has been a slew of re-statements in the last five years or so by the listed companies in the USA, indicating need for some checks and balances in the SEC's policy.

94. Incidentally, SCODA, at its December 2006 meeting, recommended that the auditors of the listed companies may be required to submit to SEBI financial statements containing audit qualifications and that, to this effect, SEBI may write to the ICAI requesting them to advise its members suitably. This recommendation needs to be implemented in the right earnest.

95. Further, SCODA's suggestion made at its meeting held in January 2007 'to amend Clause 41 of the listing agreement to make it mandatory for listed companies to ensure that their auditors submit the Annual Financial Statements to SEBI, along with the Auditor's Report wherever the same are qualified by the auditors' needs closer examination as to the actual follow-up of such a requirement. Guidelines may be prepared for determination of materiality of audit qualification having regard to following major areas:

(i) Where financial statements do not give a true and fair picture of the financial position of the company;

(ii) Non-observance of statutory provisions which may lead to imposition of penalties; and

(iii) Absence of information due to which auditors were unable to express an opinion or instances where auditors have been misled.

10.7 Access to Working Papers

96. Keeping in view the global environment and emergence of large corporate entities in India, the Panel endorses the recommendation of SEBI that, where a company has a material subsidiary whose audit has not been done by the principal auditor, the principal auditor should have the obligation to review the working papers of the other auditors who have audited the financial statements of such subsidiaries.

10.8 Functional Independence to the Auditing and Assurance Standards Board

97. To maintain the credibility and continuing relevance of the profession to the society, it is essential that a message is sent to the stakeholders that the Institute exists to serve the public interest. It is also, similarly, important to demonstrate that the auditing

standards that are used by the auditors in carrying out audits of financial statements are to protect and serve the public interest and not to protect the auditors or help them shirk their responsibilities. As of date, though the Standards, are formulated by the AASB, the same are finally subject to the approval of the Council of the ICAI, which is the supreme body in the Institute, with a majority representation from practicing chartered accountants. It is, therefore, essential that, as is the world-wide phenomenon today, that functional independence is given to the Auditing and Assurance Standards Board *vis-à-vis* the Council of the Institute by making it the final authority for drafting and issuance of the Standards and the Council confining itself to the administrative, but not functional, control of the AASB.

10.9 Rationalising and Strengthening Auditor Independence

98. As mentioned earlier, the Companies Act, 1956 contains stringent provisions to protect the financial/personal independence of the auditors. In addition to the fundamental requirements in a number of clauses in the two Schedules to the Chartered Accountants Act, 1949 which again are explicitly or implicitly aimed at protecting the independence of the auditors, the Institute, too, has issued a number of self-regulatory measures for its members. One such measure is restricting the fees from one client to 40 per cent of the total revenues of the firm. Having regard to the growth of the auditing profession and changes in the economics of audit firms and operating environment of the clients, it is felt that the limit of 40 per cent is too large. The independence of the auditor may actually, or apparently, be jeopardised by the time the limit of 40 per cent is reached. It is, therefore, suggested that the limit be reduced to 25 per cent.

10.10 Free Flow of Information Among Different Players in the Regulatory Framework

99. Business enterprises today are functioning in an expanded regulatory regime, especially, those functioning in the corporate form and/or those which involve large public interest, for example, banking companies, insurance companies, or *per se* companies listed on stock exchanges. The Ministry of Corporate Affairs, through its Registrar of Companies, calls for a number of documents to be submitted by the companies, including their financial statements and the related audit report. Similarly, the Reserve Bank as well as the IRDA also require a number of returns, containing vast amount of information, to be filed by the entities falling under their regulatory regime. In the same way, SEBI, through means of the various requirements in the Listing Agreement, requires all listed companies, to submit financial and other information periodically.

100. In addition to the filing requirements, certain regulators, for example, the Reserve Bank undertakes inspections of banks. It would be beneficial if there is a free exchange of information between the different players in the legal and regulatory framework, especially, in relation to financial irregularities found by them.

References

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12. The International Federation of Accountants, (2007); *Handbook of International Auditing, Assurance and Ethics Pronouncements.*
13. The Institute of Chartered Accountants of India (2007); *Handbook of Auditing Pronouncements.*

Appendix A

List of Publications[19]

1952	:	Non-partner Chartered Accountant not to Sign Report on Behalf of the Firm
1955	:	Audit of Accounts of General Insurers
1957	:	Answers to Queries Regarding the Companies Act, 1956
1958	:	Council's View on the Form of Certificate
1959	:	Disclosure in the Final Accounts of the Company
1961	:	Profit & Loss Account and Profit & Loss Appropriation Account
1962	:	Auditing of Accounts of Liquidators
		Mode of Valuation of Fixed Assets
1963	:	Recommendations regarding Non-Provision of Taxation
		Form of Balance Sheet Recommended by the Council
		Accounting & Auditing: Statement Issued by the Research Committee
1964	:	Maintenance of Unduly Heavy Cash Balances by Companies
		Treatment in Accounts of Taxation & Proposed Dividend
		Statement on Auditing Practices
1965	:	Statement on Section 227(1A) of the Companies Act, 1956
1966	:	Obligations under Certain Provisions of the Companies Act, 1956
1967	:	Guarantees and Counter-Guarantees given by Companies
1968	:	Independence of Auditors
1970-71	:	Statement on Qualifications in Auditor's Report
		A Guide to Company Audit
		Audit of Banking Companies
1975	:	Statement on Manufacturing and Other Companies (Auditor's Report) Order, 1975
		Statement on Payment to Auditors for Other Services

[19] Publications brought out by the ICAI prior to formation of the Auditing Practices Committee in 1982.

Appendix B

New Categorisation and Re-numbering of Auditing Standards

SQC No.	Title of the SQC	Old AAS No.
1	Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements	
SA No.	**Title of the SA**	**AAS No.**
200	Basic Principles Governing an Audit: Objective and Scope of the Audit of Financial Statements	01 02
210	Terms of Audit Engagements	26
220	Quality Control for Audits of Historical Financial Information	17
230	Audit Documentation	03
240	The Auditor's Responsibilities to Consider Fraud in an Audit of Financial Statements	04
250	The Auditor's Consideration of Laws and Regulations in an Audit of Financial Statements	21
260	Communication with Those Charged with Governance	27
299	Responsibility of Joint Auditors	12
300	Planning an Audit of Financial Statements	08
310	Knowledge of the Business *(withdrawn pursuant to issuance of ISA 315 and 330)*	20
315	Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement	6, 20 and 29
320	Audit Materiality	13
330	The Auditor's Responses to Assessed Risks	6, 20 and 29
400	Risk Assessments and Internal Control *(withdrawn pursuant to issuance of ISA 315 and 330)*	06
401	Auditing in a Computer Information Systems Environment *(withdrawn pursuant to issuance of ISA 315 and 330)*	29
402	Audit Considerations Relating to Entities Using Service Organisations	24
500	Audit Evidence	05
501	Audit Evidence – Additional Considerations for Specific Items	34
505	External Confirmations	30
510	Initial Engagements – Opening Balances	22
520	Analytical Procedures	14

SA No.	Title of the SA	AAS No.
530	Audit Sampling	15
540	Audit of Accounting Estimates	18
550	Related Parties	23
560	Subsequent Events	19
570	Going Concern	16
580	Representations by Management	11
600	Using the Work of Another Auditor	10
610	Relying Upon the Work of Internal Audit	07
620	Using the Work of an Expert	09
700	The Auditor's Report on the Financial Statements	28
710	Comparatives	25
ISRE No.	**Title of the ISRE**	
2400	Engagements to Review Financial Statements	33
ISAE No.	**Title of the ISAE**	
3400	The Examination of Prospective Financial Information	35
ISRS No.	**Title of the ISRS**	
4400	Engagements to Perform Agreed-upon Procedures Regarding Financial Information	32
4410	Engagements to Compile Financial Information	31

Reconciliation of the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services, issued by the International Federation of Accountants with the Standards issued by ICAI (as on April 1, 2008)

(A)	**International Standards issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC)**		
	(I) International Standards on Quality Control (ISQC 1) (II) International Standards on Auditing (ISAs) (III) International Standards on Review Engagements (ISREs) (IV) International Standards on Assurance Engagements (ISAEs) (V) International Standards on Related Services Engagements (ISRSs)		1 32 2 2 2
	Grand Total		**39**
(B)	**Standards issued by the Auditing and Assurance Standards Board (AASB) of the Institute of Chartered Accountants of India (ICAI)**		
	(I) Standards on Quality Control (SQC 1) (II) Standards on Auditing (SAs) (i) Two AASs correspond to one ISA *i.e.*, AAS 1 and AAS 2; hence one to be reduced. (ii) AAS corresponding to which no International Standard has been issued – (AAS 12, *Responsibility of Joint Auditors*) (iii) 3 AASs correspond to 2 ISAs that have now been withdrawn by IAASB; hence one AAS to be reduced. 1. AAS 06, *Risk Assessment and Internal Control* 2. AAS 20, *Knowledge of the Business* 3. AAS 29, *Auditing in a Computer Information Systems* (III) Standards on Review Engagements (SREs) (IV) Standards on Assurance Engagements (SAEs) (V) Standards on Related Services Engagements (SRSs)	1 31 (1) (1) (1) 1 1 2	29
	Total		**33**
(C)	**International Standards Corresponding to which Standards are Under Preparation/Under Consideration of the AASB**		
	1. ISA 545, *Auditing Fair Value Measurements and Disclosures* 2. ISA 701, *Modifications to the Independent Auditor's Report* 3. ISA 720, *Other Information in Documents Containing Audited Financial Statements* 4. ISA 800, *The Independent Auditor's Report on Special Purpose Audit Engagements* 5. ISRE 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity* 6. ISAE 3000, *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*		
	Total		**6**
	Grand Total		**39**

Appendix C

Statements on Auditing

1. Statement on Auditing Practices (1964)
2. Statement on Qualification in Auditor's Report (1970)
3. Statement on Section 227 (1A) of the Companies Act, 1956 (1975)[20]
4. Statement on the Companies (Auditor's Report) Order, 2003 [Issued under Section 227 (4A) of the Companies Act, 1956] (Replaced the Statement issued in 1975)[20]
5. Statement on Payments to Auditors for Other Services (1975)

List of Guidance Notes

1. Provision for Proposed Dividend
2. Auditing of Accounts of Liquidators
3. Guidance Note on Independence of Auditors (Revised)
4. Preparation of Financial Statements on Letter-heads and Stationery of Auditors
5. Guidance Note on Auditor's Report on Revised Accounts of Companies Before Circulation to Shareholders
6. Guidance Note on Certificate to be Issued by the Auditor of a Company Pursuant to Companies (Acceptance of Deposits) Rules, 1975
7. Guidance Note on the Duty Cast on the Auditors under Section 45-MA of the RBI Act, 1934
8. Guidance Note on Audit Reports and Certificates for Special Purposes
9. Guidance Note on Accountants' Report on Profit Forecasts and/or Financial Forecasts
10. Guidance Note on Section 293 A of the Companies Act and the auditor
11. Guidance Note on Audit of Fixed Assets
12. Revision/Rectification of Financial Statements
13. Guidance Note on Audit of Accounts of Non-corporate Entities (Bank Borrowers)
14. Guidance Note on Reports in Company Prospectuses (Revised)
15. Guidance Note on Audit of Abridged Financial Statements
16. Guidance Note on Certification of Documents for Registration of Charges
17. Guidance Note on Audit of Inventories
18. Guidance Note on Audit of Investments
19. Guidance Note on Audit of Debtors, Loans and Advances

[20] Currently in force

20. Guidance Note on Audit of Cash and Bank Balances
21. Guidance Note on Audit of Liabilities
22. Guidance Note on Audit of Revenue
23. Guidance Note on Certificate on Corporate Governance (Revised)
24. Guidance Note on Section 227(3)(e) and (f) of the Companies Act, 1956 (Revised)
25. Guidance Note on Audit of Expenses
26. Guidance Note on Revision of the Audit Report
27. Guidance Note on Special Consideration in the Audit of Small Entities
28. Guidance Note on Audit of Miscellaneous Expenditure [Revised]
29. Guidance Note on Audit of Consolidated Financial Statements
30. Guidance Note on Computer-assisted Audit Techniques (CAATs)
31. Guidance Note on Audit of Payment of Dividend
32. Guidance Note on Audit of Capital and Reserves

Industry-specific Guidance Notes

1. Guidance Note on Audit of Banks
2. Guidance Note on Audit of Companies Carrying on Life Insurance Business
3. Guidance Note on Audit of Companies Carrying on General Insurance Business
4. Guidance Note on Audit of Accounts of Members of Stock Exchanges

Appendix D

Extracts from the Chartered Accountants Act, 1949

The First Schedule

[See sections 21(3), 21A(3) and 22]

PART I

Professional misconduct in relation to chartered accountants in practice

A chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he

(1) allows any person to practice in his name as a chartered accountant unless such person is also a chartered accountant in practice and is in partnership with or employed by him;

(2) pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualifications as may be prescribed, for the purpose of rendering such professional services from time to time in or outside India.

Explanation :- In this item, 'partner' includes a person residing outside India with whom a chartered accountant in practice has entered into partnership which is not in contravention of item (4) of this Part;

(3) accepts or agrees to accept any part of the profits of the professional work of a person who is not a member of the Institute:

Provided that nothing herein contained shall be construed as prohibiting a member from entering into profit sharing or other similar arrangements, including receiving any share, commission or brokerage in the fees, with a member of such professional body or other person having qualifications, as is referred to in item (2) of this Part;

(4) enters into partnership, in or outside India, with any person other than a chartered accountant in practice or such other person who is a member of any other professional body having such qualifications as may be prescribed, including a resident who but for his residence abroad would be entitled to be registered as a member under clause *(v)* of sub-section (1) of section 4 or whose qualifications are recognised by the Central Government or the Council for the purpose of permitting such partnerships;

(5) secures, either through the services of a person who is not an employee of such chartered accountant or who is not his partner or by means which are not open to a chartered accountant, any professional business:

Provided that nothing herein contained shall be construed as prohibiting any arrangement permitted in terms of items (2), (3) and (4) of this Part;

(6) solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means:

Provided that nothing herein contained shall be construed as preventing or prohibiting

(i) any chartered accountant from applying or requesting for or inviting or securing professional work from another chartered accountant in practice; or

(ii) a member from responding to tenders or enquiries issued by various users of professional services or organisations from time to time and securing professional work as a consequence;

(7) advertises his professional attainments or services, or uses any designation or expression's other than chartered accountant on professional documents, visiting cards, letter-heads or sign boards, unless it be a degree of a University established by law in India or recognised by the Central Government or a title indicating membership of the Institute of Chartered Accountants of India or of any other institution that has been recognised by the Central Government or may be recognised by the Council:

Provided that a member in practice may advertise through a write-up setting out the services provided by him or his firm and particulars of his firm subject to such guidelines as may be issued by the Council;

(8) accepts a position as auditor previously held by another chartered accountant or a certified auditor who has been issued certificate under the Restricted Certificate Rules, 1932 without first communicating with him in writing;

(9) accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of section 225 of the Companies Act, 1956[21] in respect of such appointment have been duly complied with;

(10) charges or offers to charge, accepts or offers to accept in respect of any professional employment, fees which are based on a percentage of profits or which are contingent upon the findings, or results of such employment, except as permitted under any regulation made under this Act;

(11) engages in any business or occupation other than the profession of chartered accountant unless permitted by the Council so to engage:

Provided that nothing contained herein shall disentitle a chartered accountant from being a director of a company (not being a managing director or a whole-time director) unless he or any of his partners is interested in such company as an auditor;

(12) allows a person not being a member of the Institute in practice, or a member not being his partner to sign on his behalf or on behalf of his firm, any balance-sheet, profit and loss account, report or financial statements.

PART II

Professional misconduct in relation to members of the Institute in service

A member of the Institute (other than a member in practice) shall be deemed to be guilty of professional misconduct, if he being an employee of any company, firm or person –

(1) pays or allows or agrees to pay directly or indirectly to any person any share in the emoluments of the employment undertaken by him;

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[21] No.1 of 1956

(2) accepts or agrees to accept any part of fees, profits or gains from a lawyer, a chartered accountant or broker engaged by such company, firm or person or agent or customer of such company, firm or person by way of commission or gratification.

PART III

Professional misconduct in relation to members of *the Institute generally*

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he –

(1) not being a fellow of the Institute, acts as a fellow of the Institute;

(2) does not supply the information called for, or does not comply with the requirements asked for, by the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority;

(3) while inviting professional work from another chartered accountant or while responding to tenders or enquiries or while advertising through a write-up, or anything as provided for in items (6) and (7) of Part I of this Schedule, gives information knowing it to be false.

PART IV

Other misconduct in relation to members of *the Institute generally*

A member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he

1) is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term not exceeding six months;

(2) in the opinion of the Council, brings disrepute to the profession or the Institute as a result of his action whether or not related to his professional work.

The Second Schedule

[See sections 21(3), 21B(3) and 22]

PART I

Professional misconduct in relation to chartered accountants in practice

A chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he –

(1) discloses information acquired in the course of his professional engagement to any person other than his client so engaging him, without the consent of his client or otherwise than as required by any law for the time being in force;

(2) certifies or submits in his name, or in the name of his firm, a report of an examination of financial statements unless the examination of such statements and the related records has

been made by him or by a partner or an employee in his firm or by another chartered accountant in practice;

(3) permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast;

(4) expresses his opinion on financial statements of any business or enterprise in which he, his firm, or a partner in his firm has a substantial interest;

(5) fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement where he is concerned with that financial statement in a professional capacity;

(6) fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity;

(7) does not exercise due diligence, or is grossly negligent in the conduct of his professional duties;

(8) fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion;

(9) fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances;

(10) fails to keep moneys of his client other than fees or remuneration or money meant to be expended in a separate banking account or to use such moneys for purposes for which they are intended within a reasonable time.

PART II

Professional misconduct in relation to members of *the Institute generally*

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he –

(1) contravenes any of the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council;

(2) being an employee of any company, firm or person, discloses confidential information acquired in the course of his employment except as and when required by any law for the time being in force or except as permitted by the employer;

(3) includes in any information, statement, return or form to be submitted to the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false;

(4) defalcates or embezzles moneys received in his professional capacity.

PART III

Other misconduct in relation to members of the Institute generally

A member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term exceeding six months.

Appendix E

A Comparative Study Between Standards on Auditing of ICAI and International Standards on Auditing of IAASB As on October 23, 2008

ISA No.	ISA	SA no. (AAS No.)	SA	Remarks
General Principles and Responsibilities				
200	Objective and General Principles Governing an Audit of Financial Statements	200 (1)	Basic Principles Governing an Audit	ISA 200 deals with the important aspects of an audit of financial statements, *viz.,* objective of an audit of financial statements, scope of an audit of financial statements, professional skepticism, reasonable assurance, audit risk and materiality, responsibility for the financial statements, determining the acceptability of the financial reporting framework, expressing an opinion on the financial statements.
		(2)	Objective and Scope of an Audit of Financial Statements	Though AAS 1 and 2 also deal with the significant principles like the objective and scope of an audit of financial statements, responsibility for financial statements, the concept of 'professional skepticism' has been dealt by the AAS 4, *The auditor's responsibility to consider fraud and error in an audit of financial statements.* The concept of 'audit risk' has been dealt in AAS 6, *Risk Assessment and Internal Control.* Further, the

				concept of 'reasonable assurance' has been dealt in the Framework for Statements on Standard Auditing Practices and Guidance Notes on Related Services. The IAASB has recently issued the Revised ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing,* under the Clarity Project. The AASB has also constituted a study group to prepare the draft of the Revised SA 200.
210	Terms of Audit Engagement	210 (26)	Terms of Audit Engagements	ISA 210 lays down standards in respect of how the auditor and the client should agree on the terms of the engagement and the auditor's response to a client's request to change the terms/scope of the engagement to that which provides lower level of assurance. It contains guidance on the principle contents of an audit engagement letter, considerations in case of a recurring audit, and considerations for the auditor before accepting a change in the terms of the engagement. AAS 26 is generally consistent with the principles laid down in ISA 210, except that it does not contain a provision for reference in the engagement letter to the 'form of any reports or other communication of results of the engagement.' Further, AAS 26 is also more explicit on the management's responsibility concerning financial statements. Unlike ISA 210, AAS 26, due to the client confidentiality

				requirements prescribed for an auditor under the Chartered Accountant Act, 1949 also contains a provision for an explicit reference to the fact in the audit engagement letter that the audit may be subject to a peer review. (IAASB has issued an Exposure Draft of the Redrafted ISA 210, *Agreeing to the Terms of the Engagement.* The AASB has also issued the Exposure Draft of the revised SA 210 (Revised) based in ISA Exposure Draft.)
220	Quality Control for Audits of Historical Financial Information	220 (17)	Quality Control for Audit Work	ISA 220 lists down standards for maintaining quality control in respect of audits of historical financial information. The principles enunciated include those in respect of leadership responsibilities for quality in audits, ethical requirements, client acceptance and continuance considerations, assignment of engagement teams, engagement performance, consultation, differences of opinion, engagement quality control review and monitoring. AAS 17 is not as detailed as the ISA 220 and focuses on general aspects relating to the engagement performance, *viz.*, direction, supervision and review only. Unlike ISA 220, it does not

				also *per se* contain practical guidance on implementation of the quality control policies. The IAASB has issued an exposure draft of the redrafted ISA 220 under the Clarity Project. AASB has also constituted a study group to revise SA 220.
230	Audit Documentation	230 (3)	Audit Documentation (Revised)	Both ISA 230 and AAS 3 lay down the basic principles relating to documentation of audit working papers by the auditor. The ISA 230, however, contains guidance in respect of certain additional significant principles relating to audit documentation such as nature of audit documentation, concept of experienced auditor, documentation of the identifying characteristics of specific items being tested, documentation of significant matters, documentation of departures from basic principles or essential procedures, identification of preparer and reviewer, assembly of the final audit file and changes to documentation after the date of the auditor's report. The revised SA 230 has been placed for the consideration of the Council at its November 2008 meeting. The revised SA 230 is based on the redrafted ISA 230 issued under the Clarity Project.
240	The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements	240 (4)	The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements	Both ISA 240 and AAS 4 essentially take the same view on the responsibilities of the auditor for detecting frauds. However, ISA 240 provides significantly detailed guidance on nature of frauds, and the auditor's procedures to address risks of material misstatement due to

				frauds. Another major difference is the fact that the ISA 240 does not dwell on the issue of errors like AAS 4. The AASB in 2007 issued the revised SA 240 based on the Revised ISA 240 issued by IAASB in December 2006 under its Clarity Project. The revised SA 240 is effective from April 1, 2009. The revised SA 240 does not contain any material modifications *vis-à-vis* Redrafted ISA 240 except that the specific reference to application of certain requirements of the Standard to public sector entities (as given in ISA 240) have been generalised since in terms of the revised Preface issued by the AASB, auditing standards apply equally to all entities irrespective of their nature, size, *etc.*, and also given the fact that the term 'public sector' as understood in India is different from its definition as given in the IFAC Glossary of Terms.
250	Consideration of Laws and Regulations in an Audit of Financial Statements	250 (21)	Consideration of Laws and Regulations in an Audit of Financial Statements	Both the Standards ISA 250 and AAS 21 lay down principles in relation to auditor's responsibility to consider laws and regulations in an audit of financial statements and cover significant aspects such as responsibility of management for compliance with laws and regulations, auditor's

				consideration of compliance with laws and regulations, reporting of non-compliance and withdrawal from the engagement. An important difference between the two is that whereas ISA 250 requires communication without delay if the non-compliance is believed to be intentional *and* material whereas AAS 21 requires such communication if the non - compliance is believed to be intentional *and/or* material. The Council of the Institute at its meeting held in October 2008 has approved the revised SA 250 (Effective from April 1, 2008) which is based on the redrafted ISA 250 issued by IAASB under the Clarity Project. The revised SA 250 does not contain any material modifications *vis-à-vis* the ISA 250 issued under the Clarity Project
260	Communication of Audit Matters with Those Charged with Governance	260 (27)	Communication of Audit Matters with Those Charged with Governance	Both the Standards lay down principles in respect of communication of audit matters between the auditor and those charged with governance of the entity and contain guidance on important related aspects such as who constitute those charged with governance, timing of communications, forms of communications, other matters, confidentiality, laws and regulations, *etc.* AAS 27 is generally consistent with the requirements of ISA 260 except that the AAS 27, unlike ISA 260, specially identifies the 'importance and sensitivity of the audit matters of governance interest' as one of the factors to

				be considered in determining the persons with whom audit matters of governance interest need to be communicated. The Council of the Institute at its meeting held in October 2008 has approved the revised SA 260 (effective from April 1, 2008) which is based on the redrafted ISA 260 issued by IAASB under the Clarity Project. The revised SA 260 does not contain any material modifications *vis-à-vis* the ISA 260 issued under the Clarity Project
	–	299 (12)	Responsibility of the Joint Auditors	The practice of appointing more than one auditor to conduct the audit of large entities, especially, in case of public sector undertakings and banks is quite common in India. Such auditors are known as joint auditors and they conduct the audit jointly and report on the financial statements of the entity. In November 1996, the Institute issued a Standard, *Responsibility of Joint Auditors.* This SA deals with the professional responsibilities which the auditors undertake in accepting such appointments as joint auditors. The important aspect of joint audit assignments as covered by this SA include possible basis of division of work among joint auditors, co-ordination among joint auditors, joint and several liability of joint

				auditors, responsibility for obtaining and evaluating information and explanation from management, responsibility for scrutiny of branch accounts and returns, need for review of work performed by one joint auditor by other joint auditor(s), reporting responsibilities, *etc.* The IAASB has not yet issued any Standard on joint audits.
Risk Assessment and Response to Assessed Risks				
300	Planning an Audit of Financial Statements	300 (8)	Planning an Audit of Financial Statements	The AASB in 2007 issued the revised SA 300 based on the Revised ISA 300 issued by IAASB in December 2006 under its Clarity Project. The SA 240 is effective from April 1, 2008. The revised SA 300 does not contain any material modifications *vis-a - vis* the ISA 300 issued under the Clarity Project.
315	Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatements	315 (6)	Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatements	The AASB in 2007 issued the SA 300 and SA 315 based on the ISA 300 and ISA 315 issued by IAASB in December 2006 under its Clarity Project. These two SAs combine the subject matter of AAS 6, *Risk Assessments and Internal Control,* AAS 20, *Knowledge of the Business* and AAS 29, *Auditing in a Computer Information Systems Environment.* The SA 300 & SA 315 is effective from April 1, 2008. The revised SA 315 does not contain any material modifications *vis-à-vis* the ISA 315 issued under the Clarity Project.
330	The Auditor's Response to Assessed Risks	330 (20)	The Auditor's Response to Assessed Risks	–

320	Audit Materiality	320 (13)	Audit Materiality	AAS 13 and the corresponding international standard, *viz.,* ISA 320, *Audit Materiality*, are quite similar. Both require the auditor to give due consideration to materiality when (a) determining the nature, timing and extent of audit procedures, and (b) evaluating the effect of misstatements. Also, both the standards recognise that materiality and audit risk have an inverse relationship. Despite these similarities in the overall approach, there are some semantic differences between the two standards. There is also a significant conceptual difference between them. According to AAS 13, materiality depends on the size and nature of an item, judged in the particular circumstances of its misstatement. ISA 320, on the other hand, quotes the definition of materiality from International Accounting Standards Board's 'Framework for the Preparation and Presentation of Financial Statements' according to which materiality depends on the size of an item or error judged in the particular circumstances of its omission or misstatement. Thus, AAS 13 seems to take a broader view of materiality than ISA 320. An item could be material under AAS 13 independently of its size, but not so under ISA 320.

				The IAASB has recently issued the revised ISA 320 under the Clarity Project. The AASB has also prepared the draft of the revised SA 320 based on the said ISA and will soon issue an Exposure Draft of the same.
402	Audit Considerations relating to Entities Using Service Organisations	402 (24)	Audit Considerations relating to Entities Using Service Organisations	ISA 402, *Audit Considerations Relating to Entities Using Service Organisations* has recently been revised by IAASB to conform to its new risk standards which leads to differences between Indian and international standards on auditor's assessment of and response to risks. Under AAS 24, *Audit Considerations Relating to Entities Using Service Organisations*, if the information is insufficient, the auditor of the client would first consider the need to request the service organisation to have its auditor perform such procedures and to supply the necessary information in the form of reports. It is only if such reports are not made available within a reasonable time that the auditor of the client would consider the need to visit the service organisation to obtain the relevant information. Under ISA 402, on the other hand, the auditor can straightway consider visiting the service organisation as an alternative to requesting the service organisation to provide the reports of its auditor. Under AAS 24, if the service organisation's auditor is a chartered accountant, there is no need for the client's auditor to consider his professional

				competence but ISA 402 requires such an assessment in all cases. The IAASB has issued an Exposure Draft of the revised ISA 402 under the Clarity Project. The AASB has also issued an Exposure Draft of the revised SA 402 based on the Exposure Draft of the ISA.
Audit Evidence				
500	Audit Evidence	500 (5)	Audit Evidence	While both the Standards ISA 500 and AAS 5 enunciate the basic principles underlying the collection and evaluation of audit evidence, ISA 500 is more detailed. Further, unlike ISA 500, the relationship of audit evidence with audit risk has not been covered in AAS 5. Nor does the present AAS 5 elaborate on situations where tests of control are necessary and situations where substantive procedures can be totally dispensed with for material items. The IAASB has issued an Exposure Draft of the revised ISA 500 under the Clarity Project. The AASB has also issued an Exposure Draft of the revised SA 500 based on the Exposure Draft of the ISA.
501	Audit Evidence – Additional Considerations for Specific Items	501 (34)	Audit Evidence – Additional Considerations for Specific Items	Both the Standards ISA 501 and AAS 34 contain guidance relating to collection of audit evidence relating to certain specific items/

				disclosures in financial statements, *viz.*, attendance at physical inventory counting, inquiry regarding litigation and claims, valuation and disclosure of long-term investments and segment information. The two Standards are same except for the following differences: (a) Due to practical reasons, paragraph 23 of the AAS requires that when litigation or claims have been identified by the management or when the auditor believes they may exist, and are likely to be material, the auditor may seek direct communication with the entity's lawyers. The auditor need not necessarily communicate with the entity's lawyers and such other professionals whom the entity engages for litigation and claims in case the auditor is able to obtain sufficient appropriate audit evidence regarding the identification of litigation and claims involving the entity which may have a material effect on the financial statements. The ISA on the other hand requires that the auditor should communicate with the entity's lawyers to obtain sufficient appropriate audit evidence as to whether potentially material litigation and claims are known and management's estimates of the financial implications, including costs, are reliable.

				(b) Each part of the AAS contains the requirements related to obtaining the management representation. There is, however, no such requirement in the ISA. The IAASB has issued an Exposure Draft of the revised ISA 501 under the Clarity Project. The AASB has also constituted a study group to revise SA 501 based on the Exposure Draft.
505	External Confirmations	505 (30)	External Confirmations	Both ISA 505 and AAS 30 lay down the basic principles in respect of external confirmation as audit evidence and deal with related aspects such as relationship of external confirmation procedure to inherent and control risks, assertions addressed by external confirmations, timing of external confirmations, design of external confirmation requests, nature of information being confirmed, prior experience, form of confirmation request, characteristics of respondents, external confirmation process, evaluating the results of the confirmation process, management representations, *etc.* AAS 30 is, however, different from ISA 505 on the following counts:

				(a) The AAS requires the auditor to obtain an understanding of the substance of transactions and agreement with the third parties to decide about the information to be included in the request for confirmation. ISA 505 does not contain any requirements in this regard. (b) The AAS requires the auditor to consider the information from audits of earlier years. This requirement is not present in ISA 505. (c) The AAS requires the auditor to request the management to verify and reconcile the discrepancies revealed by the external confirmations received or by the additional procedures carried out by the auditor. The AAS further requires the auditor to consider what further tests can be carried out to satisfy himself as to the correctness of related assertions. This requirement is not present in ISA 505. The IAASB has issued an Exposure Draft of the revised ISA 501 under the Clarity Project. The AASB has also constituted a study group to revise SA 501 based on the Exposure Draft.
510	Initial Engagements – Opening Balances	510 (22)	Initial Engagements – Opening Balances	Both ISA 510 and AAS 22 contain principles relating to audit of opening balances in case of initial engagements, *i.e.*, when the financial statements are audited for the first time or when the financial statements of the preceding period were audited by

				another auditor. The basic point of difference between the ISA 510 and AAS 22 is that unlike the ISA, the AAS 22 does not permit modifications to the prior period's balances in the current period. The IAASB has issued the redrafted ISA 510 under the Clarity Project. The AASB has also issued an Exposure Draft of the revised SA 510 based on the said ISA, for public comments.
520	Analytical Procedures	520 (14)	Analytical Procedures	AAS 14, *Analytical Procedures,* and the corresponding international standard, *viz.,* ISA 520, establish standards on the application of analytical procedures during an audit. Both the standards take the same view of the nature and purpose of analytical procedures, the stages of an audit at which analytical procedures should, or may, be used, and the extent to which reliance can be placed on these procedures. The IAASB has issued the Exposure Draft of the redrafted ISA 520 under the Clarity Project. The AASB has constituted a study group to prepare the draft of the revised SA 520 based on the said Exposure Draft.
530	Audit Sampling and Other Means of Testing	530 (15)	Audit Sampling	The AASB had issued the Exposure Draft of the revised SA

				530 for public comments. The Exposure Draft is being finalised in the light of the final redrafted ISA 530 issued by IAASB under the Clarity Project.
540	Audit of Accounting Estimates	540 (18)	Audit of Accounting Estimates	Both the Standards ISA 540 and AAS 18 enunciate principles relating to audit of accounting estimates and related aspects such as nature of accounting estimates, audit procedures responsive to risk of material misstatements in estimates and reviewing and testing the process used by the management, use of independent estimates and evaluation of results of audit procedures. AAS 18 is principally in line with the requirements contained in ISA 540. AASB has issued the Exposure Draft of the revised SA 540 based on the revised ISA 540 issued by IAASB under the Clarity Project.
545	Auditing Fair Value Measurements and Disclosures		–	–
550	Related Parties	550 (23)	Related Parties	AAS 23, *Related Parties* very closely follows ISA 550, *Related Parties.* Like ISA 550, AAS 23 requires the auditor to perform audit procedures designed to obtain sufficient appropriate audit evidence regarding the identification and disclosure by management of related parties and the related party transactions that are material to the financial statements though it recognises (like ISA 550) that an audit cannot be expected to detect all related party transactions.

				AASB has issued the Exposure Draft of the revised SA 550 based on the revised ISA 550 issued by IAASB under the Clarity Project.
560	Subsequent Events	560 (19)	Subsequent Events	While both the Standards deal with the auditor's responsibility in connection with the subsequent events, the definition of subsequent events in ISA 560, *Subsequent Events* is considerably broader than the definition in AAS 19, '*Subsequent Events*' as it also includes the facts discovered after the date of the auditor's report. Unlike AAS 19, ISA 560 does not deal with the effect of management's refusal or failure to account for material subsequent events properly. AASB has issued the Exposure Draft of the revised SA 560 based on the revised ISA 560 issued by IAASB under the Clarity Project.
570	Going Concern	570 (16)	Going Concern	Both the Standards deal with the auditor's responsibility in relation to reporting on the going concern aspect. The ISA 570 is, however, more detailed. Further, Under AAS 16, *Going Concern*, the period for which the continuance of the entity is to be judged is 'generally a period not to exceed one year after the balance sheet date'. While ISA

				570, *Going Concern* indicates that the aforesaid period should be at least, but not limited to, one year from the balance sheet date. ISA 570 also deals with the auditor's duties in situations where (a) the management is unwilling to make or extend its assessment relating to going concern assumption when requested by the auditor or (b) there is significant delay in signature or approval of the financial statements by the management. The Council of the Institute has recently approved the revised SA 570 based on the redrafted ISA 570 issued by IAASB under the Clarity Project.
580	Management Representations	580 (11)	Representations by Management	Both ISA 580 and AAS 11 deal with the auditor's responsibility relating to representations received from management during the course of the audit. ISA 580, *Management Representations* states that written representations may be limited to material matters when other sufficient appropriate audit evidence cannot reasonably be expected to exist. AAS 11, *Representations by Management* does not specifically state so. AASB has issued the revised SA 580 based on the redrafted ISA 570 issued by IAASB under the Clarity Project. The revised SA 570 does not contain any material modifications *vis-à-vis* the ISA 570 issued under the Clarity Project.

Using Work of Others				
600	Using the Work of Another Auditor	600 (10)	Using the Work of Another Auditor	According to AAS 10, *Using the Work of Another Auditor,* barring exceptional cases, the principal auditor is entitled to rely on the other auditor's work in situations where the appointment of the other auditor is pursuant to a statute. ISA 600, *Using the Work of Another Auditor*, on the other hand, does not entitle the principal auditor to rely so. ISA 600 lists review of the working papers of the other auditor as one of the audit procedure that the principal auditor may employ to obtain audit evidence concerning the adequacy of the other auditor's work. AAS 10 requires the principal auditor to consider the professional competence of the other auditor only where the other auditor is not a member of the ICAI. ISA 600 requires assessment of the other auditor's professional competence, in the context of the specific assignment, in all cases. AASB has issued the Exposure Draft of the revised SA 600 based on the revised ISA 600 issued by IAASB under the Clarity Project.
610	Considering the Work of Internal Auditing	610 (7)	Relying Upon the Work of an Internal Auditor	Both ISA 610 and AAS 7 lay down standards in respect of use of the work of an internal auditor by the independent auditor.

				ISA 610, *Considering the Work of Internal Auditing* does not list physical examination and verification of assets whereas AAS 7, *Relying upon the Work of an Internal Auditor* does not list the 'review of compliance with laws, regulations and other external requirements and with management policies and directives and other internal requirements' among the principal activities of internal audit function. AASB has constituted a study group to prepare the draft of the revised SA 610 based on ISA 610 issued under the Clarity Project.
620	Using the Work of an Expert	620 (9)	Using the Work of an Expert	Both the Standards deal with the factors to be considered by the auditor when using the work of an expert. AAS 9 and ISA 620 are quite similar in approach. The IAASB has issued an Exposure Draft of the revised ISA 620 under the Clarity Project, The AASB has also constituted a study group to revise SA 620 based on the said Exposure Draft.
Audit Conclusion and Reporting				
700	The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements	28	The Auditor's Report on Financial Statements	Both the Standards deal with the fundamental principles involved in reporting the auditor's opinion. However, AAS 28 differs from ISA 700 inasmuch as that according to AAS 28, *The Auditor's Report on Financial Statements*, the date of the auditor's report is the date on which the auditor signs the report. ISA 700, *The Independent Auditor's Report on a Complete Set of General Purpose Financial*

705	Modifications to the Opinion in the Independent Auditor's Report			*Statements,* on the other hand, requires that the auditor should date the report on the financial statements no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements. AAS 28 requires that the audit report should name a specific location which is 'ordinarily the city where the audit report is signed'. ISA 700, on the other hand, construes that the report should name the location in the country or jurisdiction where the auditor practices. As per AAS 28, where a firm is appointed as auditor, the audit report should be signed in 'the personal name of the auditor and in the name of the firm', along with the membership number of the partner/proprietor signing the audit report. ISA 700 requires that the audit report should be signed 'in the name of the audit firm, the personal name of the auditor or both, as appropriate for the particular jurisdiction'. AAS 28 considers it preferable that an emphasis-of-matter paragraph precede the opinion paragraph. ISA 700, on the other hand, prefers such a paragraph to be included after the opinion paragraph.
706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report			

				The IAASB has issued ISA 705 and 706 under the Clarity Project. The AASB has also constituted a study group to prepare the draft of the SAs 705 and 706 based on the said ISAs.
710	Comparatives	25	Comparatives	AAS 25, *Comparatives* deals with auditor's responsibilities relating to comparatives only under the 'corresponding figures' framework. AAS 25 does not deal with the auditor's responsibilities when the 'comparative financial statements' framework is used. There is a significant difference between them in relation to the auditor's responsibilities where, in performing the audit of the current period financial statements, the auditor becomes aware of a material misstatement that affects the prior period financial statements on which an unmodified report has been previously issued. Another major difference between AAS 25 and ISA 710, *Comparatives* relates to the procedures prescribed in a situation where the prior period financial statements are not audited. The IAASB has issued an Exposure Draft of the revised ISA 710 under the Clarity Project. The AASB has also constituted a study group to revise SA 710 based on the said Exposure Draft.
720	Other Information in Documents Containing Audited Financial Statements	720		AASB has issued Exposure Draft of the SA 720 based on ISA 720 issued under the Clarity Project.

Specialised Areas				
800	The Independent Auditor's Report on Special Purpose Audit			*Though as such there is no AAS or SA on this topic as yet, the ICAI has already issued a Guidance Note on Special Purpose Audit Reports and Certificates.* The IAASB has issued an Exposure Draft of the revised ISA 800 under the Clarity Project. The AASB has also constituted a study group to prepare the drafts of the SA 800 based on the said Exposure Draft.
International Standards on Review Engagements				
2400	Engagements to Review Financial Statements	2400 (33)	Engagement to Review Financial Statement	ISRE 2400 and SA 2400 lay down the basic principles to be observed by the auditor in carrying out review engagements, *viz.*, general principles, scope of a review, moderate assurance, terms of engagement, planning, work performed by others, documentation, procedures and evidence, conclusion and reporting. SRE 2400, *'Engagements to Review Financial Statements'* does not require the engagement letter to include form of report to be issued pursuant to the engagement since the format of report, in some cases, is prescribed by the law or regulations pursuant to which the financial statements are required to be reviewed. AAS 33 requires

				that the auditor should not agree to a change of engagement where there is no reasonable justification for doing so. If the auditor is unable to agree to a change of the engagement and is not permitted to continue the original engagement, the auditor should withdraw and consider whether there is any obligation, either contractual or otherwise, to report the circumstances necessitating the withdrawal to other parties, such as the board of directors or shareholders. There is no corresponding requirement in ISRE 2400.
2410	Review of Interim Financial Information Performed by the Independent Auditor of the Entity			*AASB has constituted a study group to prepare the draft of this Standard.*
Assurance Engagements Other Than Audits or Reviews of Historical Financial Information				
3000	Assurance Engagements Other Than Audits or Reviews of Historical Financial Information			*No Standard on this topic as yet.*
3400	The Examination of Prospective Financial	3400 (35)		Both the standards ISA 3400 and AAS 35 lay down principles and procedures to be Information adopted by the auditor while examining prospective financial information prepared by the client. Though these fundamental principles are same in both the Standards, the major point of difference between the SAE 3400 and ISAE 3400 arises on account of the requirements of the Chartered Accountants Act, 1949 pursuant to which SAE 340 precludes the auditor from expressing positive assurance regarding the assumptions as it may tantamount to vouching for

				the accuracy of the forecast/ projection/hypothetical assumptions.
Related Services				
4400	Engagements to Perform Agreed upon Procedures regarding Financial Information	SRS 4400 (32)		Engagements to Perform Agreed upon Procedures regarding Financial Information Unlike ISRS 4400, *Engagements to Perform Agreed-upon Procedures Regarding Financial Information*, SAR 4400, *Engagements to Perform Agreed-upon Procedures Regarding Financial Information* recognises the possibility that in certain circumstances, the report of an agreed-upon procedures engagement may not be restricted only to those parties that have agreed to the procedures to be performed, and may be made available to a wider range of entities or individuals, e.g., in the case of government organisations. ISRS 4400 specifically states that the auditor may consider attaching to the engagement letter a draft of the type of report of factual findings that will be issued. SRS 4400 does not specifically mention the above. SRS 4400 requires 'place of signature' to be mentioned in the report whereas the requirement in ISRS 4400 is of mentioning the 'auditor's address'.

4410	Engagements to Compile Financial Information	4410 (31)		There is much greater emphasis in SRS 4410, '*Engagements to Compile Financial Information*' on a clear enunciation of the management's responsibilities in both the engagement letter and the report to be issued pursuant to the engagement as compared to ISRS 4410, '*Engagements to Compile Financial Information*'. SRS 4410 also requires that the financial statements should be approved by the client before compilation report is signed by the accountant. SRS 4410, unlike ISRS 4410, also prohibits the accountant from preparing the financial statements on his letter head or other stationery bearing his (or firm's) name or address. SRS 4410 separately deals with situations where the client has an identified financial reporting framework and those where the client does not have an identified financial reporting framework. Similarly, it deals specifically with a situation where the client happens to be a company and there is a non-compliance with accounting standards. ISRS 4410 does not contain such a discussion.

Appendix F

Auditing Standards
A Peer Review of the Advisory Panel Report

By N. P. Sarda

Dear Shri Rakesh Mohan,

I refer to your letter bearing ref.DO.MPD/CFSA.No.4019/06.55.00/2007-08 dated April 9,2008.

As I am on a visit to Canada and USA and I shall return to India after 2-3 weeks, I am giving here below my brief comments through this e-mail message.

Overall Opinion:

The Coverage, Completeness, Conciseness and Quality of the draft Report are excellent.

Brief Observations:

(1) An Independent Oversight Mechanism:

Page 89 of the draft report refers to the constitution of the Quality Review Board (QRB). QRB has been constituted, but has not yet started effective functioning. The exact role of QRB has not yet been decided. Whether the role of QRB would be regulatory in nature or would it be advisory in nature? The determination of the role of QRB is of utmost importance for the functioning of the independent oversight mechanism. Whether the role of QRB would be on the same lines as the role of PCAOB in USA or the equivalent quality oversight boards in Europe or Japan or not ? If the role of QRB in India is not on the same lines as the quality oversight boards in USA,Europe or Japan, the audit firms in India issuing audit reports for the companies listed in USA,Europe or Japan or major subsidiaries of companies listed in those countries would have to undergo the inspection and other regulatory requirements of the quality oversight boards of the respective countries.

Stance of the Panel: Accepted. This has been incorporated in the Report.

(2) Implementation of Auditing Standards:

Para 85 covers the need for effective implementation of auditing standards and suggests adoption of a three pronged strategy. The heading of the para may be changed to 'Implementation of auditing standards' instead of 'training and guidance by ICAI'. Further, though ICAI has introduced a scheme of networking of audit firms to ensure adequate resources and infrastructure for effective service capabilities of audit firms, the response to the scheme of networking has not been encouraging. Further steps for improving the resources and skills of the audit firms in the context of new and updated standards on auditing and growing sizes of entities of auditees should be thought of, encouraged and implemented.

Stance of the Panel: Accepted. This has been incorporated in the Report.

Appendix G

Auditing Standards
A Peer Review of the Advisory Panel Report

By Mr. Ian Mackintosh

I have reviewed both documents. In both cases I cannot comment on the accuracy of the reporting of the history and the present situation. I have no personal knowledge of these matters. My comments are therefore contained to the situation going forward.

Auditing

This is not my area of expertise, but I will make a few general comments:

- I agree generally with the thrust of the recommendations in the Way Forward part of the document.
- I would reinforce the warning given in paragraphs 93 to 95 on the non-acceptance of qualified audit reports. In some cases there is a place for qualified audit reports.
- I think it is very important that the AASB is given functional independence.
- The big question, not in my opinion adequately addressed, is whether a regime of self-regulation can be sustained in the future. There may well be a case for more independent regulation, not directly involving the Institute.

Stance of the Panel: Accepted. This has been incorporated in the Report.

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Chapter IV

Assessment of Corporate Governance Standards

1. Background

1.1 This assessment of adherence to corporate governance standards has been conducted by a Sub-group[1] set up by the Advisory Panel on Institution and Market Structure (IMS). The Sub-group met several times before finalising the assessment and Report. The comments of the Panel have been incorporated in the assessment. The Report was also peer reviewed by Sir Andrew Large whose comments are furnished in **Annex B** along with the stance of Advisory Panel**.** The comments of the peer reviewer have also been appropriately incorporated in the Report.

1.2 The Report begins with an introduction to the concept of corporate governance and traces the history of corporate governance in India. A detailed assessment, with reference to OECD Principles of corporate governance, constitutes the most significant portion of this Report. The detailed assessment has been furnished in Appendix II and a summary of the same appears in the body of the Report. The Report also spells out the approach and methodology followed in carrying out the assessment and evaluates the relevance of OECD benchmarks for India. The Report concludes with a section on recommendations.

2. What is Corporate Governance?

2.1 What constitutes corporate governance, has been a subject of intense debate throughout the world with no concise, universally agreed upon, defined parameters. However, the concept has evolved in different ways over the last two decades depending upon the prevailing economic system.

2.2 As per some of the well-accepted definitions[2], corporate governance refers to the following:

- system by which business corporations are directed and controlled.
- the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.
- relationship among various participants in determining the direction and performance of corporations.
- balance between economic and social goals and between individual and communal goals.
- efficient use of resources and accountability for the stewardship of those resources.

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[1] Comprising representatives from SEBI,the Reserve Bank, Ministry of Corporate Affairs and IRDA.

[2] OECD, Calpers, Sir Adrian Cadbury, Kumar Manglam Birla Committee Report.

- enhancement of the long-term shareholder value while at the same time protecting the interests of other stakeholders.

2.3 Corporate governance clearly impinges upon the direction, goals and performance of a corporation. The belief that maximisation of shareholder value is the main purpose of the modern business has been associated with the 'Anglo-Saxon' agency model of the corporation. A clear separation between management control and shareholder ownership is the primary feature of this model.

2.4 This contrasts with the 'German' conception of the company as a social institution, wherein, the majority shareholder is a part of the supervisory board along with other stakeholders like workers/employees. This is popularly known as 'Insider System'. In another model which has evolved in East Asian economies, the family controls the substantial shareholding and also actively participates in the management of the company. This is close to the corporate ownership structures in India where the family-run business groups still play a crucial role. Shareholdings in Indian companies are segregated mainly as promoter and non-promoter shareholding. The promoters usually have substantial shareholding. The absence of clear lines of distinction between the role of the family as shareholder(s), as board member(s) and in management needs special consideration in evolving corporate governance framework in India.

2.5 The central corporate governance issue, irrespective of the economic model, is aligning the objectives of management with the objective of shareholder wealth maximisation. Companies are encouraged in most systems to take into consideration the interests of all the stakeholders while making their decisions. The idea is to emphasise that the board is responsible not only to shareholders but also to individuals or groups who have a stake in the actions and decisions of such an organisation.

2.6 In this debate about corporate governance, the concepts of accountability, transparency and equality of treatment to all the shareholders occupy the centre-stage irrespective of the economic system. Companies around the world are realising that better corporate governance adds considerable value to their operational performance.

3. History of Corporate Governance in India

3.1 Corporate governance initiatives in India, unlike some other parts of the world, were not triggered by any serious nationwide financial, banking and economic collapse. At the time of independence in 1947, the country inherited a functional stock market with a well-developed banking system. In the decades after Independence, a conscious tilt towards socialism led to the creation of a regime of licensing, protection and controlled growth of capital market and the corporate sector. The development financial institutions played a dominant part by providing long-term finance to companies in the absence of a vibrant capital market.

3.2 In the 1980s, however, this situation changed. There have been wide-ranging changes

in both the laws and the regulations in the field of corporate law and the capital market. Since reforms began in 1991, India has emerged far better endowed than many other countries.

3.3 The single most important event in the field of investor protection in India has been establishment of Securities and Exchange Board of India (SEBI) in 1992. The introduction of Clause 49[3] in Listing Agreements (Annex A) in the year 2000 by SEBI was a major turning point in the history of corporate governance in India. The Companies Act, 1956 has also been amended substantially in the years 1997, 1999, 2000, 2001, 2002 and 2006 to provide a solid foundation of corporate governance in India. There have, however, been some financial scams.[4] These revealed certain structural loopholes in the financial system and the corporate governance framework which, in turn, have led to a series of reforms.

3.4 To briefly trace the important developments in the area of corporate governance in India, the Confederation of Indian Industry (CII), purely as a voluntary effort, released a Desirable Corporate Governance Code for listed companies in 1998. In 1997, the Kumar Mangalam Birla Committee constituted by SEBI designed a mandatory-cum-recommendatory code for listed companies on a roll-out plan. SEBI implemented the recommendations of the Birla Committee through the enactment of Clause 49 in the Listing Agreement in the year 2000. As stated earlier, this Clause has served as a milestone in the evolution of corporate governance practices in India. In 2002, the Naresh Chandra Committee on corporate audit and governance submitted its Report. Subsequently, in order to review the existing corporate governance code, SEBI constituted the Narayana Murthy Committee based on whose recommendations made in 2003, far-reaching changes were made in the Listing Agreement in 2004. The Ministry of Corporate Affairs also constituted an Expert Committee on Company Law under the chairmanship of Dr. J J Irani which released its Report in May 2005. The Consultative Group of Directors of Banks and FIs set up by the Reserve Bank under the Chairmanship of Dr. Ashok Ganguly to review the supervisory role of boards submitted its Report in April 2002. The recommendations given by these Committees are furnished in **Appendix I.**

3.5 The aforesaid Committees appointed by SEBI and the Reserve Bank for making recommendations for evolving corporate governance framework have had the benefit of building upon similar codes developed in other countries including OECD jurisdictions. Thus, international practices and developments have been factored into these studies. For instance, the Narayana Murthy Committee was set up to review the corporate governance norms in the aftermath of major corporate developments in US in the early years of this decade. While bodies like National Foundation of Corporate Governance set up by the Ministry of Corporate Affairs are engaged in a dialogue with both national and international agencies on an ongoing basis, it is essential that learning from the experience of other countries should be a dynamic process and not a static one. The corporate governance code should be constantly reviewed in light of the ever-changing global scenario.

4. Corporate Governance Framework

4.1 The corporate structure in India can be broadly categorised under two heads, namely,

[3] Clause 49 of the Listing Agreement of SEBI requires the companies who are listed to comply with certain provisions relating to board of Directors, Audit Committee, subsidiary companies, disclosures, report on corporate governance and compliance.

[4] Harshad Mehta scam in 1992 and Ketan Parekh scam in 2001.

listed companies[5] and unlisted companies. In the case of listed companies, the public interest involved is generally much higher than those in unlisted companies. Both listed and unlisted companies can either be from the public sector or the private sector. Some banks and insurance bodies are also constituted as companies. Some of the banks are also listed. Presently, none of the companies from the insurance sector are listed.

4.2 The corporate governance framework in India primarily consists of the following legislations and regulations:

The Companies Act, 1956: All companies in India, whether listed or unlisted, are governed by the Companies Act which provides *inter alia* for incorporation of different types of companies – private limited, public limited, limited by guarantee, not-for-profit companies, *etc.* The Companies Act is administered by the Ministry of Corporate Affairs (MCA). The Act is comprehensive and deals with the rules and procedures regarding incorporation of a company; prospectus and allotment of ordinary and preference shares and debentures; management and administration of a company; annual returns; frequency and conduct of shareholders' meetings and proceedings; maintenance of accounts; board of directors, prevention of mismanagement and oppression of minority shareholder rights; the power of investigation by the government, including powers of the CLB, *etc.* The Companies Act does not stipulate distinction on compliance as regards the preparation of accounts, based on the nature of companies.

Securities and Exchange Board of India (SEBI) Act, 1992: SEBI Act mandates SEBI to protect interest of investors and develop and regulate the securities markets. The powers of the board comprise registering and regulating the working of various intermediaries in the securities markets, promoting and regulating self-regulatory organisations, prohibiting undesirable activities like insider trading, fraudulent and unfair trading practices, regulating acquisition activity of listed companies, overseeing IPOs and further offerings by listed companies. SEBI has the power to impose penalties for violation of the Act and Regulations made under the Act. The Act empowers SEBI to investigate, adjudicate, hold enquiry and prosecute. There are also general powers to pass directions against listed companies or responsible persons in the interest of investors or the orderly development of securities market.

The Securities Contracts (Regulation) Act, 1956: SCRA and Securities Contracts (Regulations) Rules regulate transactions in securities. The Act deals with recognition of stock exchanges by Central Government (whose powers in this case are delegated to SEBI), powers to suspend the business of stock exchange or supersede its governing board. It provides for regulation of contracts and options in securities. There are also provisions relating to listing of securities and right to appeal to

[5] Listed companies: Companies which raise funds from public by issuing prospectus and are listed on SEBI-recognised Stock Exchanges. 4,687 companies are listed on BSE and 1,185 companies on NSE.

Securities Appellate Tribunal in case of refusal by exchange to list securities of listed companies. Under the Act, there are provisions for adjudication proceedings to be conducted by adjudicating officer apointed by SEBI and imposition of monetary penalties for various violations. SEBI also has powers to issue directions against entities such as stock exchanges, listed companies *etc*. There are also provisions for initiation of prosecution proceedings under the Act. The Central Government has also issued Securities Contracts (Regulation) Rules, 1957 which *inter alia* contain qualification for persons to be members of stock exchange, books of accounts to be maintained by members, listing conditions *etc*.

The Depositories Act, 1996: This Act provides for regulation of depositories in securities markets. The Act *inter alia* deals with rights and obligations of depositories, depository participants, issuers and beneficial owners. A depository needs certificate from SEBI for commencement of business. Under the Act, SEBI has got powers to call for information and enquiry, give directions, levy penalties and adjudicate. Presently there are two depositories, *viz.,* National Securities Depository Ltd. and Central Depository Securities Ltd.

The Banking Regulation Act, 1949: This Act covers all aspects relating to licensing of banks, the activities which banking companies can engage in, power of the Reserve Bank to give directions, suspension of business and winding up of banking companies.

The Insurance Regulatory and Development Authority Act, 1999: Insurance Act 1938 and various regulations framed under the Insurance Regulatory and Development Authority Act, 1999 cover all aspects relating to registration of insurance companies and licensing of insurance intermediaries, investments of insurance companies, assets, liabilities and solvency margin of insurers, reinsurance, preparation of financial statements, protection of policy-holders' interest, fit and proper criteria, transfer of shares, winding up of an insurance company, *etc*.

Listing Agreement with Stock Exchanges: Listing Agreement is an agreement entered between a stock exchange and the company seeking listing of securities on the exchange. It contains various requirements and disclosure obligations that companies must follow to remain as listed entities. The corporate governance requirements that listed companies must follow are specified in Clause 49. The model Listing Agreement has been stipulated by SEBI and is reviewed and amended by SEBI from time to time. Stock exchanges are primarily responsible for ensuring compliance of various requirements under Listing Agreement. SCRA stipulates penalties upto Rs 25 crore for non-compliance of listing conditions pursuant to adjudication by an adjudicating officer appointed by SEBI.

4.3 As can be seen from above, the legislative framework is wide enough to cover corporate governance issues for a diversified corporate sector.

5. Approach and Methodology

5.1 For the purposes of this study, the OECD principles on corporate governance, revised in 2004, have been used as benchmark for assessment. The OECD principles of corporate governance, cover six main areas. They call on governments to put in place an effective institutional and legal framework to support good corporate governance practices (Principle I). They aims at a corporate governance framework that protects and facilitates the exercise of shareholders' rights (Principle II). They also strongly support the equal treatment of all shareholders, including minority and foreign shareholders (Principle III). They recognise the importance of the role of stakeholders in corporate governance, while

they also look at the importance of timely, accurate and transparent disclosure mechanisms (Principle IV and V, respectively). They deal with board structures, responsibilities and procedures (Principle VI). These principles are further broken down into sub-principles.

5.2 The assessment with respect to each principle has been done on the scale of 'Not Implemented' to 'Fully Implemented'. The current position against each principle has been set out before determining the assessment. Inputs from policy-makers, various institutions like stock exchanges, depositories, and professionals have been obtained for the purpose. The assessment ratings broadly reflect the robustness of the system to deal with the issue. Further, while doing the assessment on the basis of OECD principles on corporate governance, guidance provided under the commentary of 'Evaluation Methodology' published by the OECD has been followed.

5.3 It may be recalled that in April 2004, a Corporate Governance Country Assessment for India was carried out as part of the joint World Bank/IMF program of Reports on the Observance of Standards and Codes (ROSC). To provide a comparative perspective, principle-wise assessment as per this Report, wherever applicable, has been placed alongside the current assessment. In the said World Bank Report, the observance of principles was assessed on the scale which ranged from 'Observed' to 'Not Observed'. However, as per the latest OECD evaluation methodology (2004), the assessment of revised principles has been done on the scale ranging from 'Fully Implemented' to 'Not Implemented'.

Sr. No.	*Previous Assessment Scale*	*Current Assessment Scale*
1	2	3
1.	Observed	Fully Implemented
2.	Largely Observed	Broadly Implemented
3.	Partially Observed	Partially Implemented
4.	Materially Not Observed	—
5.	Not Observed	Not Implemented
6.	—	Not Applicable

5.4 The present assessment is based on the study of the working of various constituents of the corporate sector – listed and unlisted companies, banking, insurance and public sector enterprises. Corporate governance issues are particularly significant for listed companies due to the high level of public interest involved. So far, listed companies have attracted greater attention even in terms of prescriptive corporate governance measures for them. Besides the Companies Act, which is applicable to both listed and unlisted companies, Clause 49 of the Listing Agreement stipulates comprehensive requirements with respect to corporate governance only for listed companies. As such, special focus has been attached to listed companies in this Report.

5.5 As many corporate governance requirements (*e.g.*, Clause 49 of Listing Agreement) do not apply at present to unlisted companies, a separate section has been included in the Report. This section deals with the issues and the existing corporate governance framework pertaining to them.

5.6 Further, banking and insurance companies are important constituents of the financial

system and involve substantial public interest (depositors and policy-holders). There are additional legislations, namely, the Banking Regulations Act, the Insurance Regulatory Development Act and the Insurance Act which impinge upon the corporate governance requirements for these sectors. The Report, therefore, deals with these sectors separately.

5.7 As regards the public sector, the requirements of corporate governance have been enunciated in the code of corporate governance which has been brought out by the Department of Public Enterprises. The level of actual compliance by these enterprises varies depending on their listing status. The requirement of corporate governance in this code has been almost modelled on the lines of Clause 49 of the Listing Agreement which is applicable only to the listed companies.

6. Corporate Governance: Why OECD Benchmarks?

6.1 Given the increasing interdependence and integration of financial markets across the world, it was considered important that some degree of uniformity and coherence is established in the regulatory framework. With this in mind the OECD council, meeting at ministerial level on April 27-28, 1998 called upon the OECD to develop, in conjunction with national governments, other international organisations and the private sector, a set of corporate governance standards and guidelines. In order to fulfill this objective, the OECD established the *ad hoc* Task Force on corporate governance to develop a set of non-binding principles that embody the views of OECD countries on this issue. The original OECD Principles were issued in 1999. Subsequent corporate scandals in a number of countries led to the revision of these principles in 2004.

6.2 The principles are non-binding and their implementation must be adapted to different legal, economic and cultural circumstances. This is a key strength of the principles, which has made them a useful tool worldwide, in developed as well as emerging markets.

6.3 There are a number of other reasons for adopting these principles as the basis for evaluation. First, no other alternative parameters of evaluation are available to bench-mark the level of corporate governance in different jurisdictions. Second, OECD principles have been adopted by the World Bank to evaluate the level of corporate governance for ROSC assessment. in various jurisdictions across the world. Third, in the case of India, similar Report on Observance of Standards and Codes (ROSC) assessments have been done by the World Bank in 2001, followed by another assessment in 2004. Lastly, international organisations such as International Organisation of Securities Commission (IOSCO) and Financial Stability Forum (FSF) also recognise OECD principles as standards in the area of corporate governance.

7. India and the OECD Principles

7.1 Experience has shown that India has a well-established corporate governance framework. It remained unaffected by the Asian financial crisis of the late 1990s. Indeed, the movement towards adopting good corporate governance practices, better financial and non-financial disclosures and the promotion of transparent and efficient markets in India had built up well before the East Asian debacle. This is evident from the assessment done by the World Bank in its last study conducted in 2003, which has been brought out in their Report on Observence of Standards and Codes (ROSC).

7.2 The World Bank in its ROSC-2004 identified several areas for reform out of which major ones like sanctions and enforcement should be credible deterrent, especially in the area of insider trading and related party transactions. Fragmented structure of regulatory

oversight over the listed companies by SEBI, stock exchanges, and MCA leads to weaker enforcement and regulatory arbitrage. Board practices need to be strengthened, and role of institutional investors could play an important role in the corporate governance of their portfolio companies.

7.3 In the last three years, decisive steps have been taken to enhance the level of corporate governance requirements and also to improve the quality of disclosures on a real-time basis. The experience shows that in recent years, the capital market has amply rewarded those companies which have a proven record of good governance practices. The legal and regulatory framework has enabled and facilitated the growth of such companies.

7.4 Further, a number of steps have also been taken by the government and the securities market regulator by prescribing stiff penalties for those found guilty of insider trading, which also includes disgorgement of ill-gotten gains. Moreover, a state-of-the-art integrated surveillance system has been put in place to monitor the stock market transactions on a real-time basis to check manipulation. The disclosure norms for the related party transactions have also been strengthened. There are forums to facilitate co-ordination amongst various regulatory authorities. As far as board practices are concerned, the provisions of Clause 49 of the Listing Agreement have been strengthened and the Institute of Company Secretaries of India has recently brought out the 'Secretarial Standard on Board Room Practices' with a view to bring about uniformity in these matters. Developments *vis-à-vis* these aspects have been detailed in the assessment.

8. Summary Assessment of OECD Principles[6]

(For detailed assessment, please see Appendix II)

Principle	FI[7]	BI	PI	NI	NA	
I. Ensuring the Basis for an Effective Corporate Governance Framework						
IA. Enhancement of market integrity and promotion of transparent and efficient markets		×				● Comprehensive statutory framework in place for listed companies. Companies Act applicable to all companies. ● SEBI mandated to regulate and develop securities market and protect investors under SEBI Act. ● SCRA and SCRR regulate transactions in securities. ● Listing Agreement applicable to all listed companies.

[6] Unless there are specific provisions under the Insurance Act and the Regulations, the provisions of the Companies Act are equally applicable to insurance companies.

[7] FI - Fully implemented, BI - Broadly implemented, PI - Partially implemented, NI - Not implemented, NA - Not Applicable.

Principle	FI	BI	PI	NI	NA	
						● Depositories Act governs electronic trading. **Banking** ● Banking Regulations Act, 1949. **Insurance** ● Insurance Act, 1938, Insurance Regulatory and Development Authority Act, 1999. **Overall Comments** ● Corporate Governance for listed companies. has received a lot of focus and is increasingly being adopted by listed companies. ● Need to enhance focus on unlisted companies.
IB. Transparent and enforceable legal and regulatory requirements	×					● Companies Act stipulates directors' responsibility Statement, Audit Committees, postal ballot. Registrar of Companies (RoCs) can initiate prosecution for non-filing of compliance. ● Clause 49 of the Listing Agreement provides for composition of Board of Directors (BoD), Independent Directors, Constitution of Audit Committee, Disclosures in Annual Reports, Subsidiary Companies, Code of Conduct, CEO/CFO certifications, Quarterly Report on corporate governance. ● For the quarter ended Sptember 30, 2007, 1210/1295 companies at NSE and 2848/4162 at BSE submitted Corporate Governance Report. ● Provision for financial penalties/prosecution for non-compliance. **Banking** ● Banks are required to put up a Report to BoD, in compliance with the Reserve Bank's Circular dated June 20, 2002 based on recommendation of Ganguly Committee. For private sector banks, additional fit and proper directives and guidelines on 'ownership and governance' were issued on June 25, 2004. **Insurance** ● The Management Report is required to confirm compliance with the provisions of

Principle	FI	BI	PI	NI	NA	
						the IRDA Act and the regulations framed thereunder. However, all the stipulations on corporate governance are not placed under one set of regulations. This is being addressed through issue of separate comprehensive guidelines on corporate governance. **Overall Comments** ● Legal and regulatory requirements are consistent with rule of law and are in public domain. Requirements are of two types – mansdatory and non-mandatory.
IC. Division of responsibilities amongst authorities	×					● All companies to file fundamental documents with RoCs. ● Listed companies to comply additionally with Listing Agreement. ● The provisions of Companies Act related to management and administration and minority shareholder protection administered by Ministry of Corporate Affairs (MCA) (Sections 401, 408, 388B). ● SEBI has general powers to pass directions under Section 11B against listed companies under SEBI Act and also certain delegated powers under SCRA (Section 12A). ● Securities market intermediaries and depositories regulated by SEBI under provisions of SEBI Act and Depositories Act. ● In respect of stock exchanges, SCRA assigns regulatory role between Central Government and SEBI. ● SEBI has elaborate responsibilities in matters relating to issue of shares by listed companies, market misconduct, substantial acquisitions and takeovers of listed companies, *etc.*

Principle	FI	BI	PI	NI	NA	
						• Certain provisions of Companies Act are administered by SEBI. • Trading on stock exchanges governed by bye-laws of the stock exchanges under overall policy laid down by SEBI. • Trading in government securities and money market instruments under the purview of the Reserve Bank. • IRDA and the Reserve Bank are regulator for insurance and banking sector, respectively. • Various mechanisms in place for co-ordination and exchange of information amongst regulators. **Overall Comments** • Jurisdictions and roles are clearly defined and there is co-ordination among regulators.
ID. Efficient supervisory, regulatory and enforcement framework	×					• Company Law Board (CLB) independent quasi-judicial body for matters pertaining to Companies Act. • Electronic compliance managment system under MCA for electronic filing of documents by the companies in a 24×7 time-frame and effective monitoring by RoCs. • SEBI is an autonomous, statutory body established under SEBI Act, 1992. • SEBI Board has representation from various Ministries concerned. • Rules are made by the Central Government under SEBI Act and Securities Contracts (Regulation) Act in a consultative manner. • Public comments obtained for regulations and major proposals, before finalisation. • Expenses of SEBI are met through fees and charges received from intermediaries. • SEBI has comprehensive investigative and enforcement powers to issue directions under SEBI Act. SEBI also has enforcement powers under SCRA. • Appellate authority for appealing against SEBI orders. • Principles of natural justice followed by competent authorities.

Principle	FI	BI	PI	NI	NA	
						● Provision for SROs under SEBI Act. **Overall Comments** ● Position as outlined above reflects basis for present assessment.
						II. The Rights of Shareholders
IIA. Basic shareholder rights	×					● Companies Act, SEBI Act, Depositories Act, SCRA and regulations made thereunder provide enabling framework. ● For shares in physical form, record-keeping by issuer or Share Transfer Agent. For shares in dematerialised forms, depositories record allotment and transfer of ownership. Under Clause 49 of Listing Agreement, listed companies to delegate share transfer to an officer or a committee which meet at least once in a fortnight. ● Complaint redressal mechanism laid down by SEBI and MCA. ● Shares of public/listed companies freely transferable under Companies Act. On stock exchanges rolling settlement on T+2 basis and counter-party risk guaranteed. ● Under Companies Act, Memorandum of Understanding (MoU)/Articles of Association (AoA) and financials to be filed with RoC. ● Detailed disclosures under SEBI (Disclosure and Investor Protection) Guidelines and Listing Agreement at the time of raising funds. ● In terms of Listing Agreement, all material and price-sensitive information to be in public domain. Clause 30, 31, 32, 33, 35, 36, 37, 41 and 49 stipulate periodic disclosure on shareholding, directorship, auditors and financials in Audited Results/stock exchange who, in turn, display on their website.

Principle	FI	BI	PI	NI	NA	
						• Provisions under Listing Agreement related to disclosure of quarterly-year-to-date financials to be submitted to stock exchange within 15 minutes of board meeting and in newspapers within 48 hours. 7 days prior intimation for board meetings. • Every issuer company to inform material deviations in the utilisation of issue proceeds to stock exchange and Audit Committee through advertisement in newspapers. • Under MCA-21 information regarding companies available on-line. • As per SEBI's initiative electronic disseminating/filings under www.corpfiling.co.in. • Shareholders have right to participate, vote in general meetings. • Shareholders appoint directors by passing resolutions and can propose candidates. • In terms of Listing Agreement, companies must provide relevant information regarding candidates. • Shareholders to share the profits by way of dividends. • Dividend must be paid within 30 days of AGM. Redressal mechanism and penal provisions for non-compliance. **Insurance** • Companies Act applicable. • In addition, provisions of Insurance Act permits issuance of only equity shares with single face value. Paid-up amount is same at Rs.10/-. • Voting rights are strictly proportionate to paid up amount. • Shares are not freely transferable at the threshold limit of 1 per cent and above. • Process of introduction of a shareholder after due diligence by supervisor. **Overall Comments** • Recent initiatives have further improved position.

Principle	FI	BI	PI	NI	NA	
IIB. Rights to participate in fundamental decisions	×					● Shareholders have powers for appointment/ removal of directors and auditors, authorising, issuing share capital, amendments to MoU/AoA, remuneration of Board Members, major corporate transactions, change in business, objects, delisting, *etc.* ● U/s 81 pre-emptive rights for capital increase. ● Disposal of substantial business assets requires special majority. ● Special Resolution (SR) required for extraordinary transactions. ● Accounts minutes filed with RoC available for inspection. ● As per SEBI Disclosure and Investor Protection Guidelines, at the time of raising of funds from public, all material information regarding company, promoters, management, project, financials and risk factors to be disclosed. ● Under Listing Agreement, continuous disclosures requirement of material events. SEBI Takeover Regulations have provisions for minority shareholder protection and participation in change in management. Delisting guidelines enable shareholder participation and protection. **Insurance** ● Quarterly reporting of financial results and the solvency position. **Overall Comments** ● Adequate provisions enshrined in the law.
IIC. Shareholders' AGM rights	×					● Companies Act stipulate AGM, prior notice with agenda and explanatory statement (in case of special resolution), shareholders can

Principle	FI	BI	PI	NI	NA	
						raise questions and propose new resolution. Provisions for proxy voting and postal ballot. ● Sections 225, 257 of Companies Act govern appointment of directors. ● Sections 198, 309 and Schedule XIII of Companies Act prescribe provisions for remuneration. ● Shareholders approve maximum remuneration to BoD. ● Under Listing Agreement, shareholders approval required for fees/compensation to independent directors. ● ESOPs require shareholders approval under Companies Act and SEBI Regulations. ● Position under IIA and VI D may be seen. **Overall Comments** ● Companies Act and Listing Agreement enable shareholders' participation. ● Need to explore alternative methods for voting to ensure greater shareholders participation and spread awareness.
IID. Disproporti-onate control disclosure		×				● Provision in Companies Act for issuance of shares with disproportionate voting rights. ● Companies disclose capital structures/ shareholding patterns that allow certain shareholders to exercise control disproportionate to their cashflow rights in Audited Results. ● Restrictions under Section 108A to 108E of Companies Act to prevent creation of monopolistic groups. ● Disclosure requirements under Section 187C of Companies Act. ● Joint venture arrangement and private equity investments may provide clauses as per which shareholders may obtain a degree of control which is disproportionate. ● The equity holding details are to be disclosed on quarterly basis. ● Any change in shareholding pattern of 1 per cent and above to be disclosed.

Principle	FI	BI	PI	NI	NA	
						Insurance ● Provisions of Companies Act applicable. ● Every person who has any interest in shares of a company which stands in the name of other person, make a declaration regarding acquisition of interest. **Overall Comments** ● Ownership through cross-holdings and use of trusts and private companies for owning shares in group companies give rise to opaque and non-transparent structures. ● Disclosure norms need to be continuously strengthened. ● Stringent penal action to be enforced.
IIE. Markets for corporate control should be allowed to function		×				● Provisions in Listing Agreement and SEBI (SAST) Regulations, 1997 to facilitate corporate restructuring and acquisitions. ● Issue of beneficial interest dealt with under Section 187C and 187D of Companies Act. ● Continuous disclosure on ownership by investor category as well as at various thresholds of ownership. ● stock exchanges disseminate the information through trading terminals and websites. ● In case of change in control, acquirer is required to make a public offer at every stage. Entire process to be completed in prescribed time. Provisions for competitive bids. ● Section 391-394 and 293 (1) of Companies Act govern mergers and sale of corporate assets. **Insurance** ● Insurance Act, 1938 contains prescriptions on regulatory approvals on transfer of stakes beyond specified thresholds.

Principle	FI	BI	PI	NI	NA	
						Overall Comments ● Comprehensive regulatory framework has facilitated acquisitions over the last few years. ● In case of mergers and amalgamations role of MCA *vis-à-vis* courts needs to be reviewed. ● Competition Act stipulates time period before which proposed combinations cannot take place. ● Changes proposed under Competition Act and their impact have not been studied.
IIF. Cost/benefit to voting			×			● No regulatory requirement for Institutional Investors to disclose their voting policies, procedure and conflicts of interest. ● As per latest World Bank Report Institutional Investors do not exercise their voting rights actively. **Overall Comments** ● Need to initiate dialogue with the industry on the issue. ● Possibility of stipulating requirements as good practice or mandatory requirements to be explored.
IIG. Consultation amongst shareholders including institutional investors	×					● SEBI and MCA recognise Investor Associations to take up investors rights and grievances. ● Provisions under SEBI Takeover and Insider Regulations to check potential misuse of shareholder co-operation. **Overall Comments** ● Forum available to facilitate interaction among shareholders. Checks and balances also in place.
III. Equitable Treatment of Shareholders						
IIIA. All shareholders should be treated equally		×				● Within each class of shares, all shares carry the same rights. Any change subject to the approval of shareholders. Proxy voting permitted. ● MCA has a portal for investor complaints. Provisions under Companies Act for action in cases of oppression and mismanagement, false statements, defaults in provisions of Companies Act.(388, 391, 397, 398, 401, 408)

Principle	FI	BI	PI	NI	NA	
						● Liability for directors under Companies Act. Class action permitted under Criminal Procedure Code (CrPC). ● SEBI deals with investor grievances pertaining to areas delegated to it under SEBI Act, against listed companies for non-compliance of takeover regulations, market manipulation, insider trading, *etc.* Under Listing Agreement requirement of shareholders/Investor Grievances Committee under the chairmanship of a non-executive director. ● Proxy voting permitted. Custodians to provide information to Institutional Investors. ● Voting rights in respect of foreign depository receipt holders determined by the agreement between the issuer and the depository. ● DIP guidelines provide for lock-in of shares and disclosure requirements. ● Position under IIE, IIA and IIC may be seen. ● Under section 621 of Companies Act, any shareholder can complain, file prosecution against company/officers in default. ● Provisions in delisting guidelines. **Insurance** ● Position under IIA may be seen. ● At present the equity is closely held. In case of State-owned companies, the equity is held by the Government of India. **Overall Comments** ● Structure is in place. Scope for expediting the process on implementation side and sensitising shareholders about their rights and responsibilities.
IIIB. Insider trading and abusive	×					● Insider trading, an offence under SEBI Act, attracts penalty of Rs 25 crore/3 times profits or 10 year imprisonment.

Principle	FI	BI	PI	NI	NA	
self-dealing is prohibited.						● Disclosure requirements under Insider Trading Regulations, Takeover Regulations and Listing Agreement and other requirements such as Trading Window, pre-clearance, holding period, code of conduct for transactions by Listed Companies/Board Members/senior management. ● Market surveillance by stock exchanges. SEBI has Integrated Market Surveillance System to monitor and detect instances of insider trading and front-running. Requirement of Unique Client and Know Your Client norms and Permanent Account Number. ● During the last two years, SEBI has initiated actions against few entities for indulging in front-running, abusive self-dealing, violation of disclosure requirements. ● Insider Trading Regulations reviewed from time to time to strengthen framework. **Overall Comments** ● SEBI has comprehensive powers for investigation. ● Regulatory framework and oversight strengthened to deter insider trading which is complex and difficult to prove even in advanced countries. ● In 2005-06 and 2006-07, respectively, 13 and 26 regulatory/enforcement action initiated for violation of insider trading regulations. ● During 2005-06 and 2006-07, 239 cases taken up for investigation pertaining to market manipulation and price rigging under SEBI (PFUTP) Regulations. Investigation completed in 139 cases.
IIIC. Board/ Managers disclose interests	×					● Disclosure of material conflict of interest, related party transactions, directorships in other companies, shareholding required under Companies Act and Listing Agreement. ● Central Government approval required for certain related party transaction and loans to directors. ● Restrictions on participation by interested parties in such matters.

Principle	FI	BI	PI	NI	NA	
						● Shareholders, parties related to directors not allowed to take loans from companies. **Banks** In terms of Banking Regulation Act, there are prohibition on: ● director in BoD of banking company to be director in any other banking company. ● partners/members on behalf of any firm in which any of its directors is interested as partner, manager, employee or guarantor or any company. **Insurance** ● Related party transaction to be disclosed under Accounting Standard 18. ● Insurers to furnish a schedule on payments to individuals, firms, companies in which its directors are interested and make disclosures in management report. **Overall Comments** ● With amendments in Listing Agreement, the disclosure framework for observance of the principle is in place.
IV. Role of Stakeholders in Corporate Governance						
IVA. Stakeholder rights respected	×					● Shareholders have enforceable rights to participate. ● Debt-holders/creditors have rights in respect of matters which affect their rights, *e.g.*, reduction in capital. ● Depositors can approach CLB for default in repayment. ● General laws applicable for customers/ suppliers, *etc.* ● As per Section 217 of Companies Act, Board reports annually on company activities,

Principle	FI	BI	PI	NI	NA	
						including company performance on environment issues, labour issues, tax compliance and provisions of Companies Act. ● National Foundation for Corporate Governance, Trust in Partnership with CII, ICAI and ICSI has been set up to strengthen the role of stakeholders. **Insurance** ● Provisions of Companies Act applicable. ● Provisions for protection and servicing of policyholders. **Overall Comments** ● Various laws recognise rights of stakeholders. ● Need for greater disclosure and publicity of Corporate Social Responsibility initiatives.
IVB. Redressal for violation of rights		×				● Shareholders, creditors have enforceable rights under Companies Act. ● Framework by SEBI, MCA, stock exchanges to attend to investor grievances. ● Other Acts like SARFAESI Act to safeguard interests of creditors. ● For other stakeholders, remedies available under other general laws. ● Refer Principle IIIA and IVA. **Insurance** ● IRDA (Protection of Policy-holders' interest) Regulations, 2002 address rights of policy-holders. ● Insurance Ombudsman and consumer courts. **Overall Comments** ● SARFAESI Act has strengthened creditors' rights. ● The liquidation process is time consuming. ● Need for speedy disposal by courts. ● Setting up of dedicated courts may expedite disposal.
IVC. Performance enhancement	×					● Profit-sharing by employees provided under Companies Act. ● Section 79A of Companies Act and SEBI (ESOP and ESPS) Guidelines, 1999 govern issuance of stock options to employees of the listed companies.

Principle	FI	BI	PI	NI	NA	
						● Reservation for employees in public issues permitted under SEBI Disclosure and Investor Protection Guidelines. ● Factories Act and Industrial Disputes Act also facilitate employee participation in decision-making. **Overall Comments** ● Enabling provisions in place
IVD. Access to information	×					● Information about company disclosed periodically under Listing Agreement (immediately, in case material in nature) in the newspapers/to the stock exchange, who display on their website. ● MCA-21[8] provides access to information filed with Registrar of Companies (RoC). ● For IPOs and issues by listed companies disclosures to be made in prospectus under SEBI (DIP) Guidelines. ● Any listed company making issue of debt securities on a private placement basis and listed on a stock exchange is required to make full disclosures as per Companies Act, 1956, SEBI (DIP) Guidelines, 2000. ● Position under IIA and VE may be referred. **Insurance** ● Access to information through website and MCA-21. **Overall Comments** ● Emphasis on transparency and accurate and timely information.
IVE. Free communication			×			● Listing Agreement stipulates Whistle-Blower Mechanism as non-mandatory condition with adequate safeguards for employees.

[8] A project initiated by Ministry of Corporate Affairs (MCA) to automate all processes related to proactive enforcement and compliance of the legal requirements under the Companies Act, 1956.

Principle	FI	BI	PI	NI	NA	
of unethical practices to the board						• Legislations namely Factories Act, PF Act, and Industrial Disputes Act. **Overall Comments** • Protection available under other legal enactments. • Non-mandatory conditions. • Need to review experience gained in this area.
IVF. Enforcement of creditor rights		×				• Section 100-104, 391-394 of Companies Act recognise creditors' rights and provide for winding up. **Overall Comments** • Position under Principle IVB may be referred.
V. Disclosure and Transparency						
VA. Disclosure standards	×					• Provisions for adoption and statutory filing of financial statement under Companies Act. • Under Listing Agreement, quarterly financial statements to be published. Quarterly results are to be approved by the board or a committee thereof. • Audited Results to be published and circulated (full or abridged version). Management Discussion and Analysis stipulates (under Companies Act, Listing Agreement), *inter alia*, consolidated financial statements required to be filed including discussion on the company's competitive position, incorporating opportunities and threats, outlook, risks and concerns, *etc*. • Under Companies Act and Listing Agreement (quarterly), share ownership to be disclosed in Annual Report/stock exchange by investor category and tranches of ownership information disseminated on website of the stock exchange. • Under Companies Act/Listing Agreement, board member and key executives remuneration available in the Audited Results and balance sheet. Under Clause 49, senior management to disclose to the board all matters/transactions involving conflict of interest. • Sec 217 of Companies Act and Clause 49 stipulate reporting on employees and other

Principle	FI	BI	PI	NI	NA	
						stakeholder issues, developments in HR, information on companies governance policies, discussions on opportunities and threats, *etc.* **Banks** ● Additional disclosures in the 'Notes to Accounts' on asset quality, business ratio, maturity pattern of certain items of assets and liabilities, exposures to sensitive sectors. **Insurance** ● IRDA (Preparation of Financial Statements and Auditors' Report of Insurance Companies) Regulations, 2002 prescribes formats for various financial statements to be submitted by life insurers and non-life insurers separately. Quarterly reporting mandatory. Financial statements such as actuarial returns, business underwriting details, *etc.*, to be submitted as per stipulated prescriptions. **Overall Comments** ● With amendments in Listing Agreement, disclosures mandated under legal framework. ● Adjudication against 20 companies initiated by SEBI for non-compliance with Clause 49 of Listing Agreement.
VB. Standards of accounting and audit	×					● ICAI is responsible to the Accounting Standards Board which issues Accounting Standards primarily based on IFRS. ● Information is prepared, audited and disclosed in accordance with the Accounting Standards. ● IFRS to be adopted from April 2011. ● Listing Agreement requires quarterly financial results to be approved by BoD, certified by CEO and CFO.

Principle	FI	BI	PI	NI	NA	
						● Major variation between the un-audited quarterly or yearly financial results, amendment on limited review to be explained, duly approved by the board. **Insurance** ● Joint audit by two audit firms annually. ● Norms for appointment of statutory auditors issued by Supervisor. ● Tenure of audit firm restricted to five consecutive years. ● Statutory auditors to file Report as specified in IRDA Regulations. **Overall Comments** ● Recent initiatives have enhanced the credibility and quality of disclosures.
VC. Independent audit annually		×				● Under Companies Act annual accounts to be audited by an independent, competent and qualified auditor appointed by shareholders. ● Act governing ICAI, ICSI and ICWAI recently amended to enhance transparency and professionalism (disciplinary mechanism), limit extent of non-audit services to the client company and stipulate adequate related disclosures. ● The concept of peer audit review introduced for listed companies. **Banks** ● Banking Regulation Act,1949 also applicable. **Insurance** ● Annual Joint Audit by two auditors. **Overall Comments** ● Recent initiatives have enhanced the credibility and quality of disclosures.
VD. Accountability of auditors		×				● Principle V C may be referred. ● Companies Act and Listing Agreement stipulate setting up of Audit Committee. ● Peer review of auditors of listed companies recommended by SCODA. **Overall Comments** ● Auditors accountability would be further enhanced with introduction of peer review.

Principle	FI	BI	PI	NI	NA	
VE. **Fair and timely dissemination**	×					● Principle II A, IVD may be referred. ● Section 219(iv) of Companies Act and Clause 32 of Listing Agreement permit listed companies to send abridged balance sheet, profit and loss account to shareholders. ● Online information available under MCA-21, and also, in www.watchoutinvestors.com and www.corpfiling.co.in. **Insurance** ● Annual accounts of companies are also consolidated and published in Supervisor's Annual Report at www.irdaindia.org. ● Consolidated monthly performance of insurers on website. **Overall Comments** ● Adequate provisions available under Companies Act, Disclosure and Investor Protection guidelines and Listing Agreement.
VF. **Provision of professional advice**		×				● Brokers, MFs, portfolio managers, credit rating agencies registered and regulated by SEBI. ● Mandatory IPO grading. ● Regulations for Investment Advisors under preparation by SEBI. ● Disclosure requirement under Listing Agreement and SEBI Insider Trading Regulations. ● Restrictions and Disclosure requirement in terms of code of conduct under SEBI Stock Broker Regulations. **Overall Comments** ● Various initiatives taken for disclosure and transparency.
			VI. Responsibilities of the Board			
VIA. **Board Acts with due diligence, care**	×					● Provisions in the Companies Act for effective management and accountability of BoD to the company and shareholders.

Principle	FI	BI	PI	NI	NA	
						• Under Listing Agreement, board and independent directors to protect the interest of the stakeholders (Clause 41 and 49). • Listing Agreement lays composition of board (combination of executive and independent directors). • Board to be assisted by committees (Audit Committee, Investors' Grievances Committee and Remuneration Committee). • Board can seek information on all significant issues. • Quarterly financials to be approved by the BoD. • Minimum number frequency of board meeting and limit on number of companies where director can be on board. • CEO and CFO certification on authenticity of financial results. **Banks: Private Sector Banks** • 'Fit and proper' criteria, deed of covenant for directors. • Nomination Committee to exercise due diligence. **Public sector banks** • 'Fit and proper' criteria applicable other than directors nominated by Govt. of India under Section 9(3)(h) of the Banking Companies **Insurance** • Additional appointment of whole-time director requires the approval of IRDA. • Authority can also remove a Director or CEO. • ¼ of directors (not less than 2) to be elected by policyholders of life insurance company. • No insurance agent eligible to be a director. • Life insurer cannot have a common director with another such insurer. • In the de-tariffed scenario, the boards of general insurance companies have been assigned additional responsibilities. **Overall Comments** • With amendments in Listing Agreement, necessary requirements in place for coporates. Board responsibility of banks and insurance companies also specified.

Principle	FI	BI	PI	NI	NA	
VIB. Treat all shareholders fairly		×				● BoD obligated to take decisions in a fair manner and interests of the company. ● Shareholders have remedy under CLB for oppression by board. ● Listing Agreement provides for an optimum combination of executive and non-executive directors and setting up Shareholder committee to look into investor grievances. **Overall Comments** ● Rights of shareholders legally protected, scope on implementation side.
VIC. Apply high ethical standards	×					● Directors' responsibility statement under Section 217(2AA). ● Company Secretary ensures that the board complies with its statutory duties. ● Reporting requirements on board under Section 217. ● Powers and duties of directors contained in Sections 291 and 293 of Companies Act. ● Listing Agreement- CEO and CFO certification and code for BoD. ● Auditors/Company Secretaries to certify compliance of conditions of corporate governance under Listing Agreement. **Insurance** ● Statutory Auditors confirm compliance with Insurance Act and registration requirment. **Overall Comments** ● Companies Act and Listing Agreement stipulate obligations on BoD.
VID. The board should fulfill certain key functions		×				● Companies Act governs remuneration to BoD/ managerial personnel. ● Shareholders appoint regular directors. BoD can appoint casual directors, additional directors and alternate director.

Principle	FI	BI	PI	NI	NA	
						• Provisions in Companies Act for monitoring, managing potential conflicts of interest/ misuse of corporate assets/abuses in related party transactions. • In terms of Listing Agreement, separate section on corporate governance in Audited Results and non-compliance of mandatory requirements with reasons and extent to which non-mandatory requirements adopted to be highlighted. • Committees under Listing Agreement monitor effectiveness of the company's governance practices. • Audit Committee oversee and review the financials of the company, its subsidiaries, related party transactions, functioning of auditors, whistle-blower mechanism and utilisation of issue proceeds. • Process of selecting, compensating and monitoring key executives by the company managements. • Disclosure requirements for compensation to employees beyond the prescribed threshold. • ESOPs to be approved by the board and shareholders. • Listing Agreement states that fees/ compensation to non-executive directors to be fixed by the board with prior approval of shareholders. • Under Listing Agreement, all material transactions along with management's justification to be placed before the Audit Committee. • At least one independent director on the board of the holding company to be director on the board of a material non-listed Indian subsidiary company. Audit Committee reviews financial statements, investments and related party transactions of material unlisted subsidiary company. • Minutes of board meetings and statement of all significant transactions and arrangements

Principle	FI	BI	PI	NI	NA	
						entered into by the material unlisted subsidiary company are to be placed before the board of listed holding company. ● Manager/secretary and the two directors of the company (managing director must sign, if there is one) are required to sign financial statements. ● Certification by the CEO/CFO of financials. ● Compliance Certificate from auditors/CSs. ● Board oversee the process of disclosure and communications. ● Position under IIA, VIB may be seen. ● Management Discussion and Analysis to include discussion on risks and concerns. ● Requirement to keep board informed about the risks assessment and minimisation procedures. ● Disclosure requirement with respect to risks due to foreign exchange exposure. **Insurance** ● Investment committees in accordance with regulations. ● Additional responsibility on board of non-life insurance companies in de-tariffed scenario. ● Management Report to be submitted confirming payment of statutory dues, shareholding pattern, maintenance of solvency margins, overall risk exposure, *etc.* **Overall Comments** ● Board's responsibilities enhanced under amended Listing Agreement. Need to evaluate extent of implementation. Action needs to be taken for non-compliance, need to promote credible institute for directors. Need for deterrent provisions and strict penalties for violation of provisions relating to related party transactions.

Principle	FI	BI	PI	NI	NA	
						• Need to strengthen risk management framework, setting up of Risk Management Committee under Listing Agreement to be explored.
VIE. The board should be able to exercise objective judgment		×				• Listing Agreement stipulates the composition of BoD, committees, representation of independent director, frequency of meetings, attendance, maximum number of companies in which a person could be a director. • Position under VIA may be seen. **Overall Comments** • Listing Agreement amended to bring clarity in these areas. Variance on extent of compliance. Maximum term of independent directors to be statutorily restricted. Eventually, definition of independent directors to be brought in Companies Act.
VIF. Access to information	×					• Listing Agreement stipulates the minimum information that must be made available to the board and empowers the board at any point of time any information and access to expert advice. **Overall Comments** • Requisite provisions in law. • Institute of Company Secretaries has brought out a secretarial guide on boardroom practices to serve as a repository.

9. Corporate Governance Assessment – Unlisted Companies

9.1 The corporate governance assessment of the financial sector would be incomplete without having an examination of the unlisted companies, which constitute a dominant part, at least in number, of the corporate structure. This is very much evident from the following table:

Table 2: Number of Companies Registered as on March 31, 2007	
Total No. of Companies	**8,20,862**
No. of Public Limited Companies	**98,865**
No. of Private Limited Companies	**7,21,720**

9.2 Recently, there has been a trend amongst some of the bigger names in the corporate sector to get their companies delisted so as to escape the increasing requirements of disclosure, mounting pressure of public scrutiny and rigorous compliance requirements and increased cost of compliance. This is substantiated by the fact that none of the following requirements are applicable to the unlisted companies: (i) no requirement to constitute a board with more than 33 per cent/ 50 per cent of independent directors; (ii) no requirement to constitute an Audit Committee for public companies with less than Rs. 5 crore paid-up capital; (iii) no code of conduct is

required for the directors; (iv) no requirement to constitute remuneration committee and shareholder grievance redressal committee; (v) no disclosure requirement for material subsidiary company transactions; and (vi) no requirement for CEO/CFO certification.

9.3 Nonetheless, the fact remains that a substantial portion of unlisted companies, which are in the form of private limited companies, consist of small and medium companies, which need concession in terms of compliance, disclosure and certification requirements.

Further, private equity has emerged as an alternate source of finance for the unlisted companies in a big way. This development is also going to impact the corporate governance structure and practices in such companies.

9.4 It is important to note that insofar as corporate governance is concerned, the difference between a listed and an unlisted company is substantially confined to one class of stakeholders, namely, shareholders. The concerns of other stakeholders, *viz.,* employees, creditors, Government, consumers, *etc.,* particularly in large companies are no different between listed and unlisted companies. The unlisted companies do not necessarily mean lack of public interest and involvement in their affairs since a majority of them access the institutional finance, including from banks. Consequently, the need for evolving a corporate governance code for unlisted companies cannot be overlooked. This can take two forms, *viz.,* (i) unlisted companies can voluntarily evolve and adopt a code of corporate governance. This would involve a huge cultural shift. Trade associations like CII, FICCI/ASSOCHAM can play an important role in this. (ii) Ministry of Corporate Affairs can consider mandating, in respect of unlisted companies above a particular size, compliance of applicable provisions of Clause 49 of the Listing Agreement[9]. Companies Act would need to be amended in this regard.

10. Corporate Governance Assessment – Banks

10.1 Banks are 'special' as they not only accept and deploy large amounts of uncollateralised public funds in fiduciary capacity, but also leverage such funds through credit creation. Banks are also important for the smooth functioning of the payments system. In view of the above, legal prescriptions for ownership and governance of banks laid down in the Banking Regulation Act, 1949 have been supplemented by regulatory prescriptions issued by the Reserve Bank from time to time for improving the standard of corporate governance in banks in India.

10.2 In particular, the following measures have been taken to improve the standard of corporate governance in banks in India:

(i) The Consultative Group of Directors of Banks/Financial Institutions (Chairman: Dr. Ashok Ganguly) set up in April 2002, looked into all the issues relating to the supervisory role of the boards of banks and made several recommendations for making

[9] Cross-referencing to other laws is not uncommon in the Indian context. For example, Income Tax Act refers and mandates compliance with several provisions of the Companies Act.

the role of BoD more effective with a view at minimising risk. The Report of the Dr. Ganguly Group was forwarded to all the banks in June 2002 by the Reserve Bank and they were advised to adopt and implement, based on the decision taken by their respective boards, the recommendations relating to: (i) responsibilities of the BoD, (ii) role and responsibilities of the independent/non-executive directors, (iii) training facilities for directors, (iv) submission of information to the board, (v) agenda and minutes of the board meetings, (vi) constitution of various committees of the board like Shareholders Grievance Redressal Committee, Risk Management Committee and Supervisory Committee, and (vii) disclosure and transparency.

(ii) Based on the recommendations of the Advisory Group on Banking Supervision, (Chairman: Shri M.S.Verma), banks were advised in June 2003 by the Reserve Bank to strengthen their risk management framework, review connected lending, prepare strategic business plans and ensure its percolation to the grass-root level as also to strengthen the internal control system.

(iii) Guidelines for acknowledgement of transfer/allotment of shares in private sector banks were issued by the Reserve Bank in February 2004, which envisaged that acknowledgement from the Reserve Bank for acquisition/transfer of shares would be required for all cases of acquisition of shares which would take the aggregate holding of an individual or group to the equivalent of 5 per cent or more of the paid-up capital of the bank. Further, it was indicated that in deciding whether or not to grant acknowledgement, the Reserve Bank would take into account, among other things, the aspect relating to 'fit and proper' status of the shareholders whose aggregate holdings are above the specified thresholds. It was also advised that for deciding the 'fit and proper' status of the applicant for an acknowledgement of transfer/allotment of shares, criteria such as integrity, reputation, track record in financial matters, compliance with tax laws, source of funds for the acquisition and where the applicant is a corporate body, its track record of reputation for operating in a manner that is consistent with the standards of good corporate governance, financial strength and integrity, in addition to assessment of individuals and other entities associated with the corporate body, would also be taken into account. Higher levels of scrutiny were also envisaged for acquisition or investment, which would take the shareholding of the applicant to higher levels (10 per cent or more).

(iv) All the banks in the private sector were advised by the Reserve Bank in June 2004 that they should undertake a process of 'due diligence' to determine the suitability of the persons for appointment/continuing to hold appointment as directors on the board, based upon qualifications, expertise, track record, integrity and other 'fit and proper' criteria. For this purpose, banks were advised to obtain a 'declaration and undertaking' in a prescribed format from the proposed/existing directors. Banks were also advised that the Nomination Committees of the Board should undertake this process of due diligence. All the banks in the private sector appear to have carried out the 'due diligence' exercise in respect of directors on their boards through the Nomination Committees, taking into account the information furnished by the directors in the 'declaration and undertaking' in the prescribed format.

Banks have also confirmed that they have undertaken an annual exercise to ascertain whether there is any change in the information already provided by the directors on their 'fit and proper' status and wherever there is any change, the requisite details have been furnished by the directors. Further, banks in the private sector were advised by the Reserve Bank in the above-mentioned circular, that the nominated/elected directors should execute a deed of covenant to discharge the responsibilities as directors to their best of abilities.

(v) The Government issued guidelines in September 2004 (which were modified in October 2006 and subsequently in November 2007) for appointment of non-official directors on the boards of nationalised banks, the SBI, the NABARD, NHB, *etc.,* which recommended that the suitability of nominees for the above appointment should be assessed in terms of formal qualifications and expertise, track record, integrity, *etc.* For assessing integrity and suitability, information on criminal records, financial position, civil actions undertaken to pursue personal debts, refusal of admission to or expulsion from professional bodies, sanctions applied by regulators and similar bodies and previous questionable business practices, *etc.,* would be relied upon. It also envisaged that persons with special academic training or practical experience in the fields of agriculture, rural economy, banking, co-operation, economics, business management, human resources, finance, law, marketing, industry and information technology may be considered.

(vi) SEBI circulated the revised Clause 49 of the Listing Agreement in October 2004 which was applicable to all the listed entities including listed banks. The revised Clause covers several aspects, which touch upon corporate governance issues such as: (i) composition of the board, (ii) directors' compensation and disclosures, (iii) role of independent directors, (iv) role and powers of the Audit Committee, (v) enhanced disclosure, and (vi) compliance. It was observed that the provisions of the revised Clause 49 were largely in tune with the various instructions issued by the Reserve Bank on corporate governance and as such the banks would not find it difficult to comply with the provisions of Clause 49.

(vii) The Reserve Bank issued guidelines on 'Ownership and Governance' in private sector banks in February 2005, which envisaged that ultimate ownership and control of private sector banks should be well-diversified, thereby minimising the risk of misuse or imprudent use of leveraged funds. Further, banks were advised that the important shareholders (shareholding of 5 per cent and above) should be 'fit and proper' as laid down in the Reserve Bank guidelines on acknowledgement for allotment and transfer of shares issued in February 2004. It was also reiterated to banks that the Directors and CEO who manage the affairs of the bank should be 'fit and proper' and

they should observe sound corporate governance principles. Further, banks were advised that, as a matter of desirable practice, not more than one member of a family or a close relative (as defined under Section 6 of the Companies Act, 1956) or an associate(partner, employee, director, *etc.*) should be on the board. The banks were also expected to ensure that they had minimum capital/net worth for optimal operations and systemic stability. In addition, it was expected that the policies and processes of banks are transparent and fair.

(viii) The Banking Companies (Acquisition and Transfer of Undertaking) Act, 1970/1980 were amended in October 2006 providing for introduction of 'fit and proper' criteria for directors elected in terms of Section 9 (3) (i) of the Act. *Based on the above amendment, the Reserve Bank has issued suitable guidelines to nationalised banks and associate banks of the SBI in November 2007.*

(ix) Keeping in view the recommendations of Ganguly Group, as also the best corporate governance practices, all private sector banks were advised by the Reserve Bank in May 2007 to have a part-time chairman of the BoD and a separate Chief Executive Officer/Managing Director who would be responsible for day-to-day management of the bank.

(x) In addition to the above, the Banking Regulation Act, 1949 contains certain provisions covering corporate governance aspects:

a. Not less than 50 per cent of BoD shall include persons with professional experience in areas like accountancy, agriculture and rural economy, banking, co-operation, economics, finance, law, small-scale industry or any other matter as specified by the Reserve Bank as useful [Section 10–A(2)(a)–Independent Directors];

b. No banking company incorporated in India shall have as a director in its BoD any person who is a director of any other banking company (Section 16 – Conflicts of Interests);

c. No banking company shall enter into any commitment for granting any loan or advance or advance to or on behalf of (i) any of its directors, (ii) any firm in which any of its directors has interest as partner, manager, employee or guarantor or (iii) any company of which any of the directors of the banking company is a director, managing agent, manager, employee or guarantor or in which he holds substantial interest, or (iv) any individual in respect of whom any of its directors is a partner or guarantor (Section 20 – Self-Dealing/Conflicts of Interests);

d. Power of the Reserve Bank to remove managerial and other persons from office (Section 36 AA) if it is felt that the affairs of the banking company are conducted in a manner detrimental to the interests of the depositor; and

e. Power of the Reserve Bank to appoint additional directors (Section 36 AB).

(xi) Incidentally, Basle Committee on Banking Supervision has published a document in February 2006 enumerating the following principles of corporate governance:

a. The board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank;

b. The BoD should approve and oversee the bank's strategic objectives and corporate values that are communicated throughout the banking organisation;

c. The BoD should set and enforce clear lines of responsibility and accountability throughout the organisation;

d. The BoD should ensure that there is appropriate oversight by senior management consistent with the board policy;

e. The board and senior management should effectively utilise the work conducted by internal audit function, external auditors and internal control functions;

f. The BoD should ensure that compensation policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy and control environment;

g. The bank should be governed in a transparent manner;

h. The BoD and senior management should understand the bank's operational structure, including where the bank operates in jurisdictions or through structures that impede transparency (*i.e.,* 'know-your-structure').

(xii) It is observed that the principles of corporate governance adopted by banks in India are largely in tune with the principles published by Basle Committee on Banking Supervision in February 2006.

11. Corporate Governance Assessment – Insurance Companies

11.1 All insurers are required to ensure compliance with corporate governance as per the provisions of the Companies Act, 1956. In addition, the insurers have to comply with the requirements of the Insurance Act, 1938 and the regulations framed thereunder. The various requirements stipulated by the Authority to ensure good governance in the management of affairs of the insurers and transparency in their operations *inter alia* cover such aspects as internal controls and processes; constitution of an investment committee, its duties and responsibilities; appointment of managerial personnel to meet the 'fit and proper' criteria subject to prior approval of the Authority; disclosure on payments made to individuals, firm, companies and organisations in which directors are interested; stipulation on appointment of joint auditors, their qualifications and rotation of auditors and format of the audit report; defined role of the appointed actuary; representation of the policyholders on the board; and provisions against commonality of interest through presence of similar directors in two insurance companies. The various accounting standards framed by the Institute of Chartered Accountants of India facilitate conformity with the accounting principles and disclosure of specified information has been stipulated to ensure transparency in operations.

11.2 In particular, the following measures have been taken to improve the standard of corporate governance in insurance companies in India:

(i) Capital Structure and Rights of Shareholders: At present, insurance companies are closely held. As such, the provisions applicable to listed companies are not applicable to them. However, the Insurance Act envisages that the domestic promoters of companies would be required to disinvest after ten years of the commencement of operations. It is expected that this obligation would act as a pre-determinant of governance requirements as applicable to listing companies at present. Section 6A(5) requires the beneficial shareholder to declare his interest to the company in the prescribed form (to be countersigned by the person in whose name the share is registered) where any shares of a company stand in the name of another person in the register of members of the company. This declaration is required to be made within 30 days from the date of acquisition of such an interest. All shareholders have access to the said register. Thus, the beneficial ownership is required to be disclosed. In addition, all the provisions of the Companies Act, 1956 apply as regards the maintenance of details of the beneficial shareholders.

(ii) Transferability of Shares: It is a pre-requisite for an insurance company to be a public limited company. Shares of the insurance companies are, however, not freely transferable in view of certain specific provisions in the Act, *viz.,* any transfer of 1 per cent and above of the paid-up equity requires the approval of the Authority. Where the transferee is likely to acquire 5 per cent or more (the threshold limit is lower at 2.5 per cent or more in case of a banking company), prior approval of the supervisor is required.

(iii) Shareholders/Promoters and Board:

(a) Fit and Proper stipulations: The insurance sector is capital intensive in nature with the minimum paid-up capital requirement of Rs.100 crore in case of life and non-life insurance companies; and Rs.200 crore in case of reinsurance companies. In addition, all insurance companies are required to maintain a solvency margin ratio of 1.5 at all times. The requirement for injection of additional capital is particularly significant in the case of the life insurance companies during the initial seven to ten years. Being unlisted public limited companies, the shareholders are expected to inject additional capital into the venture till such time as the operations of the company stabilise (which could be a period of 7 to 10 years). The promoter shareholders are very careful in the choice of the shareholders/promoters (both in the initial registration process and during the course of operations of the company) to ensure that they comply with the 'fit and proper' requirements.

(b) Board of Directors: The election and removal of members of the board is governed by the provisions of the Companies Act. In addition, the appointment of whole-time directors requires the approval of the supervisor. The Insurance Act also provides for removal of a director or CEO under specific conditions.

(c) Policyholders' representation on the board: There are specific provisions in the Act, which provide for the constitution of the board: (i) No insurance agent who solicits or procures life insurance business and no chief agent or special agent is eligible to be or remain a director of any insurance company carrying on life insurance business; and (ii) A life insurer shall not have a common director with another such insurer.

(iv) Share in the Profits of the Company: The provisions relating to distribution of the surplus of insurance companies are contained in two different legislations. In the case of a non-life insurance company, the applicable provisions are those under the Companies Act, 1956. In case of a life insurance company, provisions of Section 49 of the Insurance Act read with the

IRDA (Distribution of Surplus) Regulations, 2002 is applicable.

(v) Loans to Senior Management: No insurance company can grant loans or temporary advances, either on hypothecation of property or on personal security or otherwise, except loans on life policies issued by him within their surrender value, to any director, manager, managing agent, actuary, auditor or officer of the insurer of the company.

(vi) Borrowings: The legislation provides for raising of funds by insurance companies only through the equity share capital mode. These restrictions have been put in place because the sector was opened up only in 1999 and the supervisor has adopted a cautious approach on various prudential and regulatory issues. Options for providing other avenues for raising funds can be considered in due course.

(vii) Redressal Mechanisms for Stakeholders: IRDA (Protection of Policy-holders' Interest) Regulations, 2002 addresses various issues relating to protection of rights of policyholders. These regulations cover aspects from the point of sale up to settlement of claims. The other fora for redressal of grievances include the insurance ombudsman and consumer courts. With respect to other stakeholders, such as minority shareholders, the provisions of various corporate laws apply. An Appellate Authority has been set up under the Ministry of Finance to provide for the appeal by the insurance companies against the orders passed by the supervisor. There are special provisos which take care of the interest of the various stakeholders in case of restructuring/winding up of insurance companies. In cases where the Act is silent, the provisions of the corporate legislation are applicable.

(viii)Penal Provisions Applicable to Senior Management: The provisions of Sections 21 (1), 102, and 104 of the Insurance Act are applicable for calling for additional information from the senior management and for initiating penal action in case of default in complying with or acting in contravention with the provisions of the legislation. In addition, provisions of corporate laws are applicable in case of contravention of any provisions of the applicable legislations.

(ix) Furnishing Reports: Section 11(1) of the Insurance Act requires every insurer to prepare the balance sheet, revenue account, receipts and payments account and profit and loss account for each financial year. Insurance companies are required to consolidate their operations within and outside India to present the same in the Annual Report. The accounts and statements have to be signed by the Chairman, if any, two Directors and the Principal Officer[10] of the company. The Annual Report includes the directors' report; balance sheet; profit and loss account; cash flow statement; notes to the financial statements; auditors' Report; management report; management discussion and analysis; financial ratios and summary of financial statements for the last five years. Accounting Standards issued by ICAI are

[10] 'Principal Officer' means any person connected with the management of the company or any other person to whom the Authority has served notice of its intention of treating him as the principal officer thereof.

applicable to insurance companies to the extent indicated in the standards and also as indicated in IRDA regulations on preparation of financial statements. IRDA (Preparation of Financial Statements and Auditors' Report of Insurance Companies) Regulations, 2002 prescribe the formats for various financial statements to be submitted by life insurers and non-life insurers (including the re-insurer) separately. The various periodic reports required to be submitted by the insurance companies include: (i) Business underwritten details on monthly basis, (ii) Equity holding pattern on quarterly basis, (iii) Actuarial returns and solvency statements, (iv) Investment returns (also on a quarterly basis), and (v) Reinsurance returns.

The supervisor has recently stipulated quarterly submission of un-audited financial statements and solvency position effective December 2007.

(x) Audit: The accounts of insurance companies are required to be audited jointly by two audit firms annually. The norms for appointment of statutory auditors have been issued by the IRDA, which are required to be complied with by the insurance companies while appointing the statutory auditors. The norms prescribe the minimum number of partners in the audit firm and the educational/ professional qualifications and experience of the partners. As part of the corporate governance stipulations, an audit firm cannot be appointed/ continued for more than five consecutive years. No two audit firms can simultaneously carry on audit work for more than four years. An audit firm on completion of its tenure of five/four years as the case may be, is subject to a cooling-off period of two years during which period it cannot accept statutory audit assignment of the said insurance company for the next two years. The statutory auditors are required to file their audit report as per the format specified at Schedule C of IRDA Regulations on preparation of financial statements and auditors' report. Duties and audit procedures of statutory auditors of insurance companies are required to be compliant with the prescriptions laid down by the ICAI. The operating expenses schedule of the financial statements filed by the insurance companies requires specific disclosure of the requirement of the expenses incurred on the auditors including the auditors' fees, expenses, *etc.* as auditor; as adviser or in any other capacity, in respect of taxation matters, insurance matter, management services and in any other capacity.

Overall Assessment

11.3 While the various prescriptions on corporate governance are laid down in the various provisions of the insurance legislation and the regulations framed thereunder and the provisions of the corporate law are also applicable, there is a felt need for issuing comprehensive guidelines on corporate governance applicable to the insurance companies.

11.4 The supervisor is in the process of finalising the existing statutory and regulatory requirements on corporate governance under various provisions of the Insurance Act and the regulations framed thereunder into one comprehensive document. Care is being taken to align the existing principles and guidelines listed in the OECD guidelines and the IAIS documents and blending them with domestic practices and other statutory regulations for corporate entities.

12. Recommendations: The Way Forward

12.1 The last decade has seen extensive activity on the corporate governance front. Its importance is increasingly being recognised, Corporate governance norms are becoming an integral part of the corporate framework. While, to a certain extent, better compliance will be driven by the more stringent enforcement of regulations, the momentum will come from the

forces of competition and demand for low-cost capital.

12.2 Indian corporate sector is becoming increasingly significant in the global context. In the service sector, Indian companies have been able to establish themselves as key players especially in sectors such as information technology, BPO and finance. India has emerged as a manufacturing base for international corporations. Also, Indian companies have made significant acquisitions of entities abroad. With these developments, the Indian corporate sector would be under increasing scrutiny from various potential stakeholders at the global level. Therefore, quality of corporate governance in these companies would be a key determinant affecting their ability to attract capital, business, global partners and quality manpower. Good corporate governance in such companies is likely to be emulated by other corporates, thereby enhancing overall levels of corporate governance in India.

12.3 Some evidence of this emerging phenomenon is already visible in corporate India with new companies aggressively being managed by a new generation of professionals who place a great deal of value on corporate governance and transparency – if not for self-interest but as an instrument for obtaining access to cheaper capital. Therefore, such companies are more than willing to have members who are true professionals on their boards and voluntarily follow disclosure standards that measure up to the best in the world. The capital market also substantiates this by putting premium on the valuations of such companies. The concept of sustainable development has been taken in the right earnest by some of these companies and has been integrated in their business plans.

12.4 As regards the enabling framework, it is evident that the initiatives taken by the Government/regulators have raised corporate governance standards in India at par with the best in the world. The policy framework is mostly in place and the compliance has also been increasing. At the same time, there are certain areas, as identified in the assessment where more needs to be done. In our view, steps on the following lines would strengthen the corporate governance framework:

(i) Investor education can play a key role in spreading awareness about exercise of their rights and impact on board governance. Work in this direction is already being done by the various concerned authorities, which needs to be taken up on a larger scale and reach. A co-ordinated approach amongst authorities can further enhance effectiveness of efforts in this direction (refer Principle IIC and IIIA).

(ii) It has been observed that presently the participation by shareholders in decision-making is somewhat constrained due to their inability to be present for the AGM/EGMs, lack of understanding about issues, absence of co-ordination amongst themselves due to their dispersed geographical spread (refer Principle IIC). Certain steps like introduction of postal ballot for voting for some decisions, provision for proxy voting, *etc.* have already been taken to obviate the need for

physical presence of the shareholders. Following measures can also be considered to ensure greater shareholder participation:

a. holding of AGM at a place where majority of shareholders are resident;
b. explore alternate methods for voting which are convenient to shareholders (refer Principle IIC);
c. investor associations can play an active role in providing a platform for co-ordination amongst investors. There is a need to have a larger number of credible investor associations and encourage interaction amongst them. At the same time, there should be checks in place to avoid misuse of such forums.

(iii) Institutional investors need to be encouraged to declare their voting policy and to effectively participate in the corporate decision-making. Institutional investors are expected to have better knowledge and understanding of affairs of the company. There is a need to initiate dialogue with the industry to develop the awareness about the contribution that institutional investors can make in the corporate governance of a portfolio company. Possibility of stipulating specific requirements either as good practice or mandatory requirements may be explored (refer Principle IIF, IIG).

(iv) The present corporate governance framework for the listed companies attaches a lot of importance to the role of independent directors. However, there are no mandatory requirement pertaining to the tenure of their directorship. It is felt that to ensure that the independence of independent directors is maintained in spirit, an upper limit on the tenure of independent directors should be provided for in the law. Further, the definition of independent directors could be included in corporate law in due course (refer Principle VIE).

(v) Credible institutional mechanism for the training of directors including the independent directors needs to be created on a priority basis. It is noted that steps have already been initiated in this regard by Ministry of Corporate Affairs as well as SEBI. ICAI and ICSI which are playing a crucial role in addressing this requirement (refer Principle VID).

(vi) To address concerns regarding ownership through cross holding and opaque, non-transparent structures (refer Principle IID), there is a need for strengthening disclosure norms to bring about greater transparency in ownership structures. Further, stringent penal action needs to be enforced whenever such undesirable practices are unearthed.

(vii) There is a need for strengthening the enforcement mechanism by focusing on the efforts of tracking of defaulters or non-compliance by the corporate. These would act as deterrent for future non-compliance and also boost the confidence of the investors in the system.

(viii) Various provisions have been incorporated both under the Companies Act and the Listing Agreement to address conflict of interest issue in related party transactions. Information pertaining to material related party transactions is required to be in public domain. As a further step, appropriate penalties may be provided for in the law for non-compliance pertaining to related party transactions (refer Principle VID).

(ix) Penal provisions for fraudsters may be strengthened in corporate law by

providing for the disgorgement of gains and confiscation of assets.

(x) India today boasts of a robust regulatory framework. There are, however, bottlenecks due to delays in the judicial process. The liquidation process is time-consuming and lengthy, thereby, hardly leaving any effective remedy for the stakeholders other than secured creditors. It has been observed that setting up of dedicated courts for certain areas has led to expeditious disposal of cases. Therefore, an effective institutional mechanism for time-bound resolution of cases needs to be created urgently (refer Principle IVB).

(xi) There is a need for evolving a corporate governance code for unlisted companies. This can take two forms:

- Unlisted companies can voluntarily evolve and adopt a code of corporate governance. Trade associations like CII, FICCI and ASSOCHAM can play an important role in this regard.
- A separate Corporate Governance Code for unlisted companies may be brought out under the Companies Act, by the Ministry of Corporate Affairs which takes into account the interest of stakeholders in such companies. The Ministry can also consider mandating, in respect of unlisted companies of above a particular size, compliance with applicable provisions of Clause 49 of Listing Agreement. Companies Act would need amendment in this regard (refer Principle IA).

(xii) In the case of mergers and amalgamations, role and responsibility of Ministry of Corporate Affairs *vis-à-vis* courts may be reviewed, particularly with reference to valuation and interest of minority shareholders.

(xiii) In terms of the recommendations made by Narayana Murthy Committee, certain requirements of Clause 49 of the Listing Agreement were non-mandatory. It was probably hoped that many companies would move, over time, towards complying with the non-mandatory requirements. Four years have lapsed since the recommendations of the Committee were implemented. At present, the listed companies are required to disclose the extent to which the non-mandatory requirements have been adopted. It is recommended that the listed companies may be required to also disclose the reasons for non-compliance with non-mandatory requirements (refer Principle VID).

(xiv) Presently, in terms of Clause 49 of the Listing Agreement, the requirement to establish whistle-blower mechanism is not mandatory and depends on discretion of the companies. Four years have passed since this non-mandatory requirement was introduced. It may, therefore, be worthwhile to gather information on the experience of the companies which chose to implement this mechanism so far and consider further course of policy change, if any, in this area (refer Principle IVE).

(xv) Recent developments in the derivatives market have brought to the forefront the

importance of risk management. There is a need for strengthening the existing framework with regard to risk management in the listed companies. Introducing the requirement of having Risk Committees in the Listing Agreement can be specifically explored in this regard (refer Principle VID).

(xvi) There is a need for greater disclosure and publicity of CSR (corporate social responsibility) initiatives by the corporate sector. This would put peer pressure on companies inactive in this area. Industry groups and chambers of commerce like FICCI and CII can play an important role in this regard (refer Principle IVA).

(xvii) Impact of the new Competition Act on the markets for corporate control needs to be studied and suitable action taken to ensure that such markets function in an efficient and transparent manner (refer Principle IIE).

(xviii) While international practices and developments have apparently been factored into the evolution of corporate governance framework in India, it is essential that learning from the experience of other countries should be a dynamic process and not a static one. The corporate governance code should be constantly reviewed in light of the ever-changing global scenario.

Appendix I

Recommendations of Various Committees

CII Code on Corporate Governance

(i) Any listed company with a turnover of Rs.100 crore and above should have professionally competent, independent, non-executive directors, who should constitute at least 30 per cent of the board if the chairman of the company is a non-executive director or at least 50 per cent of the board if the chairman and managing director is the same person.

(ii) No single person should hold directorships in more than 10 listed companies.

(iii) Audit committees consisting of at least three members, all drawn from a company's non-executive directors, who should have adequate knowledge of finance, accounts and basic elements of company law, should be constituted.

(iv) Non-financial disclosures were recommended by the Working Group on the Companies Act. A comprehensive Report on the relatives of directors–either as employees or board members–would be an integral part of the directors' Report of all listed companies. Details of loans to directors should be disclosed as an annex to the directors' Report in addition to being a part of the schedules of the financial statements. A compliance certificate, indicating that the requirements under the Companies Act have been adhered to, should be part of Annual Report.

(v) Financial disclosures recommended by the Working Group were a tabular form containing details of each director's remuneration and commission as a part of the directors' report.

(vi) Costs incurred, if any, in using the services of a group resource company must be clearly and separately disclosed in the financial statement of the user company.

(vii) A listed company must give information on its divisions or business segments as a part of the directors' report in the Annual Report.

(viii) Where a company had raised funds from the public by issuing shares, debentures or other securities, it would have to give a separate statement showing the end-use of such funds. This disclosure would be in the balance sheet as a separate note forming a part of accounts.

(ix) Major Indian stock exchanges should gradually insist upon a compliance certificate, signed by the CEO and the CFO, with regard to the fairness of the financial statements.

The Code was adopted by over 25 leading companies between 1998 and 2000.

Kumar Mangalam Birla Committee Report

In 1997, the Kumar Mangalam Birla Committee constituted by SEBI designed a mandatory-cum-recommendatory code for listed companies on a rollout plan. SEBI implemented

the recommendations of the Birla Committee through the enactment of Clause 49 in the Listing Agreement in the year 2000. This clause has served as a milestone in the evolution of corporate governance practices in India. The important mandatory recommendations were:

(i) Board of a company to have an optimum combination of executive and non-executive Directors with not less than 50 per cent of the board comprising the non-executive directors.

(ii) Setting up of an audit committee-The constitution, powers and functions of the audit committee were laid out in detail to facilitate effective control and functioning.

(iii) The BoD should decide the remuneration of the non-executive directors. Full disclosure should be made to the shareholders regarding the remuneration package of all the directors.

(iv) Board meetings to be held at least four times a year. A director should not be a member in more than ten committees or act as the chairman of more than five committees across all companies in which he is a director.

(v) Management discussion and analysis reports should form part of the Annual Report to the shareholders, as part of the directors' report or as an addition thereto.

(vi) In the case of the appointment of a new director or re-appointment of a director, shareholders must be provided with a brief resume of the director, his expertise and the names of companies in which the person also holds directorship and the membership of committees of the board.

(vii) A board committee to be formed to look into the redressal of shareholders' complaints like transfer of shares, non-receipt of balance sheet, dividend, *etc.*

(viii) Information like quarterly results, presentation made by companies to analysts to be put on company's website or sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own website.

(ix) Enforcement of accounting standards, strengthening the obligation to make more disclosures in annual financial reports.

(x) The management to make disclosures to the board relating to all material, financial and commercial transactions, where they have personal interest that may have a potential conflict with the interest of the company at large.

(xi) There would be a separate section on corporate governance in the Annual Reports of the companies with a detailed compliance report.

Some of the non-mandatory recommendations were:

(i) Board to set up a remuneration committee to determine the company's policy on specific remuneration packages for executive directors.

(ii) Half-yearly declaration of financial performance including summary of the significant events to be sent to each shareholder.

(iii) Non-executive chairman would be entitled to maintain a chairman's office at the company's expense and also allowed reimbursement of expenses incurred in performance of his duties. This would enable the discharge of responsibilities effectively.

Naresh Chandra Committee Report

In 2002, the Naresh Chandra Committee on Corporate Audit and Governance submitted its Report with the following recommendations:

(i) Ensure the independence of auditors by laying down certain restrictions on rendering of non-audit services and over exposure or dependency on one client.

(ii) Rotation of audit firms: The Committee recommended compulsory audit partner rotation. There is no need to legislate in favour of compulsory rotation of audit firms. However, the partners and at least 50 per cent of the engagement team (excluding article clerks and trainees) should be rotated every five years. Also, persons who are compulsorily rotated could, if need be, allowed to return after a break of three years.

(iii) Setting up of independent quality review board through legislative action and also provide for a peer review system within the ICAI. Further, it recommended expeditious disciplinary action against errant auditors.

(iv) Management certification regarding auditor's replacement.

(v) Appointment, remuneration of auditors (not applicable to scheduled banks and government companies) to be recommended by the audit committee.

(vi) Certification of annual audited accounts by CEO and CFO.

(vii) Setting up of a corporate Serious Fraud Office.

(viii) Strengthening of disciplinary mechanism for professional misconduct against auditors.

(ix) Setting up of an independent regulator similar to the Public Company Accounting Oversight Board as per the Sarbanes Oxley Act.

(x) The role of independent directors, and how their independence and effectiveness be ensured.

Narayana Murthy Committee Report

Subsequently, in order to review the existing corporate governance code, SEBI constituted the Narayana Murthy Committee based on whose recommendations made in 2003, the following far-reaching changes were made in the Listing Agreement in 2004:

(i) Definition of independent director expanded to exclude persons related to promoters, occupying management positions at the board level and one level below executives, in the preceding three financial years.

(ii) Associate, senior management, relative, nominee directors defined.

(iii) Requirement of previous approval of shareholders for remuneration (including limit for maximum number of stock-options) to non-executive directors stipulated.

(iv) Meaning of directorship, for the purpose of considering the limit of committees on which a director can serve, explained.

(v) Requirement of code of conduct (to be laid down by board) for board members, senior management and affirmation regarding compliance by the said persons and declaration to this effect by CEO in Annual Report stipulated.

(vi) At least 2/3rd of members of the audit committee to be independent directors

(earlier majority were to be independent directors). The term 'financially literate' should be defined. Audit committee to meet at least four times a year in place of earlier requirement of thrice in a year.

(vii) Role of audit committee be expanded to include reviewing, with the management, the annual financial statements before submission to the board for approval.

(viii) At least one independent director on the BoD of the holding company to be a director on the BoD of a material non-listed Indian subsidiary company.

(ix) Requirement now to disclose any treatment different from that prescribed in accounting standards in preparation of financial statements together with the management's explanation.

(x) Uses/application of funds raised through an issue, by major category, on quarterly basis to be disclosed to the Audit committee which, in turn, is to make appropriate recommendation.

(xi) All pecuniary relationship of non-executive directors *vis-à-vis* the company, to be disclosed in the Annual Report. Non-executive Directors to disclose, in the general meeting, their shareholding in the listed company in which they are proposed to be appointed as directors, prior to their appointment.

(xii) CEO/CFO certification confirming the review of financial statements, no fraudulent, illegal transaction violative of company's code of conduct entered into and the responsibility for establishing and maintaining internal control for financial reporting.

(xiii) Companies to submit a quarterly compliance report to stock exchanges, signed by CEO/Compliance Officer. Compliance with mandatory requirements, adoption (and compliances)/non-adoption of the non-mandatory requirements to be disclosed in the annual report.

The following were the non-mandatory requirements:

(i) *Audit qualification:* Move towards a regime of unqualified financial statements.

(ii) *Training of board members.*

(iii) *Mechanism for evaluation of non-executive members:* Performance evaluation by peer group comprising the entire BoD excluding the director being evaluated.

(iv) *Whistle-blower Policy:* Mechanism for employees to report to the management unethical behavior. Safeguards against victimisation.

Irani Committee Report

The Ministry of Corporate Affairs also constituted an Expert Committee on Company Law under the chairmanship of Dr. J. J. Irani which released its Report in May 2005 with the following recommendations:

(i) Company law should enable self-regulation and impose greater accountability through disclosures and speedy administration of sanctions.

(ii) The law should consider the requirements of different kinds of companies while prescribing the corporate governance structure for them.

(iii) The law should recognise one-person companies by giving them a simpler legal regime.

(iv) No restriction on the number of subsidiary companies.

(v) Limited liability partnerships should be facilitated through a separate enactment.

(vi) Strict action to be taken against companies, which vanish with the

investors funds, by taking suitable measures in the registration process itself, and thereafter a regular regime of filing of documents. The power to disgorge the ill-gotten gains and lifting of corporate veil to be given to the registering authorities.

(vii) Law should recognise the principle of independent directors and spell out their attributes, role, qualifications, liability and manner of appointment along with the criterion for independence. The number and proportion of such directors in the board may vary depending upon the size and type of company.

(viii) Decision on remuneration of directors not to be based on a Government approval system.

(ix) Basic duties of directors to be specified in the Act in an inclusive manner.

(x) Conditions for disqualifications of directors should also be specified in the Act itself.

(xi) The use of postal ballot during meetings of members should be allowed to be used widely. AGMs may be held at a place where at least 105 members reside.

(xii) Strict disclosure norms and approval of board/shareholders in case of related party transactions.

(xiii) Minority and minority interest should be defined in the substantive law itself.

(xiv) Law should recognise shareholders interest by providing for class action and derivative actions.

(xv) Certification by CEOs and CFOs of financial statements. All directors to sign the financial statements. Dissemination of accounts through the website for the investors.

(xvi) Small companies should be given exemption or at least some relaxation in respect of disclosure requirements.

(xvii) Restriction on auditors for providing non-audit services.

(xviii) Valuation of shares of companies involved in mergers and acquisition by independent registered valuers to be made mandatory.

Ashok Ganguly Committee Report

The Consultative Group of Directors of banks and FIs set up under Chairmanship of Dr. Ashok Ganguly by the Reserve Bank to review the supervisory role of boards submitted its Report in April 2002 with the following recommendations:

Recommendations applicable to all banks

(i) *Responsibilities of the Board of Directors:* A strong corporate board should fulfil the following four major roles, *viz.,* overseeing the risk profile of the bank, monitoring the integrity of its business and control mechanisms, ensuring the expert management, and maximising the interests of its stakeholders.

(ii) *Role and responsibility of independent and non-executive directors:* The independent/non-executive directors have a prominent role in inducting and sustaining a pro-active governance

framework in banks. It would be desirable for the banks to take an undertaking from each independent and non-executive director to the effect that he/she has gone through the guidelines defining the role and responsibilities and enter into covenant to discharge his/her responsibilities to the best of their abilities, individually and collectively. A model form of 'deed of covenants with a director' is provided in the Consultative Group's Report.

(iii) *Training facilities for directors:* Need-based training programmes/seminars/ workshops may be designed by banks to acquaint their directors with emerging developments/challenges facing the banking sector and participation in such programmes could make the directors more sensitive to their role.

(iv) The board should ensure that the directors are exposed to the latest managerial techniques, technological developments in banks and financial markets, risk management systems, *etc.* so as to discharge their duties to the best of their abilities.

Committees of the Board

(i) Banks should set up the following Committees: (a) Shareholders' Grievance Redressal Committee. (b) Risk Management Committee. (c) Supervisory Committee.

Disclosure and Transparency

The following disclosures should be made by banks to the Board of Directors at regular intervals as may be prescribed by the board in this regard:

(i) progress made in putting in place a progressive risk management system, and risk management policy and strategy followed by the bank.

(ii) exposures to related entities of the bank, *viz.,* details of lending to/investment in subsidiaries, the asset classification of such lending/investment, *etc.*

(iii) conformity with corporate governance standards, *viz.,* in composition of various committees, their role and functions, periodicity of the meetings and compliance with coverage and review functions, *etc.*

Recommendations applicable only to private sector banks

Eligibility criteria and 'fit and proper' norms for nomination of directors: The board of directors of the banks while nominating/co-opting directors should be guided by certain broad 'fit and proper' norms for directors, *viz.,* formal qualification, experience, track record, integrity *etc.* For assessing integrity and suitability features like criminal records, financial position, civil actions initiated to pursue personal debts, refusal of admission to or expulsion from professional bodies, sanctions applied by regulators or similar bodies, previous questionable business practices, *etc.,* should be considered. The board of directors may, therefore, evolve appropriate systems for ensuring 'fit and proper' norms for directors, which may include calling for information by way of self-declaration, verification reports from market, *etc.*

Appendix II

Detailed Assessment of Corporate Governance

I: Ensuring the Basis for an Effective Corporate Governance Framework

The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

Principle IA: The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets.

Earlier Assessment: Not Available

Current Position:

i. There is a comprehensive corporate governance framework in India for listed companies. All companies are governed by the Companies Act, which deals with various aspects like types of companies, incorporation of companies, management and administration of the companies, board of directors, issuance of capital, corporate restructuring, minority shareholder protection, revival and rehabilitation of sick companies, winding up and dissolution of companies, *etc.*

ii. The SEBI is the apex securities market regulator with a mandate to protect the interest of investors and develop and regulate the securities market under SEBI Act 1992. SEBI has, since its inception, led the securities market reforms in the country. Various initiatives of SEBI like dematerialisation, rolling settlement, comprehensive risk management framework, elaborate disclosure standards, introduction of derivatives, corporate governance norms, *etc.*, have contributed a great deal in enhancing the market integrity apart from making the markets efficient and transparent.

iii. SCRA and SCRR regulate transactions in securities. Listing agreement has also emerged as an important component of the corporate governance framework. Depositories Act, 1996 facilitated dematerialisation and paperless trading.

iv. For banking and insurance sectors, there are specific statutes, *i.e.*, Banking Regulations Act, 1949 and Insurance Act, 1938, Insurance Regulatory Development Authority Act, 1999, LIC Act, GIC Act and Insurance Act, respectively.

Banks

i. The Reserve Bank is an autonomous statutory body established under an Act of Parliament, *i.e.*, RBI Act, 1934. The objectives for establishing the Reserve Bank as given in the Preamble to the RBI Act are regulation of the issue of bank notes and the keeping of reserves with a

view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage.

ii. The general superintendence and direction of the affairs and business of the Reserve Bank is entrusted to an independent Central Board of Directors headed by the Governor.

iii. The Central Board would consist of a Governor, not more than four Deputy Governors, four directors to be nominated by the Central Government, one from each of the Local Boards, ten directors to be nominated by the Central Government and one Government official to be nominated by the Central Government.

iv. In terms of the powers conferred on it under the provisions of the Banking Regulation Act, 1949 the Reserve Bank has the powers for regulating and supervising banks.

v. The regulatory and supervisory powers relate to:

(a) the forms of business in which the banking companies may engage in (Section 6);

(b) licensing of banking companies (Section 22);

(c) restriction on opening of new banks and transfer of existing places of business by banks (Section 23);

(d) powers to inspect banks (Section 35);

(e) powers to give directions to banks in public interest and in the interest of banking policy (Section 35A);

(f) control over management of banking companies, including the power of the Reserve Bank to approve the appointment/terms of appointment Chairman/Chief Executive Officer of the banking company (Section 35B);

(g) prescription of minimum paid-up capital and reserves for banks (Section 11);

(h) prescription of Cash Reserve Ratio (Section 18);

(i) prescription of maintenance of percentage of assets as Statutory Liquidity Ratio (Section 24);

(j) regulations relating to publication of accounts and balance sheet (Section 29 and Section 31);

(k) appointment of auditors (Section 30); and

(l) punitive measures (Section 47A)

While regulating banks, the Reserve Bank ensures that there is a consultative process with the regulated entities (banks/NBFCs, *etc.*) before issuing various policy guidelines/circulars.

Present Assessment: Broadly Implemented

Overall Comments: Corporate governance has received a lot of focus from the concerned authorities in the last decade. As a result, a comprehensive corporate governance framework has been put in place for listed companies. The significance of good corporate governance and its linkages with capacity to attract investment is being increasingly recognised by the Indian corporate sector. While a strong corporate governance framework for listed companies has been provided for, there is apparently need for enhancing the focus on other sectors (*e.g.* unlisted companies) to strengthen the overall system.

Principle IB: The legal and regulatory requirements that affect corporate governance practices in a jurisdiction should be consistent with the rule of law, transparent and enforceable.

Earlier Assessment: Not Available

Current Position:

i. Companies Act has various provisions pertaining to corporate governance such as, mandatory Directors Responsibility Statement in the directors' report, requirement of audit committees in companies exceeding a certain size, providing facility of postal ballot in voting by shareholders on certain matters, *etc.* RoCs can initiate prosecution for non-filing of compliances.

ii. Clause 49 of the listing agreement, which is applicable to all listed companies, stipulates elaborate provisions pertaining to composition of BoD, appointment of independent directors, constitution of audit committee, disclosures in annual reports, subsidiary companies, code of conduct, CEO/CFO certifications, quarterly report on corporate governance, *etc.* to ensure high standards of corporate governance. Incidentally, for the quarter ended September 30, 2007 out of 1,295 companies listed at NSE, 1,210 companies had submitted their corporate governance report with the NSE. At BSE, 2,848 companies out of 4,162[11] companies had submitted similar reports with the BSE for the quarter ended September 30, 2007. Violation of listing agreement can attract severe financial penalties and also makes the company liable for prosecution.

iii. Clause 49 is applicable to all listed banks to the extent that it is not in violation of the provisions of Banking Regulation Act, 1949 as also the various guidelines issued by the Reserve Bank, the regulator for banks. Further, with respect to banks, based on the recommendations of the Consultative Group of Directors of Banks/FIs (Dr.Ganguly Group) which looked into the entire gamut of issues relating to corporate governance in banks and FIs, the Reserve Bank has issued a detailed circular No.DBOD.BC116/08.139.001/2001-2002 dated June 20, 2002 to all scheduled commercial banks (except foreign banks, RRBs and Local Area Banks). In terms of this circular, banks have been advised that they may place the Report of the Group as well as the list of recommendations enclosed to the circular before the BoD of the bank and based on the decision taken by the board, the recommendations can be adopted and implemented by the bank.

iv. Also in the case of private sector banks, separate circular/directive have been issued on June 25, 2004 on 'fit and proper' status of the directors of such banks. Also, guidelines on 'ownership and governance' have been issued to private sector banks in February 2005 in terms of which important shareholders (*i.e.,* shareholding of 5 per cent and above) are 'fit and proper' as laid down in the guidelines dated February 3, 2004 on acknowledgement for allotment and transfer of shares.

[11] Out of 1,314 companies which have not submitted their Report, 1,116 are suspended for trading. (Source: BSE)

Present Assessment: Fully Implemented

Overall Comments: Various legal and regulatory requirements pertaining to corporate governance are consistent with the rule of law and are in public domain. The requirements are of two kinds: mandatory and non-mandatory. The mandatory requirements are enforceable.

Principle IC: The division of responsibilities among different authorities in a jurisdiction should be clearly articulated and ensure that the public interest is served.

Earlier Assessment: Not Available

Current Position:

i. All companies, incorporated in India have to file their fundamental documents (such as bye-laws, initial directors, shareholder registry) with Registrar of Companies (RoCs), which come under the Ministry of Corporate Affairs (MCA). Listed companies are additionally required to file the documents as provided by the listing agreement/Insider Regulations/ Takeover Regulation/other regulations as may be applicable with the stock exchanges where they are listed. RoCs are empowered to prosecute a company in case of non-compliance. Similarly, stock exchanges can suspend trading, delist and also initiate prosecution proceedings for non-compliance by listed companies.

ii. The provisions of the Companies Act, 1956 which relate to management and administration of companies and minority shareholder protection are administered by the Central Government. Therefore, the powers relating to protection of shareholders in that regard is vested with the MCA. The MCA has power to file a petition on behalf of minority shareholders before the Company Law Board in cases of alleged oppression and mismanagement (s.401), appoint additional directors for prevention of oppression or mismanagement subject to approval of the Company Law Board (s. 408), power to remove managerial personnel in certain exceptional cases (s. 388B), *etc.* SEBI, however, has general powers to pass directions against listed companies or responsible persons in the interest of investors or the orderly development of securities market under Section 11B of the SEBI Act, 1992 and Section 12A of the Securities Contracts (Regulation) Act, 1956.

iii. The securities market intermediaries and depositories are totally under the oversight of SEBI under provisions of the SEBI Act, 1992 and Depositories Act, 1996. As far as stock exchanges are concerned, under provisions of the Securities Contracts (Regulation) Act, 1956 some regulatory roles are assigned to SEBI, while others are with the Central Government. Out of the functions of Central Government mentioned in that Act, most have been delegated by the Central Government to SEBI. Thus, effectively SEBI exercises almost total oversight over the stock exchanges. SEBI also has elaborate responsibility in matters of IPOs, further offerings by listed companies, policy-making in respect of secondary market, market misconduct, insider trading, substantial acquisition of shares and takeovers of listed companies, *etc.* SEBI also has statutory obligations to develop the securities market and protect the interest of investors. Secondary market trades on stock exchanges are governed by bye-laws of the stock exchanges under overall policy laid down by SEBI. Secondary market trades in government securities, money market instruments, ready forward contracts in debt securities, gold-related securities, *etc.,* which are not done through stock exchanges are regulated by the Reserve Bank in exercise of delegated powers under the Securities Contracts (Regulation) Act, 1956.

iv. SEBI administers certain enumerated provisions of the Companies Act, 1956 relating to issue of capital, transfer of securities and non-payment of dividend in respect of listed companies and companies which intend to get their securities listed.

v. The Reserve Bank is the regulator in respect of banking sector and IRDA is the regulator for insurance companies.

vi. There is co-ordination among various regulatory bodies like Registrars of Companies, Ministry of Corporate Affairs, SEBI, Reserve Bank, *etc.* The High Level Co-ordination Committee for Financial Markets (HLCCFM) provides a forum for co-ordination between SEBI, Reserve Bank and IRDA. Further, there is exchange of information between SEBI, Reserve Bank and IRDA through RBI-SEBI Technical Committee (convened by DBOD, Reserve Bank) as also Committee for RBI/SEBI/IRDA regulated entities (convened by DBS, Reserve Bank). Whenever any Reserve Bank regulated entity approaches SEBI for undertaking any activity which comes under the ambit of SEBI's regulation, SEBI seeks information from the Reserve Bank about the track record of the entity, in terms of regulatory and supervisory comfort. Similarly, whenever any RBI-regulated entity approaches IRDA for undertaking insurance business, IRDA seeks feedback from Reserve Bank on such entity.

vii. Section 11(2)(ia) of the SEBI Act enables SEBI to seek and share information with other regulators.

viii. Owing to the close co-ordination and constant exchange of information between the various agencies, there is a consultative approach in ensuring enforcement.

Present Assessment: Fully Implemented

Overall Comments: By and large, jurisdictions and roles of various regulators are clearly defined. Further, regulators interact through co-ordinating mechanisms like HLCCFM to take stock of developments in the financial system. These interactions also enable steps towards plugging of regulatory gaps in the system.

Principle ID: Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfill their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained.

Earlier Assessment: Not Available

Current Position:

1. SEBI is an autonomous statutory body established under SEBI Act, 1992. There are requirements stipulated under the act to ensure that the members of the board are persons of ability, integrity with special knowledge and experience in the relevant areas. The board also has representation from Ministry of Corporate Affairs, the Ministry of Finance and the

Reserve Bank. Rules are made by the Central Government under SEBI Act and Securities Contracts (Regulation) Act. The Central Government invariably consults SEBI before moving *suo moto* legislation/amendments in the field of securities laws. Regulations made by SEBI contain most of the substantive matters concerning securities market intermediaries, market misconduct, *etc.* All expenses of the board are met through the fees and charges received from intermediaries. As a matter of practice, all the regulations and major proposals are generally posted for public comments before finalisation.

2. SEBI has comprehensive investigation and enforcement powers under SEBI Act. The powers are wide enough to include registered entities and persons associated with securities market. Enforcement actions are carried out in a transparent manner after giving due opportunity to the party concerned to represent. SEBI also has enforcement powers under SCRA.

3. For taking actions, such as those under Sections 11, 11B or 11D of SEBI Act, the Chairman or whole-time member is the competent authority to take action after following principles of natural justice.

4. There is a provision for appeal against orders of the board and of the Adjudicating Officers to the Securities Appellate Tribunal under Section 15T of the SEBI Act. Second appeal lies on question of law to the Supreme Court of India.

5. The SEBI (self-regulatory organisations) Regulations, 2004 contemplate formation of SROs representing particular segments of the securities market and their recognition by SEBI, to facilitate better oversight and enforcement.

6. The Ministry of Corporate Affairs has launched an elaborate electronic compliance management system which enables electronic filing of documents by the companies in a 24x7 time-frame. It enables not only registration and incorporation of companies but also filing of documents and annual returns online. The electronic system enables the Registrar of Companies to monitor compliance by the corporates and also provides online access to the users of the information.

7. The Company Law Board (CLB) is an independent quasi-judicial body which is available as an effective and viable forum to redress any grievance of operations and mismanagement of the minority shareholders.

Insurance

- The Supervisory Authority: Insurance Regulatory and Development Authority (IRDA) is an autonomous body formed under an Act of Parliament, *viz.,* Insurance Regulatory and Development Authority Act, 1999. The Insurance Act, 1938 and the Regulations framed thereunder lay down the regulatory framework for supervision of the entities operating in the sector.
- The objective of supervision as stated in the preamble to the IRDA Act is to protect the interests of holders of insurance policies, to regulate, promote and ensure orderly growth of the insurance industry.
- The structure of IRDA is defined in the IRDA Act, 1999 which provides that the Authority shall consist of the Chairperson; not more than five whole-time members and not more than four part-time members. The members of the Authority are appointed by the Central Government, and must have expertise and knowledge in the specified fields, *viz.,* life insurance, general insurance, actuarial science, finance, economics, law, accountancy and administration.

- Powers and Functions: The powers and functions of the Authority are laid down in the legislation governing the insurance sector. In addition, the powers vesting with the Central Government and the Controller of Insurance (at the time of opening up of the sector) have been transferred to the Authority through amendments made in the Insurance Act, 1938.
- The Chairperson has the powers of general superintendence and direction in respect of all administrative matters of the IRDA. The policy-level decisions are taken by the Authority by a majority of votes. The Chairperson of IRDA is appointed by the Cabinet Committee on Appointments. The Committee is headed by the Prime Minister. The Central Government reserves the right to remove any member from office under specified conditions. However, no member shall be removed for reasons of abuse of office or for being in the position which is likely to prejudice his functioning, without being given a reasonable opportunity to be heard.
- Section 14(2) of the IRDA Act, and Sections 34 and 114A of the Insurance Act deal with the powers vested in the Authority. The legislative framework provides the powers to the supervisor to lay down the prescriptions on operational matters through notification of Regulations/Circulars/Guidelines. The legislation also vests the supervisor with the powers to enforce observance of the law and the regulations framed thereunder.
- The supervisor is equipped with adequate powers under the Act to order an investigation into the affairs of any insurance company. Based on the report filed with it, the Authority can, after giving due opportunity to the insurer to be heard, issue any directions as it may deem fit, including cancellation of registration or even to apply for winding up of the insurer.
- The regulatory framework provides for registration of insurance companies, maintenance of solvency margin, investments and reporting requirements on financial and actuarial matters. The Authority has also issued regulations on licensing of agents, corporate agents, brokers, and third-party administrators. Keeping in view its developmental role, regulatory framework has been established for protection of the interests of policyholders and laying down the obligations towards the rural and social sectors.
- Financial Independence: The funds requirements of IRDA are met from the various 'Fees' received from the insurance companies and intermediaries. The supervisor has the requisite financial independence while carrying out its supervisory functions; and it does not rely upon Government/other grants to finance its activities. The IRDA's budgetary allocations are approved by its board and it has complete discretion in the manner of utilisation of its resources to meet its expenses or for capital expenditure as may be required to meet its objectives or to protect against any risks as may be perceived by it.
- Consultative process and transparency: IRDA follows the process of consultation with the industry stakeholders in framing various policies/regulations. The manner of framing the regulations is transparent. In most instances, IRDA sets up a consultative committee/group

comprising experts from various fields/representing the industry to examine the various aspects related to an issue. The recommendations of the Group are submitted to IRDA, where these are exposed to the stakeholders and then vetted by the Insurance Advisory Committee. The draft of each regulation is finally approved by the board of IRDA. All regulations and circulars issued by IRDA are placed on its website. In addition, IRDA falls under the purview of the Right to Information Act, where under its activities come under public scrutiny.

- Decision making: The office procedures of the Authority require that every decision is well-supported by written office notes setting out the reasoning for the decisions. Decisions taken in other similar cases are also taken into account to ensure consistency in decisions-making. Official action taken on deviations/violation of insurers from legislation/regulations are placed on the official website of the supervisor and are also published in the IRDA Journal.

- Right of appeal: Each legal provision vesting the power of supervisory action also contains provisions for review of the decisions. The right of appeal may lie with (i) the Chairman of the Authority; (ii) the Central Government or (iii) the judiciary. This ensures that the supervisory authority is exercised judiciously and in a defensible manner. Section 110H of the Insurance Act provides for appeal against the orders of the supervisor under the specified sections of the Act to the Appellate Authority set up by the Central Government.

Present Assessment: Fully Implemented

Overall Comments: Position as outlined above reflects the basis for present assessment.

II: The Rights of Shareholder

The corporate governance framework should protect and facilitate the exercise of shareholders' rights.

Principle IIA: The corporate governance framework should protect and facilitate the exercise of shareholders' rights. Basic shareholder rights should include the right to: 1) secure methods of ownership registration; 2) convey or transfer shares; 3) obtain relevant and material information on the corporation on a timely and regular basis; 4) participate and vote in general shareholder meetings; 5) elect and remove members of the board; and 6) share in the profits of the corporation.

Earlier Assessment: Observed

Current Position:

- **Listed companies**

i. Companies Act, 1956 (CA), SEBI Act, 1992, Depositories Act, 1996 and Securities Contracts (Regulations) Act, 1956 ensure secure methods of ownership registration. In case of shares held in physical form, record-keeping is done by issuer or share transfer agent who maintains the register of members. In case of shares in dematerialised form, SEBI-registered depositories record the allotment of securities and transfer of ownership. There are adequate safeguards to ensure security and propriety of record. There are specific regulations stipulated by SEBI for regulating the functioning of registrars and share transfer agents, custodians, depositories and depository participants. To expedite the process of share transfers, in terms of Clause 49 of the listing agreement (entered into by companies with the stock exchanges), listed

companies are required to delegate the power of share transfer to an officer or a committee or to a registrar and share transfer agents. Further, the delegated authority is to attend to share transfer formalities at least once in a fortnight. Complaints pertaining to allotment/transfer can be filed with Ministry of Company Affairs (MCA) and also with SEBI for listed companies. There are penal provisions under the Companies Act[12] and SEBI Act for delay/non-redressal of queries.

ii. Shares of public/listed companies are freely transferable under the Companies Act, 1956. For transactions on the stock exchanges, rolling settlement takes place on T +2 basis and counter-party risk is guaranteed by central counter-party.

iii. The shareholders have the right to obtain relevant information about the company on a timely and regular basis under various provisions of the Companies Act, 1956.

a. All companies are required to file memorandum, articles of association and financials with RoC, which are in public domain.

b. As per SEBI (Disclosure and Investor Protection) guidelines, at the time of raising of funds from public, all material information regarding company, promoters, management, project, financials, risk factors are to be disclosed.

c. For listed companies, the listing agreement mandates that all material and price-sensitive information is available in the public domain on a real-time basis. Clauses 30[13], 31[14], 32[15], 33[16], 35[17], 36[18], 37[19], 41[20], 43[21] and 49[22] of the listing agreement contain provisions relating to periodic disclosure of information by companies pertaining to

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[12] Section 113 of the Companies Act provides the penal provisions regarding delay as well as non-redressal of complaints regarding allotment/transfer of share certificates.

[13] Company will promptly notify the Exchange of any change in Company's directorate, MD, managing agents, secretaries, treasurers and auditors.

[14] Company will forward to exchange promptly without application annual reports, balance sheets, all periodical reports, special reports, all notices, resolutions, circulars relating to new issue of capital prior to dispatch to shareholders, proceedings of AGMs, EGMs, all notices and circulars pertaining to proposed mergers, *etc.*

[15] Company to send a statement containing the salient features of the balance sheet, profit and loss account and Auditor's Report to each shareholder and, upon application, to any member of Exchange.

[16] Company to forward to Exchange copies of all notices sent to shareholders with respect to amendments to Memorandum of Association and Articles of Association.

[17] Companies to file quarterly shareholding pattern.

[18] Company to immediately inform stock exchange about all material events and price-sensitive information.

[19] Company agrees to permit stock exchange to make available immediately to its members and to the press any information supplied by the company in compliance with listing agreement.

[20] Filing of unaudited financial information on quarterly basis.

[21] Company to file statement on quarterly basis indicating variations between projected utilisation of funds made in prospectus/notice to EGM and actual utilisation of funds along with explanation thereof in case of material variations.

[22] Provisions related to corporate governance.

shareholding, directorship, auditors and financials of a company in the newspapers/ to the exchanges who in turn display them on their website.

d. The listed companies are also required to disclose information in their annual report. There are provisions related to disclosure of quarterly as well as year to date financial results of the subsidiaries. Under Clause 41, all the financial results are required to be submitted to the stock exchanges within 15 minutes of conclusion of the meeting of the board in which they are approved. Financial results are further required to be published in at least one English daily and one daily newspaper published in the language of the region where the registered office of the company is situated within 48 hours of approval. Under the listing agreement, companies are also required to give 7 days prior intimation through public notice of the date and purpose of meeting of the board in which financial results will be considered.

e. In terms of Clause 49, where monitoring agency has been appointed to monitor the utilisation of issue proceeds, the report submitted by such agency is to be placed before the audit committee of the issuer company which in turn is to make appropriate recommendations to the board. Further, issuer company is to inform the material deviations in the utilisation of issue proceeds to the stock exchange and simultaneously make the material deviations/adverse comments of the audit committee/monitoring agency public through advertisement in the newspapers.

f. With the launch of MCA-21, an e-governance project by MCA, information regarding companies is available on-line on a real-time basis to all stakeholders. Further, as per SEBI's initiative, Bombay Stock Exchange Ltd. (BSE) and National Stock Exchange of India Ltd. (NSE) have jointly launched, on January 1, 2007 a common platform at www.corpfiling.co.in for disseminating filings made by companies listed on these exchanges. In the second phase, the platform will enable electronic filing by companies listed in BSE and NSE. Under the same, SEBI has recently made electronic filing compulsory for 100 companies to be shortlisted on the basis of market capitalisation.

iv. The shareholders have the general right to participate and vote in general shareholders' meetings. Shareholders' participation is, however, not very high.

v. The shareholders appoint directors by passing resolutions in the general meetings. Company must inform all shareholders about candidature[23]. Although usually board proposes the directors, the law permits shareholders also to propose candidates. In terms of Clause 49 of the listing agreement, in case of appointment of a new director or reappointment of a director, the shareholders must be provided with the following information:

  a. A brief resume of the director,

  b. Nature of his expertise in specific functional areas,

  c. Names of the companies in which the person also holds directorship and the membership of committees of the board, and

  d. Shareholding of the non-executive directors.

vi. The shareholders have the right to share the profits of the corporation by way of payment of dividends. The board of directors recommends the rate of dividend and shareholders approve

[23] Shareholders can propose candidates up to 14 days before AGM and company must inform all shareholders about the candidates at least 7 days before the meeting.

the same. Shareholders, however, cannot increase the rate of dividend. Dividend declared must be paid within 30 days of declaration[24]. Complaints in this regard can be filed with MCA and with SEBI for listed companies. There are penal provisions in Companies Act[25] and SEBI Act for delay/non-redressal in this regard.

Insurance

i. All insurers are required to ensure compliance on corporate governance as per the provisions of the Companies Act, 1956. In addition, the insurers have to comply with the requirements of the Insurance Act, 1938 and the regulations framed thereunder. At present, insurance companies are closely held, and as such the provisions applicable to listed companies are not applicable to them. The rights of the shareholders are thus drawn from the Companies Act, 1956.

   a. The provisions of the Insurance Act, 1938, ('The Act') only permit issuance of ordinary shares (equity shares) which has a single face value (Section 6A (1)).

   b. The paid-up amount is the same for all shares (a period of upto one year can be allowed by the company for payment of calls on shares).

   c. Voting right of every shareholder shall be strictly proportionate to the paid-up amount of the shares held by him (Section 6A(2)).

   d. It is a pre-requisite for an insurance company to be a public limited company.

   e. Shares of these companies are, however, not freely transferable in view of certain specific provisions in the Act, *viz.,* any transfer of 1 per cent and above of the paid-up equity requires the approval of the Authority. Similarly, where the transferee is likely to acquire a stake of 5 per cent or more (the threshold limit is lower at 2.5 per cent or more in case of a banking company), prior approval of the supervisor, *viz.,* Insurance Regulatory and Development Authority (IRDA) is required.

   f. The process of introduction of a shareholder is preceded by a thorough due diligence process by the supervisor.

   g. Share in the profits of the corporation.

   h. In case of the non-life insurance companies, the provisions of the Companies Act, 1956 are applicable.

   i. In respect of life insurance companies, the provisions of the IRDA (Distribution of Surplus) Regulations, 2002 are applicable.

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[24] Failure in compliance would attract monetary penalty/imprisonment in term of the Companies Act, 1956.

[25] Section 207 of the Companies Act provides for penalty for failure to distribute dividend within the prescribed time of 30 days.

Present Assessment: Fully Implemented

Overall Comments: As a result of initiatives stated above, position with regard to basic shareholders' rights has further improved since the last assessment.

Principle IIB: Shareholders should have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as: (i) amendments to the statutes, or articles of incorporation, or similar governing documents of the company; (ii) the authorisation of additional shares; and (iii) extraordinary transactions, including the transfer of all or substantially all assets, that in effect result in the sale of the company.

Earlier Assessment: Observed

Current Position:

Listed Companies

i. The shareholders have powers for appointment/removal of directors, appointment and removal of auditors, authorising and issuing of share capital, amendments to the company's memorandum and articles of association, remuneration of board members, major corporate transactions such as disposal/mergers, transactions with related parties, changes in company's business or objects, delisting, *etc.*

ii. The shareholders have the pre-emptive rights in the event of capital increase. In case of extraordinary transactions, special resolution (3/4th majority) is required. In certain cases, such as under Section 395 of the Companies Act 1956, the resolution requires approval by 9/10th majority of shareholders. Disposal of business assets, as a whole or substantial part thereof, requires approval of shareholders by special majority.

iii. After adoption, accounts are filed with RoC, and other decisions are recorded in minutes and are available for inspection by members.

iv. For listed companies, under the listing agreement, there are continuous disclosure requirements of material events including quarterly results. SEBI (Substantial Acquisition of Shares and Takeovers) Regulations contain various provisions to ensure that rights of minority shareholders are protected, and that they get to participate in the event of change in management, in an informed manner.

v. Further, delisting guidelines stipulate reverse book building mechanism which enables shareholders to effectively participate in case a company wants to get delisted and also safeguards their interest.

Insurance

i. The insurance sector is capital-intensive in nature with the minimum paid-up capital requirement of Rs.100 crore in case of life and non-life insurance companies; and Rs.200 crore in case of reinsurance companies. In addition, all insurance companies are required to maintain a solvency margin[26] of 1.5 times at all times. The requirement for injection of additional capital is particularly significant in case of the life insurance companies during the initial seven to ten years.

ii. Election and removal of members of the board is as provided in the Companies Act, 1956. Further, appointment of whole-time directors requires the approval of IRDA. The Act also provides for removal of a director or CEO as per stipulations.

[26] Solvency margin is extra capital that an insurance company is required to hold.

iii. The process of sale of an insurance company needs to comply with various provisions of the Insurance Act, 1938 and requires the approval of the Authority. Only thereafter can the board consider grant of approval for sale of the company. In addition, any such sale requires approval of the shareholders.

iv. The supervisor has stipulated quarterly reporting of financial results and the solvency position to ensure continuous disclosures.

Present Assessment: Fully Implemented

Overall Comments: The observance is ensured as most of the provisions are enshrined in the law.

Principle IIC: Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, which govern general shareholder meetings. (i) Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings as well as full and timely information regarding the issues to be decided at the meeting; (ii) Shareholders should have the opportunity to ask questions to the board, including questions relating to the annual external audit, to place items on the agenda of general meetings, and to propose resolutions, subject to reasonable limitations; (iii) Effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members, should be facilitated. Shareholders should be able to make their views known on the remuneration policy for board members and key executives. The equity component of compensation schemes for board members and employees should be subject to shareholder approval; (iv) Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.

Earlier Assessment: Observed

Current Position:

i. Under the Companies Act, 1956 a company must hold an Annual General Meeting every year[27] at or near company's registered office. Notice of the general meeting indicating time, place and location along with the agenda are sent to the shareholders at least 21 days before the meeting. In case of special business, an explanatory statement is also sent along with the notice.

ii. The shareholders have the right to ask questions at the meeting[28] and they can propose new resolution to the board or management subject to certain limitations.

[27] Any shareholder can apply to the Company Law Board to call an AGM in case the company fails to comply.

[28] Shareholders' participation in general shareholder meetings are governed by Section 176, 177, 179, 183, 189 of the Companies Act, 1956.

iii. The shareholders appoint directors by passing resolutions in the general meetings. The law permits shareholders to propose candidates. Nomination and election of board members is carried out under following circumstances: a) Re-appointment of retiring directors - ordinary resolution to be passed in the general meeting (Section 225); b) Section 257 provides for rights of persons other than retiring directors to stand for directorship. For this purpose, notice for nomination/candidature is to be given within 14 days before the meeting. For remuneration, the prescribed provisions are contained in Section 198, 309 and schedule XIII. The maximum amount of remuneration to the BoD are to be approved by shareholders. In terms of Clause 49, all fees/compensations other than the sitting fees as permitted by the Companies Act,1956 if any paid to non-executive directors, including independent directors, requires previous approval of shareholders in general meeting. Listing agreement also provides for setting up of a remuneration committee though as a non mandatory condition, to ensue transparency, accountability and shareholders participation in deciding matters pertaining to remuneration of directors. ESOPs granted are to be approved at the AGM in terms of Section 79 A of the Companies Act, 1956 and SEBI (ESOP and ESPS) Guidelines, 1999. Position under Principle IIA and VI D (iii) may also be referred.

iv. The shareholders have the right to vote in person or in absentia through proxy. Postal ballot concept has already been introduced pursuant to which any shareholder can send his vote for certain fundamental decisions, through post.

Present Assessment: Fully Implemented

Overall Comments: The Companies Act enables shareholder participation in general shareholder meetings**.** The provisions of listing agreement have also strengthened the position. However, alternate methods for voting can be explored to further enhance shareholder participation. Investor education is also key to spread awareness amongst shareholders regarding their rights.

Principle II D: Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

Earlier Assessment: Largely Observed

Current Position:

i. The provision (section 86) has been made in the Companies Act, 1956 for enabling companies to issue equity shares with disproportionate voting rights. The companies are required to disclose special voting rights, caps on voting rights, significant cross-shareholdings, *etc.* in their Memorandum and Articles of Association[29].

ii. The provisions of Section 108A to 108E of the Companies Act, 1956 places restrictions on acquisition of certain shares with a view to prevent the creation of monopolistic groups.

iii. The provision of Section 187C of the Companies Act, 1956 casts an obligation on the person whose name is entered in the register of members to make a declaration before the company that the member does not hold beneficial interest in the company.

iv. In terms of listing agreement, detailed shareholding pattern is required to be submitted to the stock exchanges on a quarterly basis and the same is disseminated on the website of the

[29] The form of Memorandum and Articles of Association have been prescribed under Section 14, 28 and 29 of the Companies Act, 1956 (Schedule I).

stock exchange. Any change in shareholding pattern of 1 per cent and above to be disclosed. Capital structures/shareholding patterns that allow certain shareholders to exercise control disproportionate to their cash flow rights are to be disclosed in the annual report required to be filed under the Companies Act, 1956 by every company.

v. Joint venture arrangement and private equity investments may provide for certain clauses where certain shareholder(s) may obtain a degree of comfort which is disproportionate.

Insurance:

i. All the provisions of the Companies Act, 1956 on maintenance of details of the beneficial shareholders apply to insurance companies.

ii. In addition, there are specific stipulations under the Act which provide that every person who has any interest in any shares of a company which stands in the name of another person in the register of members of the company, shall within thirty days from the date of acquisition of such interest, make a declaration in the prescribed form (which shall be countersigned by the person in whose name the share is registered) to the company declaring his interest in such share. All the shareholders have access to the register of members. In effect, the beneficial ownership is required to be disclosed upfront.

Present Assessment: Broadly Implemented

Overall Comments: Ownership through cross-holdings and use of trusts and private companies for owning shares in group companies give rise to opaque and non-transparent structures. These issues require to be addressed by the concerned authorities. The disclosure norms need to be continually strengthened to bring about greater transparency in ownership structures. Stringent penal action needs to be enforced wherever such undesirable practices are unearthed.

Principle IIE: Markets for corporate control should be allowed to function in an efficient and transparent manner. (i) The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class. (ii) Anti-take-over devices should not be used to shield management and the board from accountability.

Earlier Assessment: Observed

Current Position:

i. There are elaborate provisions in the listing agreement as well as SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 to facilitate corporate restructuring and acquisitions.

ii. The provisions of Section 187C of the Companies Act, 1956 provides for an obligation on the member to make a declaration of the actual holder of the beneficial interest in the company.

iii. The provision of Section 187D of the Companies Act, 1956 empowers the Government, where there exist good reasons, to investigate about the beneficial ownership of the shares.

iv. The Regulations have been framed keeping in mind the principles like equality of treatment and opportunity to all shareholders and fair and truthful disclosure of all material information by the acquirer. There are timelines to be adhered to, so as to make it an efficient process.

v. In terms of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, it is required to report to the stock exchanges on a continuous basis share ownership by investor category as well as at various thresholds of ownership in terms of percentage of shares held[30]. Stock exchanges, in turn, are required to disseminate the information through trading terminals and website.

vi. In case of change in control over the target company, the acquirer has to make a public offer for acquisition of shares in the said company[31].

vii. Disclosures are required at every stage through public announcement, requirement to circulate letter of offer/notice to the general meeting. Minimum offer price is to be determined in terms of Regulations[32]. The entire process is to be completed within a prescribed time-frame.

viii. There are restrictions on issuance of securities pursuant to public announcement by the target company. Regulations provide for competitive bids.

ix. The shareholders can approach SEBI for redressal of any complaint regarding alleged change in control. SEBI can take action for non-compliance of Substantial Acquisition of Shares and Takeovers (SAST) regulations under SEBI Act which provides for monetary penalty as well as imprisonment.

x. There are specific provisions under Section 391-394 of the Companies Act which provide for furnishing a report by the Registrar of Companies before the court so as to ensure that interest of members, employees and the public are protected. This is necessary to ensure the adherence to the accounting principles while preparing the statement of affairs and fair valuation of assets. The provision of Section 293(1)(a) of the Companies Act requires the approval of the shareholders for any decision regarding lease or sale of corporate assets.

Insurance

i. The legislation governing the insurance industry enables the supervisor to call for the required information as the situation warrants. A number of reports have also been stipulated under the legislation which are required to be submitted by the insurers on a periodic basis.

[30] In case of any acquisition of shares which entitles the acquirer to more than 5 per cent, 10 per cent, 14 per cent, 54 per cent and 74 per cent voting rights in any Indian listed company, disclosure has to be made at every stage to the respective company and to the concerned stock exchange(s). In case of acquirers holding more than 15 per cent in a Indian listed company, every acquisition/sale of 2 per cent has to be reported to the company and to the concerned stock exchange(s). As per the Listing Agreement, the companies are required to report the shareholding category-wise, *i.e.,* Promoter/Non-promoter holding, Institutional/NRI/Banks/Mutual Funds, *etc*. Further the shareholding of the promoters and persons holding 1 per cent and more of shares are also required to be reported.

[31] An acquirer who crosses the 15 per cent threshold must make an offer for at least additional 20 per cent shares from existing shareholders.

[32] The minimum price for this public offer cannot be lower than the negotiated price, price paid by the acquirer in 26 weeks period prior to public announcement and 26 weeks average weekly data and 2 weeks daily data.

The consolidation of the financial highlights of statements of insurance companies is published by the supervisor its Annual Report, thereby ensuring transparency and disclosure to various stakeholders.

ii. In addition, the Annual Reports are also available on MCA-21, the website maintained by Ministry of Corporate Affairs.

Present Assessment: Broadly Implemented

Overall Comments: SEBI Takeover code has gone a long way in facilitating takeovers in a transparent manner and protecting the interest of minority shareholders. The code has been revised from time to time on the basis of experience and feedback received. In case of mergers and amalgamations role and responsibilities of MCA needs to be reviewed particularly with reference to valuation and interest of minority shareholders. Under the Competition Act, a firm proposing to enter into a combination[33], is required to notify the Competition Commission. The proposed combination cannot take effect for a period of 210 days from the date it notifies the Commission or till the Commission passes an order, whichever is earlier. While changes proposed under the new Competition Act and their impact have not been studied for the purpose of this study, the aforesaid provision is likely to have material effect on the processes involved in completing transactions.

Principle IIF: The exercise of ownership rights by all shareholders, including institutional investors, should be facilitated. (i) Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights; (ii) Institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments.

Earlier Assessment: Materially Not Observed

Current Position:

i. Presently there is no regulatory requirement on institutional investors to disclose their voting policies, procedures and conflicts of interest. At the same time, there are no restrictions on exercise of voting rights by all shareholders.

ii. The information pertaining to shareholders (including institutional investors) using their voting rights actively is not available. However, as per the study done by the World Bank in its Report 'India – Role of Institutional Investors in the Corporate Governance of their Portfolio Companies', in the year 2005, it was noted that institutional investors do not exercise their share voting rights actively.

[33] Broadly, combination includes acquisition of control, shares, voting rights or assets, acquisition of control by a person over an enterprise where such person has control over another enterprise engaged in competing businesses, and amalgamations between or amongst enterprises where these exceed the thresholds specified in the Act in terms of assets or turnover.

Present Assessment: Partially Implemented

Overall Comments: The present regulatory framework does not stipulate any mandatory requirement with regard to this aspect. At the same time, there are no restrictions in this area. There is a need to initiate dialogue with the industry to develop the awareness about the contribution that institutional investors can make in the corporate governance of a portfolio company. Possibility of stipulating specific requirements either as good practice or mandatory requirements may be explored.

Principle II G: Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse.

Earlier Assessment: Not Available

Current Position:

i. There is no legal bar as such under the law about consultation amongst shareholders. Companies Act provides for general meetings where shareholders can interact.

ii. SEBI and MCA recognise Investor Associations[34]. These recognised Associations provide a platform for investors to interact with each other on matters affecting their rights and take up their grievances and issues concerning them with corporates and other agencies include regulators.

iii. Shareholders' co-operation and co-ordination can also be misused to manipulate markets and take control over a company. However, there are regulations in place (like SEBI Takeover Regulations and Insider Trading Regulations) to prevent and deal with such eventualities.

Present Assessment: Fully Implemented

Overall Comments: As stated above, there are fora available to facilitate interaction amongst shareholders. Checks and balances in this regard are also in place.

III: Equitable Treatment of Shareholders

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

Principle IIIA: All shareholders of the same series of a class should be treated equally. (i) Within any series of a class, all shares should carry the same rights. All investors should be able to obtain information about the rights attached to all series and classes of shares before they purchase. Any changes in voting rights should be subject to approval by those classes of shares which are negatively affected; (ii) Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress; (iii) Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares; (iv) Impediments to cross-border voting should be eliminated; (v) Processes and procedures

[34] Under Companies Act, the recognition of investor associations is provided.

for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.

Earlier Assessment: Partially Observed

Current Position:

i. Within each class of shares, all the shares carry the same rights. Any change in rights in any class of shares is subject to the approval by that class of shareholders. As per the Companies Act, 1956 a person authorised to vote can do so by appointing a proxy who can vote on poll. Information pertaining to voting rights attached with all classes of shares is provided under Article of Association.

ii. Both MCA and SEBI are mandated to protect the interests of investors. Section 391, 397, 398 and 401 of the Companies Act provide for relief as well as procedure for redressal of grievances in cases of oppression and mismanagement. MCA has power to file a petition on behalf of minority shareholders before Company Law Board in cases of alleged oppression and mismanagement (Section 401), appoint additional directors for prevention of oppression or mismanagement subject to approval of Company Law Board (Section 408), powers to remove managerial personnel in certain exceptional cases (Section 388B). Position stated under Principle IIE may also be referred. In cases regarding mergers, action can be taken under Section 391-394 of the Companies Act, 1956. For matters relating to false statements in the prospectus, periodic filings, or other public statements, there is civil and criminal liability for directors under Sections 62 and 63 of the Companies Act, 1956. As per section 621, any shareholder can complain/file prosecution, if company/officers of the company make default of any provisions of the Companies Act, 1956. Class action suit against corporations/directors is possible under provisions of Order I, Rule 8 of the Code of Civil Procedure, 1908, in suitable cases, with permission of the court. For matters relating to non-delivery of shares after transfer, non-payment of dividend, non-refund, SEBI has been delegated powers under the Companies Act. Further, there are various provisions under SCRA, SEBI Act, 1992, SEBI (Prohibition of Insider Trading) Regulations, 1992, SEBI (Substantial Acquisitions of Shares and Takeovers) Regulations, 1997, SEBI (Prevention of Fraudulent and Unfair Trading Practices), 2003, *etc.,* to safeguard the interest of investors. MCA has set up a portal for investor complaints. There is an office of Investor Assistance and Education in SEBI which deals with investor grievances pertaining to areas delegated to SEBI under Companies Act, against listed companies. In terms of Clause 49 of the listing agreement, for listed companies, a board committee designated as Shareholders/Investor Grievance Committee, under the chairmanship of a non-executive director is required to be set up to specifically look into redressal of shareholders and investor grievances like transfer of share, non-receipt of balance sheet, non-receipt of declared dividends, *etc.*

iii. & iv. In India, shares are held in physical and demat form and the shareholders can appoint proxy[35] to delegate their voting rights. Custodians who hold shares on behalf of the Institutional Investors are expected to provide information to the shareholders about the proposed general meetings of the companies so as to enable them to appoint proxies/attend meetings and exercise voting rights. The custodian agreement entered into between the custodian and institution spells out the manner of providing information to shareholders. Voting rights in respect of foreign depository receipt holders such as GDRs/ADRs are determined by the agreement between the issuer and the depository. Quite often, the said agreements provides for exercise of voting rights by depository at the instruction of boards of issuer company. Sometimes such agreements provide for exercise of voting rights by depository at the instance of holders of depository receipt. In order to ensure interest of minority shareholders, in respect of shares issued on a preferential basis by listed companies, SEBI (DIP) Guidelines have provisions related to pricing and lock-in of shares. Further, relevant information such as object, shareholding pattern, identity of proposed allottees is required to be furnished in the Explanatory statements to the notice for the EGM. In case of an IPO, the entire pre-issue capital is required to be locked in for a period of one year.

v. Position under Principle IIA and II C may be referred.

Insurance:

i. Insurance companies are governed by the provisions in the Companies Act, 1956 to provide for shareholders' rights.

ii. In addition, the insurance legislation prescribes issuance of ordinary shares (equity shares) which has a single face value. The paid-up amount is the same for all shares at Rs.10/-. The voting rights of every shareholder shall be strictly proportionate to the paid-up amount of the shares held by him.

Present Assessment: Broadly Implemented

Overall Comments:. Protection of interest of minority shareholders has attracted a lot of attention of the regulators. SEBI has brought about amendments in SEBI Act , Takeover Regulations, Insider Trading Regulations and Delisting Guidelines with a view to protect minority shareholders from possible abusive actions of controlling shareholders. From time to time, SEBI issues directions and initiates regulatory actions in the interest of minority shareholders and for non-compliance with provisions of regulations. Though the structure for equitable treatment of all shareholders is mostly in place, there is scope for expediting the processes involved and improving effectiveness of the system, particularly on implementation side. There is also the need for sensitising shareholders about their rights and responsibilities.

Principle IIIB: Insider trading and abusive self-dealing should be prohibited.

Earlier Assessment: Partially Observed

Current Position:

i. Insider trading is an offence under SEBI Act and SEBI (Prohibition of Insider Trading) Regulations, 1992 which has comprehensive provisions relating to insider trading. Instances of insider trading can attract a penalty of twenty five crore rupees or three times the amount of profits made out of such failure, whichever is higher.

[35] Section 176 of Companies Act provides for proxy rights of shareholders.

ii. For listed companies, there are disclosure requirements pertaining to transactions in the company's shares by board members, senior managers or controlling shareholders, under the SEBI (Prohibition of Insider Trading) Regulations, 1992 and SEBI (Substantial Acquisition of Shares and Takeovers) Regulations and the listing agreement. All submissions made by the companies to the exchange, in this regard, are disseminated to the market and also displayed on the website of the exchange.

iii. As preventive measures, SEBI (Prohibition of Insider Trading) Regulations, 1992 lays down the Code of Conduct for listed companies and for other entities. There are pre-clearance requirements on trades executed by directors/officers/designated employees. There is also a holding period requirement of 30 days for all directors/officers/designated employees.

iv. In terms of SEBI (Prohibition of Insider Trading) Regulations, 1992 companies are required to specify a trading period, to be called 'Trading Window' during which directors and executives are not entitled to deal in company shares. There are also other restrictions on trading by directors, officers and designated employees.

v. Market surveillance is primarily the responsibility of the stock exchanges who are the first-level regulators. However, SEBI has also put in place Integrated Market Surveillance System to monitor and detect any instances of insider trading and front-running. Implementation of Unique Client code and Know Your Client norms while trading on stock exchanges has also facilitated tracing identity of persons transacting in shares of a company. PAN has been made mandatory for opening demat accounts, investments in IPOs and public issues and trading on the stock exchanges.

vi. Based on the alerts, during the last two years SEBI has initiated actions against few entities for indulging in front-running and abusive self-dealing. Besides, several cases of violation of disclosure requirements under the SEBI (Prohibition of Insider Trading) Regulations, 1992 and SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 have been identified and have been referred for further investigation or adjudication. In addition, on a regular basis, information/explanation is sought from the entities observed to be dealing in the shares of the listed companies prior to the major announcements.

vii. With a view towards incorporating an additional corporate governance measure which aligns the interests of a company's shareholders to that of the company's insiders, additional regulations are proposed to be introduced in the SEBI (Prohibition of Insider Trading) Regulations, 1992. The proposed regulation seeks to compel an 'insider' to surrender such profits to the company in any of his/her transaction concerning equity-based securities of the company (including its parents or subsidiary's shares) in the event both the buy and sell side of the transaction are entered into within six months of the other.

Present Assessment: Fully Implemented

Overall Comments: SEBI has comprehensive powers for undertaking investigation and enforcement under SEBI Act, 1992. The regulatory framework and oversight has been strengthened over years

to deter insider trading. Various regulatory and enforcement actions have also been initiated for violation of Insider Trading Regulations in the last two years (2005-06: 13, 2006-07: 26). However, the fact remains that insider trading is usually very complex and difficult to prove and this is the position even in advanced countries. To deal with market manipulation and fraudulent activities, SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations, 2003 are also in place. During the last two financial years (2005-06 and 2006-07), 239 cases were taken up for investigation pertaining to market manipulation and price rigging and investigation was completed in 139 such cases.

Principle IIIC: Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation.

Earlier Assessment: Partially Observed

Current Position:

i. The provisions[36] under the Companies Act, 1956 require the members of the board and key executives to disclose to the board whether they, directly or indirectly or on behalf of the third parties, have a material interest in any transaction or matter directly affecting the corporation. In some cases of related party transactions, even the approval of the Central Government is required (Section 297) under the Companies Act, 1956.

ii. In terms of Companies Act, directors are required to disclose their interest, if any, in the proposals which are considered by the board. They should not participate in such matters (Section 299). Directors are also required to disclose their directorships in other companies (Section 303).

iii. Listing agreement stipulates strict disclosure requirements in this respect. Under listing agreement, it is obligatory on part of senior management to make disclosures to the board relating to all material, financial and commercial transactions, where they have personal interest that may have a potential conflict with the interest of the company at large. All related party transactions are to be disclosed to the audit committee in a manner to be decided on the basis of materiality. Further, a company is required to disclose in its Annual Report:

   a. 'Related Party Disclosures' in compliance with Accounting Standard (Clause 32).

   b. all materially significant related party transactions that may have potential conflict with the interests of company at large (Clause 49).

iv. Further, in terms of Clause 49.IV.E.iv and v of the listing agreement:

   a. the company shall disclose the number of shares and convertible instruments held by non-executive directors in the Annual Report.

   b. Non-executive directors shall be required to disclose their shareholding (both own or held by/for other persons on a beneficial basis) in the listed company in which they are proposed to be appointed as directors, prior to their appointment. These details should be disclosed in the notice to the general meeting called for appointment of such director.

[36] Section 295, 297, 299, 300, 301 and 302 of Companies Act provide for disclosure requirements in this regard.

v. Shareholders are not allowed to get loan from companies. For loans to directors, Central Government's approval is required. Parties related to directors are prohibited to obtain loan from company.

Banks

i. In terms of Section 16 of the Banking Regulation Act, no banking company incorporated in India shall have as a director in its Board of Directors any person who is a director of any other banking company and this, to some extent, takes care of the conflicts of interests aspect.

ii. Further, in terms of Section 20 of the Banking Regulation Act, no banking company can grant any loans or advances to or on behalf of any of its directors, any firm in which any of its directors is interested as partner, manager, employee or guarantor or any company of which the subsidiary or the holding company of which any of the directors of the banking company is a director, managing agent, manager, employee or guarantor or in which he holds substantial interest or any individual in respect of whom any of its directors is a partner or guarantor.

Insurance:

i. Insurance companies are required to comply with the Accounting Standards (AS) issued by ICAI, as provided under the Companies Act. Accordingly, related party transactions are required to be disclosed under AS 18.

ii. In addition, insurers are also required to furnish a schedule giving details of payments made to individuals, firms, companies and organisations in which directors of the insurers are interested. These disclosures are required to be made in the Management Report which forms part of the annual financial statements.

Present Assessment: Fully Implemented

Overall Comments: With the amendments in the listing agreement, various disclosure requirements have been stipulated. The framework for observance of the principle is in place.

IV: Role of Stakeholders in Corporate Governance

The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

Principle IVA: The rights of stakeholders that are established by law or through mutual agreements are to be respected.

Earlier Assessment: Observed

Current Position:

i. The shareholders have enforceable rights to participate. Debenture holders/Creditors have rights in respect of matters which affect their rights, *e.g.*, reduction in capital, amalgamation, *etc.* Depositors have some rights to approach Company Law Board for repayment in case of default by company.

ii. There are no legal rights in respect of customers/suppliers, *etc.* under the Companies Act, 1956 but under the general laws of the land, *viz.*, Contract Act, Sale of Goods Act, *etc.,* they are well-protected. Big companies do have policies (voluntary) to take care of interests of all stakeholders.

iii. In terms of Section 217 of the Companies Act, the Board Reports annually on company activities, including company performance on environment issues, labour issues, tax compliance and provisions of Companies Act. The companies are encouraged to adopt socially responsible behaviour and many have already started resorting to the triple bottom-line reporting.

iv. In terms of Section 217 of the Companies Act, board reports annually on company activities, including company performance on environment issues, labour issues, tax compliance and provisions of Companies Act.

v. The creation and setting up of National Foundation for Corporate Governance by the Government as a Trust in partnership with the stakeholders, *viz.*, CII, ICAI and ICSI is a step towards propagating good corporate governance practices and strengthening the role of the stakeholders.

Insurance:

i. The provisions of the Companies Act are applicable for protection of the interests of the shareholders.

ii. In addition, there are provisions for protection of the interests of the policyholders. It may be mentioned that protection of the interests of the policyholders is part of the mission statement of the supervisor. Regulations have been framed for ensuring compliance by the insurance companies in this regard. These regulations are aimed at servicing of the policyholders.

iii. The overall regulatory, supervisory and reporting requirements have been framed to protect the interests of the policyholders.

Present Assessment: Fully Implemented

Overall Comments: There are various laws that recognise the rights of stakeholders. There is a general appreciation in the corporate sector relating to the concerns of all the stakeholders and these have been protected adequately under the relevant laws. There is, however, need for greater disclosure and publicity of CSR (corporate social responsibility) initiatives by corporate sector.

Principle IVB: Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.

Earlier Assessment: Partially Observed

Current Position:

i. Shareholders and creditors have enforceable legal rights under the Companies Act, 1956. Sections 397 to 407 of the Companies Act, 1956 contain provisions which have mechanisms

to prevent violation of shareholders' rights through oppression and mismanagement. Reference may be made to position under Principle IIIA.

ii. Other stakeholders can take action under general law to seek redressal. For *e.g.*, there are certain remedial measures available under Factories Act and Industrial Disputes Act for affected parties. Refer Principle IVA.

iii. SARFAESI Act addresses the rights of creditors.

iv. Further, SEBI is also mandated to protect the interests of investors. There is an Office of Investor Assistance and Education in SEBI which deals with investor grievances against listed companies. Under listing agreement, companies are required to have shareholders' committee to look into shareholders' grievances.

Insurance:

i. IRDA (Protection of Policy-holders' Interest) Regulations, 2002 addresses various issues of protection of rights of policy-holders.

ii. For other stakeholders, provisions of various other applicable laws would prevail. The other forums for redressal include insurance ombudsman and consumer courts.

Present Assessment: Broadly Implemented

Overall Comments: With the passing of SARFAESI Act, rights of creditors have been substantially safeguarded. The liquidation process is, however, time-consuming and lengthy, thereby, hardly leaving any effective remedy for the stakeholders other than secured creditors. There is also a need for speedy disposal of cases by courts. It has been observed that setting up of dedicated courts leads to expeditious disposal. Comments in response to Principle IIIA may also be referred.

Principle IVC: Performance-enhancing mechanisms for employee participation should be permitted to develop.[37]

Earlier Assessment: Observed

Current Position:

i. There are provisions under Companies Act, 1956 which allows the employees to participate in company's profits such as share ownership, share options or profit-sharing schemes.

ii. Section 79 A of the Companies Act, 1956 and SEBI (ESOP and ESPS) Guidelines, 1999 stipulate the mechanism for issuance of stock options to employees of the listed companies. SEBI (DIP) Guidelines, 2000 also provide for reservation on competitive basis, in public issues, for employees of the company. Share option schemes are approved at the AGM.

[37] Corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs and sustainability of financially sound enterprise.

iii. There are provisions under other statutes such as Factories Act, Industrial Disputes Act *etc.*, for participation of employees in the decision-making.

Present Assessment: Fully Implemented

Overall Comments: As stated above, appropriate enabling provisions are in place . The setting up of the National Foundation for Corporate Governance with the active participation of industry, professional institutes and the Government has given the requisite fillip to provide a platform for propagating good corporate governance practices.

Principle IVD: Where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis.

Earlier Assessment: Observed

Current Position:

i. The shareholders have special access to the corporate information through various provisions under the Companies Act and listing agreement.

ii. Other stakeholders have right to such information only when their rights are affected. Information about company is also disclosed periodically in terms of the listing agreement (immediately, in case, material in nature) in the newspapers/to the exchanges, which in turn display them on their website.

iii. With the introduction of MCA-21, the stakeholders have access to the information filed by companies with RoC.

iv. For IPOs and issues by listed companies, disclosures to be made under SEBI (DIP) Guidelines.

v. Further, any listed company making issue of debt securities (maturity not less than 365 days) on a private placement basis and listed on a stock exchange is required to make full disclosures (initial and continuing) in the manner prescribed in Schedule II of the Companies Act, 1956, SEBI (DIP) Guidelines, 2000 and listing agreement with the Exchange[38]. A separate listing agreement is required to be entered with the exchange for such securities. Reference may also be made to position under Principle IIA (3) and VE.

Insurance:

i. Policyholders in general have access to the various financial statements of the insurance companies which are available in the public domain through the websites of the regulator and MCA.

Present Assessment: Fully Implemented

Comments: There is a lot of emphasis on transparency in the system. Rules and guidelines are in place to ensure accurate and timely availability of material information to those concerned. India has now one of the best electronic corporate registries in the world which is capable of providing access to the corporate information on a 24×7 basis. The stakeholders can inspect the documents filed by the company with the office of RoCs. SEBI has also launched a Corporate Filing and Dissemination System to enable corporates to disseminate information electronically, on real-time basis amongst the investors.

[38] SEBI circular No. SEBI/MRD/SE/AT/36/2003/30/09 dated September 30, 2003.

Principle IVE: Stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing this.

Earlier Assessment: Not Available

Current Position:

i. There are different legislations to protect the interest of employees namely Factories Act, Provident Fund Act, Employee State Insurance Act, Industrial Disputes Act, Workman Compensation Act, *etc.*

ii. In terms of non-mandatory conditions stipulated under the listing agreement, all listed companies are required to establish a whistle-blower mechanism for employees to report to the management concerns about unethical behavior, actual or suspected fraud or violation of the company's code of conduct or ethics policy.

iii. The mechanism is also required to provide for adequate safeguards against victimisation of employees who avail of the mechanism and also provide for direct access to the chairman of the audit committee in exceptional cases and existence of mechanism to be appropriately communicated within the organisation.

Present Assessment: Partially Implemented

Overall Comments: The rights of the employees though are not covered directly under the Companies Act but ample protection is available under the specific legal enactments. Even under the listing agreement presently, the requirement to establish whistle-blower mechanism is not mandatory and depends on discretion of the companies. It would be worthwhile to gather information on the experience of the companies which choose to implement this mechanism.

Principle IVF: The corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights.

Earlier Assessment: Not Available

Current Position:

Position under Principle IVB may be referred. The company law (Section 100 to 104 and Section 391 to 394 of the Companies Act, 1956) recognises provisions for creditors' rights during normal course of business. Winding-up orders can be made, if a company is not able to pay debts.

Present Assessment: Broadly Implemented

Overall Comments: Comments under Principle IVB may be referred.

V: Disclosure and Transparency

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership and the governance of the company.

Principle VA: Disclosure should include, but not be limited to material information on (i) The financial and operating results of the company (ii) Company objectives (iii) Major share ownership and voting rights (iv) Remuneration policy for members of the board and key executives, and information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board (v) Related party transactions. (vi) Foreseeable risk factors (vii) Issues regarding employees and other stakeholders (viii) Governance structure and policies, in particular, the content of any corporate governance code or policy and the process by which it is implemented.

Earlier Assessment: Largely Observed

Current Position:

i. There are various provisions under the Companies Act, 1956 for preparation, adoption and statutory filing of financial statements (annually) with the RoC. The listing agreement gives a broad framework for listed companies in this regard. Under Clause 41 of the listing agreement, listed companies are to publish the quarterly financial statements. The quarterly results are to be approved by the board or a committee thereof. Companies are also required to publish an Annual Report, circulate its full or abridged version to all shareholders and, after adoption, file the same with RoC. This includes chairman's statement, balance sheet, profit and loss account/income statement, cash flow statement, statement of changes in equity, notes on financial statements, an audit report, *etc.* The companies are also required to file consolidated financial statements.

ii. The Companies Act mandates disclosure of company's objectives in the Annual Report (under the 'Management Discussion and Analysis'(MDA) section). In terms of listing agreement also, 'Management Discussion and Analysis' should include discussion on the company's competitive position, *inter alia,* incorporating opportunities and threats, outlook, risks and concerns, *etc.*

iii. Under the various provisions of the Companies Act, 1956 and the listing agreement, share ownership is required to be disclosed in the annual report by investor category (promoters, financial institutions, foreign investors, *etc.,*) and by tranches of ownership. The companies are required to disclose special voting rights, caps on voting rights, significant cross-shareholdings *etc.,* in their Memorandum and Articles of Association. In terms of listing agreement, detailed shareholding pattern is required to be submitted to the stock exchanges on a quarterly basis and the same is disseminated on the website of the stock exchange.

iv. The information[39] about the board members and key executives is available to investors in the annual report of the company. Besides this, the balance sheet[40] of the company discloses

[39] Appointment, remuneration to the managerial personnel are governed by Section 289, 198, 309, 309 and schedule XII of the Companies Act. Section 295, 297, 299, 300, 301 and 302 of Companies Act provide for disclosure requirement in this regard.

[40] The balance sheet and annual returns are required to be filed as per the provisions contained in Sections 220 and 159 of Companies Act.

the information about the remuneration paid to the managing directors/directors, *etc.* For the boards' remuneration, aggregate amount is disclosed and in respect of key employees, the amount is disclosed individually. Listing agreement also mandates disclosures pertaining to remuneration of directors in Annual Report as well as in the notice to the general meeting called for appointment of such directors. In terms of Clause 49 all fees/compensation other than the sitting fees as permitted by the Companies Act, 1956, if any, paid to non-executive directors, including independent directors, shall be fixed by the Board of Directors and requires previous approval of shareholders in general meeting. Position contained under Priciple IIA (5) and IIC (3) may alse be seen.

v. In terms of Clause 49, senior management[41] is required to make disclosures to the board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large. Position contained under Principle IIC may also be referred.

vi. The companies are required to disclose in their Annual Report, their policies on risk management and material foreseeable risk factors. Under the listing agreement, as part of the director's report or as an addition thereto, MDA which is required to be part of Annual Report should include discussions on risk and concerns and the internal control systems and their adequacy. Further, company is required to lay down procedures to inform board members about the risk assessment and minimisation procedures and the same are reviewed periodically.

vii. The board is required under Section 217 of the Companies Act to report annually on employee and other stakeholder issues. In terms of listing agreement, MDA should include material developments in human resources/industrial relations front, including number of people employed.

viii. Section 217 of the Companies Act, 1956 and Clause 49 of the listing agreement requires the companies to disclose information relating to company's governance structures and policies.

Apart from the above, the listing agreement stipulates MDA to include discussions on opportunities and threats, segment wise or product-wise performance, *etc.*

Banks

i. In the case of banks, the Reserve Bank guidelines as contained in the circular No.DBOD.BP.BC.No.14/21.04.018/2007-2008 dated July 2, 2007 require certain additional disclosures in the 'Notes to Accounts' on asset quality, business ratio, maturity pattern of certain items of assets and liabilities, exposures to sensitive sectors in addition to the disclosures as per Accounting Standards.

[41] Personnel of the company who are members of its core management team excluding the Board of Directors.

Insurance

i. Section 11(1) of the Insurance Act requires every insurer to prepare balance sheet, revenue account, receipts and payments account and profit and loss account on an annual basis for each financial year. Further, the IRDA (Preparation of Financial Statements and Auditors Report of Insurance Companies) Regulations, 2002 prescribes the formats for various financial statements to be submitted by life insurers and non-life insurers separately. Quarterly reporting has also been mandated by the Authority.

ii. The annual reports of insurance companies include directors Report; balance sheet; profit and loss account; cash flow statement; notes to the financial statements; auditors report; management report; management discussion and analysis; and financial ratios and summary of financial statements for five years.

iii. Apart from the financial statements that are to be submitted on an annual basis, insurance companies are required to file the following:

   a. Business underwritten details on a monthly basis.

   b. Equity holding pattern on a quarterly basis.

   c. Actuarial returns and solvency statements.

   d. Investment returns (also on a quarterly basis).

   e. Reinsurance Returns.

Present Assessment: Fully Implemented

Overall Comments: Disclosures in terms of principle VA are stipulated by the prevailing legal framework. Listing agreement, which has been amended from time to time, has served as an effective tool for ensuring availability of information in public domain on an ongoing basis. SEBI has recently initiated adjudication proceedings against 20 companies for non-compliance of Clause 49 of the listing agreement, which contains, among other things, provisions relating to disclosure and transparency.

Principle VB: Information should be prepared, and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure.

Earlier Assessment: Largely Observed

Current Position:

i. The information is prepared[42], audited and disclosed in accordance with the Accounting Standards. ICAI has called for adoption of IFRS by public interest entities (such as listed companies, banks and insurance entities) and large-sized entities for accounting periods beginning on or after April 1, 2011. The ICAI is responsible to the Accounting Standards Board which currently issues accounting standards that are based on IFRS but contain certain modifications to reflect the legal and economic environment in India.

ii. Recent notification of Accounting Standards by the Ministry with the active participation and involvement of all the stakeholders is a step in this direction.

[42] Clause 50 of Listing Agreement mandates that all listed companies will comply with Accounting Standards issued by ICAI.

iii. Listing agreement also provides for focused disclosures in a timely manner of all material information. To ensure credibility and authenticity of the financial statements, provisions of Clause 41 have been amended by SEBI vide circular dated July 10, 2007 to provide for approval of the quarterly financial results by BoD and certification by CEO and CFO.[43] Where there are major variations between the unaudited quarterly or year-to-date financial results and the results amended pursuant to limited review for the same period, the company is required in terms of the Listing agreement to submit to the exchange an explanation for the reasons for variations, duly approved by the board.

Insurance:

i. The accounts of insurance companies are required to be audited jointly by two audit firms annually.

ii. The norms for appointment of statutory auditors have been issued by the supervisor which are required to be complied with by the insurance companies. The norms prescribe the minimum number of partners in the audit firm and the educational/professional qualifications and experience of the partners. As part of the corporate governance stipulations, an audit firm cannot be appointed/continued for more than five consecutive years. In addition, no two audit firms can simultaneously carry on audit work for more than four years. An audit firm on completion of its tenure of five/four years as the case may be, is subject to a cooling-off period of two years during which period it cannot accept statutory audit assignment of the said insurance company for the next two years.

iii. Further, the statutory auditors are required to file their audit report as per the format specified at Schedule C of IRDA Regulations on preparation of financial statements and auditors' report.

Present Assessment: Fully Implemented

Overall Comments: Recent initiatives as indicated above have enhanced the credibility and quality of the financial and non-financial disclosures.

Principle VC: An annual audit should be conducted by an independent, competent and qualified auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.

Earlier Assessment: Partially Observed

[43] The quarterly financial results are to be approved by the BoD or by a committee thereof, other than the Audit Committee. While placing the financial results before the board, the Chief Executive Officer and Chief Financial Officer shall certify that the financial results do not contain any false or misleading statement or figures or do not omit any material fact which may make the statements or figures contained therein misleading.

Current Position:

i. The provisions of the Companies Act, 1956 provides that the annual accounts of the company shall be externally audited by an independent, competent and qualified auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects. External auditors[44] are appointed by the shareholders in the AGM and are also accountable to the shareholders. They owe a duty to the company to exercise due professional care in conduct of the audit.

ii. The recent amendments passed by the Government to the Acts governing the three professional institutes, *viz.,* ICAI, ICSI and ICWAI were aimed at bringing transparency and professionalism in their working and also to strengthen the disciplinary mechanism. The amendments have put a limit on the extent of non-audit services to be rendered to the client company by the statutory auditor and adequate disclosures to this effect have also been stipulated.

iii. The concept of peer audit review has also been introduced in the case of listed companies.

Banks

i. In terms of the provisions of the Banking Regulation Act, 1949 all banking companies are required to publish their annual accounts, duly audited by external auditors, in the prescribed manner and also forward copies thereof to the Reserve Bank.

Insurance

i. The insurance companies are subject to joint audit as stipulated by IRDA. There are further stipulations on the areas to be covered in the audit report.

Present Assessment: Broadly Implemented

Overall Comments: Recent amendments have strengthened the framework and enhanced accountability in the system. The real impact of the recent initiatives could be measured only after a reasonable period of time has elapsed.

Principle VD: External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit.

Earlier Assessment: Not Available

Current Position:

i. Position given under principle V C above may be referred. As per Section 292A of the Companies Act, 1956 every public company having paid-up capital of not less than Rs 5 crore is required to constitute an audit committee.

ii. As per a recent recommendation of the SEBI's Committee on Disclosures and Accounting Standards (SCODA), in view of the public funds involved, audit of listed companies should be carried out by only those auditors who have themselves been subject to the peer review. The said recommendation of SCODA has, in principle, been accepted by the Council of ICAI.

[44] The enabling provisions regarding appointment and remuneration of auditors are covered under Section 224 to 233B of Companies Act.

Present Assessment: Broadly Implemented

Overall Comments: Auditors accountability would be further enhanced with the introduction of peer review.

Principle VE: Channels for disseminating information should provide for equal, timely and cost-efficient access to relevant information by users.

Earlier Assessment: Observed

Current Position:

i. The information as provided by the companies to the exchange is being disseminated to the market through the trading terminals of the exchange and the same is also being updated on the website of the exchange. Apart from this, information is also disseminated through newspapers, by post, *etc.* Information is required to be disseminated on periodic basis as well as on real-time basis depending on materiality. Section 219(iv) of Companies Act and Clause 32[45] of listing agreement permit listed companies to send to each shareholder a statement containing the salient features of the balance sheet, profit and loss account and auditor's report instead of sending full balance sheet and annual report. Position as explained in response to Principle IIA (iii) and IVD may also be referred.

ii. The Government with the launch of MCA-21 has given access to all the corporate information to all the stakeholders in a 24×7 timeframe. Investors Education and Protection Fund (IEPF) under the Ministry has sponsored a website, *viz.*, www.watchoutinvestors.com which is a unique initiative in the world as it seeks to provide information about 84,000 entities and individuals who have been convicted of economic offences. As per SEBI's initiative, Bombay Stock Exchange Ltd. (BSE) and National Stock Exchange of India Ltd. (NSE) have jointly launched on January 1, 2007 the common platform at www.corpfiling.co.in for disseminating filings made by companies listed on these exchanges.

Insurance:

iii. Annual accounts of the insurance companies are consolidated and published in the supervisor's annual report which is hosted on the website of IRDA, *viz.*, www.irdaindia.org.

iv. Apart from the annual financial statements, monthly performance of the insurers are also consolidated and published in the website and journal of the supervisor. These are, thus, available in the public domain.

v. In addition, some of the companies are also voluntarily publishing their financial statements on their respective websites. All the insurance companies' annual accounts are also hosted on MCA's website.

[45] Amended vide SEBI circular dated April 26, 2007.

Present Assessment: Fully Implemented

Overall Comments: Companies Act, DIP guidelines and listing agreement have adequate provisions to ensure availability of information. Reference is invited to the comments provided at Principle IV D.

Principle VF: The corporate governance framework should be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others, that is relevant to decisions by investors, free from material conflicts of interest that might compromise the integrity of their analysis or advice.

Earlier Assessment: Not Available

Current Position:

i. Brokers, mutual funds, portfolio managers, credit rating agencies are registered and regulated by SEBI. SEBI has mandated rating of IPOs by SEBI-registered credit rating agencies.

ii. SEBI is also in the process of formulating regulations for investment advisors to provide credible framework for analyses and investment advice.

iii. There are disclosure requirements under SEBI Insider Trading Regulations and listing agreement to take care of conflict of interest.

iv. There are restrictions and disclosure requirements on brokers and sub-brokers, on giving advice and recommendations, in terms of Clause 7 of Code of Conduct stipulated under SEBI (Stock Brokers and Sub- Brokers) Regulations.

Insurance

At present, none of the insurance companies is listed and their shares are not widely held. Potential investors carry out due analysis of the respective companies prior to taking an investment decision.

Present Assessment: Broadly Implemented

Overall Comments: Various initiatives as indicated above have been taken in the direction of the Principle above.

VI: Responsibilities of the Board

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

Principle VIA: The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders. Board members should act on a fully informed basis, in good faith, with due diligence and care and in the best interests of the company and its shareholders.

Earlier Assessment: Largely Observed

Current Position:

i. There are provisions in the Companies Act, 1956 which provide for effective management by the board and make the board accountable to the company and shareholders.

ii. The provisions of Clause 41 and 49 of the listing agreement also seek to place a greater responsibility on the board and on the independent directors to protect the interest of the stakeholders. As per Clause 49 I(A) the BoD of the listed companies has to be an optimum combination of executive and independent directors with not less than fifty per cent of the board of directors comprising of non-executive directors, to facilitate unbiased monitoring of affairs of the company. Where the chairman of the board is non-executive director, at least one third of the board should comprise of independent directors and in case he is an executive director, at least half of the board should comprise of independent directors.

iii. The board is assisted by various committees which oversee and review the functioning of all critical areas on an ongoing basis and report directly to the board.

iv. The board is empowered to seek information on all significant issues. Clause 49 (1) (C) stipulates that the board shall meet at least four times a year, with a maximum time gap of four months between any two meetings. Minimum information to be made available to the board to facilitate informed decision has also been provided under the said clause. A director cannot be a member in more than 10 committees or act as a Chairman of more than five committees across all companies in which he is a director.

v. Recent amendments in Clause 41 are also steps towards ensuring greater accountability of the board. As per Clause 41 (II) (a) all quarterly financial results are to be approved by the BoD. There are requirements *vis-à-vis* the CEO and CFO, *i.e.,* whole-time finance director or any other person handling finance functions to certify that the financial results do not contain any false or misleading statement or figures and do not omit any material fact which may make the statements or figures contained therein misleading.

Banks: Private Sector Banks

i. In terms of the directive issued by the Reserve Bank in June 2004, all banks in the private sector have to ensure that the directors on their boards satisfy the 'fit and proper' criteria such as educational qualifications, integrity, track record, *etc.* For this purpose, all the directors are required to furnish a declaration and undertaking to the bank and the Nomination Committee of the Board is expected to carry out an exercise of due diligence in respect of the directors based on the information furnished by the directors as also based on information obtained from other sources.

ii. Further, all the directors on the boards are expected to execute a deed of covenant to discharge the responsibilities as directors to the best of their abilities.

iii. Even in the case of public sector banks, the 'fit and proper' criteria have been made applicable to elected directors by way of suitable amendments to the relevant statutes. However, in the case of directors nominated by Government of India under Section 9(3) (h) of the Banking Companies (Acquisition and Transfer of Undertaking) Act, 1970/1980 amendments to the Act making applicable 'fit and proper' criteria for nominated directors are yet to be carried out.

Insurance

i. While the provisions of the Companies Act, 1956 are applicable to all insurance companies, in addition, the following proviso is also applicable under the Insurance Act, 1938.

ii. Section 48B: A life insurer shall not have a common director with another such insurer.

Present Assessment: Fully Implemented

Overall Comments: With the recent amendments brought about in the listing agreement, the necessary requirements for compliance with the Principle are in place.

Principle VIB: Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.

Earlier Assessment: Largely Observed

Current Position:

i. The BoD is under an obligation to take decisions in a fair manner in the best interests of the company and its shareholders.

ii. In any case, if any shareholder group feels oppressed by board's other group, provisions in respect of taking up the matter with quasi-judicial forum (CLB) are available.

iii. To safeguard the interest of the minority shareholders, it has been stipulated under the listing agreement that the board should have an optimum combination of executive and non-executive directors.

iv. Further, there is a requirement to set up Shareholders' Committee headed by a non-executive director to look into investor grievances.

Present Assessment: Broadly Implemented

Overall Comments: While necessary provisions have been enshrined in the related laws, there is scope for improvement on the implementation side. The rights of the shareholders are adequately protected under the present legal structure.

Principle VIC: The board should apply high ethical standards. It should take into account the interests of stakeholders.

Earlier Assessment: Observed

Current Position:

i. Directors' Responsibility Statement under Section 217(2AA) has been provided for to hold the BoD accountable in respect of financial disclosure. The Company Secretary ensures that the board complies with its statutory duties and obligations. In terms of Section 217, the board reports annually on company activities, including company performance on environment issues, labour issues, tax compliance and provisions of Competition Act. Apart from Section 217(2AA) of the Companies Act, the powers and duties of directors are contained in Section 291 and 293 of Companies Act.

ii. The board normally relies on the committees/management for ensuring compliance with the applicable laws. However, the directors themselves also need to be reasonably aware of all applicable laws.

iii. To ensure compliance, certifications from CEO and CFO have been made mandatory. Clause 49 of the listing agreement provide for code of conduct for BoD and senior management which is required to be posted on the website of the company. All board members and senior management personnel are required to confirm compliance with the code on an annual basis.

iv. Listed companies are also required to obtain certificate from the auditors or practicing company secretaries regarding compliance of conditions of corporate governance as stipulated under listing agreement.

Insurance

i. Compliance with the stipulations of the Insurance Act and registration requirements are to be confirmed by the statutory auditors.

Present Assessment: Fully Implemented

Overall Comments: Both Companies Act and listing agreement stipulate clear-cut obligations on the BoD in this regard. The comments under Principle VI B may be referred.

Principle VID: The board should fulfill certain key functions including (i) Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures; (ii) Monitoring the effectiveness of the company's governance practices and making changes as needed; (iii) Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning; (iv) Aligning key executive and board remuneration with the longer-term interests of the company and its shareholders; (v) Ensuring a formal and transparent board nomination and election process; (vi) Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions; (vii) Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standard; (viii) Overseeing the process of disclosure and communications.

Earlier Assessment: Largely Observed

Current Position:

i. These functions are the responsibility of the board. To facilitate effective functioning there are various dedicated Committees, which are mandatory in the case of listed companies to monitor the effectiveness of the company's governance practices and making changes as

needed. Listing agreement mandates setting up of audit committee[46] which is expected to mainly oversee and review the financials of the company, its subsidiaries, related party transactions, functioning of auditors, *etc.,* The audit committee is also required to review the functioning of whistl-blower mechanism. As per recent amendments in the listing agreement the monitoring report[47] filed by the monitoring agency with the issuer company regarding utilisation of issue proceeds is to be placed before the audit committee which, in turn, will make appropriate recommendations to the board. In term of para IV(F) of Clause 49, MDA is to include discussion on 'Risks and Concerns.'

ii. In terms of listing agreement, there has to be a separate section on corporate governance in the Annual Reports of the company, with a detailed compliance report on corporate governance. Non-compliance of any mandatory requirement along with reasons thereof and the extent to which the non-mandatory requirements have been adopted are to be specifically highlighted.

iii. The process of selecting, compensating, monitoring and when necessary, replacing key executives is carried out by the company managements under the overall HR policy of the company. There are disclosure requirements for compensation to employees beyond the prescribed threshold. ESOPs are also to be approved by the board as well as shareholders.

iv. The remuneration paid to the BoD/managerial personnel is governed by the various provisions of the Companies Act, 1956, which is primarily based on the profits of the company. The terms and conditions for the appointment and payment of remuneration to them is also subject to the approval of shareholders. There is a formal and transparent board election process. The shareholders of the company appoint regular directors. The Board of Directors can appoint casual directors (Section 260), Additional Directors (Section 262) and Alternate Director (Section 313). Even the Central Government can nominate special directors on the board of the company (Section 408). Under the listing agreement all fees/ compensation to be paid to non-executive directors, including independent directors is to be fixed by board and requires prior approval of shareholders in general meeting. Under the non-mandatory requirements stipulated under the listing agreement, the Board is empowered to set up Remuneration Committee to look into various aspects pertaining to remuneration to be paid to executive directors.

v. Position under Principle VI (D) (iv) and II A (5) above may be referred.

vi. There are provisions in the Companies Act, 1956 that provides for monitoring and managing potential conflicts of interest of management, board members and shareholders including misuse of corporate assets and abuse in related party transactions. All the directors are required to disclose their interest to the company. Under listing agreement, all material transactions along with management's justification are to be placed before the audit

[46] As per Clause 49 II A of the listing agreement Audit Committee shall have
- minimum three directors
- two-third of the members as independent directors
- all financially literate members with at least one member having accounting or related financial management expertise.

Chairman of the Audit Committee shall be present at the AGM to answer shareholder queries.

Powers of Audit Committee:
- To investigate any activity within its terms of reference
- To seek information from any employee
- To obtain outside legal or other professional advice
- To secure attendance of outsiders with relevant expertise, if considered necessary.

[47] In terms of SEBI DIP Guidelines any company making a public or rights issue of more than Rs 500 crore has to appoint a monitoring agency to monitor the utilisation of issue proceeds that in turn files its report with the issuer company.

committee. Regarding subsidiary companies, there are provisions to ensure that at least one independent director on the board of the holding company is a director on the BoD of a material non- listed Indian subsidiary company[48]. The audit committee of the listed holding company reviews the financial statements, in particular, the investments made by the unlisted subsidiary company. The minutes of the board meetings of the unlisted subsidiary company are to be placed at the board meeting of the listed holding company. The management is required to periodically bring to the attention of the BoD of the listed holding company, a statement of all significant transactions and arrangements entered into by the unlisted subsidiary company. Further, as stated above, the audit committee reviews statement of significant related party transactions[49] (as defined by the audit committee), submitted by management. In terms of para IV(F) Clause 49 of listing agreement, companies are required to lay down procedures to inform board members about risk assessment and minimisation procedures. These procedures are to be periodically reviewed to ensure that executive management controls risks through means of properly defined framework. Information to be made available to the Board, as per para I(C) of Clause 49 of Listing agreement includes quarterly details of foreign exchange exposures and steps taken by the management to limit the risks of adverse exchange rate movement, if material.

vii. It is the duty of the board/management to ensure integrity of accounts/financial statements. The board is required by the law to disclose in their Annual Report about the financial position of the company. The Manager/Secretary and the two directors of the company (Managing Director must sign, if there is one) are required to sign the financial statements. It is optional if all the board members want to sign financial statements. Further there are certification requirements by the CEO/CFO pertaining to financials and operations of the company, in terms of Listing agreement. The company is also required to obtain certificate from the auditors or practicing company secretaries regarding compliance of conditions of corporate governance as stipulated under listing agreement. When money is raised through an issue (public issue, rights issue, preferential issue, *etc.,*) in terms of Clause 49 (D) there are requirements to disclose to the audit committee, the uses/applications of funds by major category (capital expenditure, sales marketing, working capital, *etc.*) on a quarterly basis as part of their quarterly declaration of financial results. On an annual basis, till the full money raised through the public issue is utilised, companies are required to prepare a statement, duly certified by statutory auditors, of funds utilised for purposes other than those stated in the offer document. Audit committee is required to make appropriate recommendation to the board to take up steps in this matter.

[48] An unlisted company incorporated in India, whose turnover or net worth exceeds 20 per cent of consolidated turnover or net worth respectively of listed holding company and its subsidiary in the immediately preceding accounting year.

[49] Any individual transaction or arrangement that exceeds or is likely to exceed 10 per cent of the total revenues or total expenses or total assets or total liabilities, as the case may be, of the materially unlisted subsidiary for the immediately preceding accounting year.

viii. Clause 49 of the listing agreement stipulates that the board oversee the process of disclosure and communication.

Banks

As per Ganguly committee recommendation, banks and FIs have been advised to have Risk Management Committee.

Insurance

i. Insurance companies are required to set up investment committees. The constitution of the committee and its functions have also been stipulated under the regulations.

ii. Additional responsibilities have been entrusted upon the boards of the non-life insurance companies in the de-tariffed scenario with specific reference to the underwriting policy of their respective companies.

iii. As part of annual financial statements, insurance companies are required to submit 'Management Report' on various issues confirming payment of statutory dues, shareholding pattern and transfer of shares are in accordance with the statutory or regulatory requirements, policyholders funds being invested in India, solvency margins have been maintained, review of values of various assets in the balance sheet, overall risk exposure and strategy adopted to mitigate the same, performance of investments *etc.*

Present Assessment: Broadly Implemented

Overall Comments: With the amendment in listing agreement brought about by SEBI pursuant to Narayana Murthy Report on corporate governance, boards' responsibilities have been substantially enhanced and further crystallised. It, however, needs to be evaluated whether the same are being implemented by companies across the board. Non-compliant companies should be identified and appropriate regulatory action initiated. Further, recent developments in the derivatives market have brought to the forefront the importance of risk management. There is a need for strengthening the existing framework with regard to risk management in listed companies. Introducing the requirement of having Risk Committees in the listing agreement can be specifically explored in this regard. Further, there is a need to promote a credible institute for the training of directors, including independent directors. Deterrent provisions and stiffer penalties may be provided for in the corporate law for violation of provisions pertaining to related party transactions.

Principle VIE: The board should be able to exercise objective independent judgement on corporate affairs (i) Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives, and board remuneration; (ii) When committees of the board are established, their mandate, composition and working procedures should be well-defined and disclosed by the board; (iii) Board members should be able to commit themselves effectively to their responsibilities.

Earlier Assessment: Partially Observed

Current Position:

i. Clause 49 of the listing agreement provides for composition of the board, *i.e.,* balance between executive and non-executive directors. It also specifies the number of independent directors required on the board. As a non-mandatory condition stipulated under listing agreement

the tenure of independent directors is not to exceed, in the aggregate, nine years, on the board of a company. Position given under Principle VIA may also be seen in this regard. There are also requirements pertaining to composition of the various committees, to be set up under the listing agreement, to ensure representation by independent directors. For instance, audit committee has to be chaired by an independent director (who is required to be present at annual general meeting to answer shareholder queries) and two-thirds of its members should be independent directors. The audit committee is also mandated to meet at least four times a year and not more than four months should lapse between two meetings. Similarly, grievance committee is to be headed by independent director. The listing agreement also provides for setting up of remuneration committee, as a non-mandatory condition.

ii. The listing agreement lays down in detail the mandate, composition and working procedure with respect to various committees required to be set up.

iii. There are sufficient provisions in the Companies Act, 1956, and the listing agreement which ensures the maximum number of companies in which one person could be a director, regular attendance of directors in the board meetings and also the frequency of board meetings.

Present Assessment: Broadly Implemented

Overall Comments: Listing agreement has been amended by SEBI, pursuant to recommendations in Narayana Murthy Report on Corporate Governance to bring about greater clarity in these areas. There is, however, variance on the extent of compliance by the companies. Maximum term of independent director on the board of a company may be statutorily restricted. Eventually definition of Independent director is required to be brought in the corporate law.

Principle VIF: In order to fulfill their responsibilities, board members should have access to accurate, relevant and timely information.

Earlier Assessment: Observed

Current Position:

i. The access to the quality information in a timely manner depends on the culture of the organisation.

ii. Clause 49 of the listing agreement stipulates that the minimum information that must be made available to the board. The list includes all material information that would be required by the board for effective functioning. Further, the board is empowered to seek at any point of time any information that it may deem to be material. They also have access to expert advice.

Present Assessment: Fully Implemented

Overall Comments: Requisite provisions have been laid down in the law. The Institute of Company Secretaries of India has brought out a Secretarial Guide on boardroom practices which would serve as a repository of good practices for making board functioning effective.

Annex A

Clause 49 of the Listing Agreement

49. Corporate Governance

The company agrees to comply with the following provisions:

I. Board of Directors

(A) Composition of Board

i. The BoD of the company shall have an optimum combination of executive and non-executive directors with not less than fifty per cent of the board of directors comprising of non-executive directors.

ii. Where the Chairman of the board is a non-executive director, at least one-third of the board should comprise of independent directors and in case he is an executive director, at least half of the board should comprise of independent directors.

Provided that where the non-executive Chairman is a promoter of the company or is related to any promoter or person occupying management positions at the board level or at one level below the board, at least one-half of the board of the company shall consist of independent directors.

Explanation-For the purpose of the expression 'related to any promoter' referred to in sub-clause (ii):

a. If the promoter is a listed entity, its directors other than the independent directors, its employees or its nominees shall be deemed to be related to it;

b. If the promoter is an unlisted entity, its directors, its employees or its nominees shall be deemed to be related to it.

iii. For the purpose of the sub-clause (ii), the expression 'independent director' shall mean a non-executive director of the company who:

a. apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director;

b. is not related to promoters or persons occupying management positions at the board level or at one level below the board;

c. has not been an executive of the company in the immediately preceding three financial years;

d. is not a partner or an executive or was not partner or an executive during the preceding three years, of any of the following:

i. the statutory audit firm or the internal audit firm that is associated with the company, and

ii. the legal firm(s) and consulting firm(s) that have a material association with the company.

e. is not a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director;

f. is not a substantial shareholder of the company, *i.e.,* owning two per cent or more of the block of voting shares;

g. is not less than 21 years of age.

Explanation

For the purposes of the sub-clause (iii):

a. Associate shall mean a company which is an 'associate' as defined in Accounting Standard (AS) 23, *Accounting for Investments in Associates in Consolidated Financial Statements*, issued by the Institute of Chartered Accountants of India.

b. 'Senior management' shall mean personnel of the company who are members of its core management team excluding BoD. Normally, this would comprise all members of management one level below the executive directors, including all functional heads.

c. 'Relative' shall mean 'relative' as defined in Section 2(41) and section 6 read with Schedule IA of the Companies Act, 1956.

d. Nominee directors appointed by an institution which has invested in or lent to the company shall be deemed to be independent directors.

Explanation:

'Institution' for this purpose means a public financial institution as defined in Section 4A of the Companies Act 1956 or a 'corresponding new bank' as defined in Section 2(d) of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 or the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 [both Acts].

(B) Non executive directors' compensation and disclosures

All fees/compensation, if any, paid, to non-executive directors, including independent directors, shall be fixed by the Board of Directors and shall require previous approval of shareholders in general meeting. The shareholders' resolution shall specify the limits for the maximum number of stock options that can be granted to non-executive directors, including independent directors, in any financial year and in aggregate.

Provided that the requirement of obtaining prior approval of shareholders in general meeting shall not apply to payment of sitting fees to non-executive directors, if made within the limits prescribed under the Companies Act, 1956 for payment of sitting fees without approval of the Central Government.

(C) Other provisions as to Board and Committees

i. The board shall meet at least four times a year, with a maximum time gap of four months between any two meetings. The minimum information to be made available to the board is given in **Annex I A.**

ii. A director shall not be a member in more than 10 committees or act as Chairman of more than five committees across all companies in which he is a director. Furthermore it should be a mandatory annual requirement for every director to inform the company about the committee positions he occupies in other companies and notify changes as and when they take place.

Explanation:

i. For the purpose of considering the limit of the committees on which a director can serve, all public limited companies, whether listed or not, shall be included and all other companies including private limited companies, foreign companies and companies under Section 25 of the Companies Act shall be excluded.

ii. For the purpose of reckoning the limit under this sub-clause, Chairmanship/ membership of the audit committee and the shareholders' grievance committee alone shall be considered.

iii. The board shall periodically review compliance reports of all laws applicable to the company, prepared by the company as well as steps taken by the company to rectify instances of non-compliances.

iv. An independent director who resigns or is removed from the board of the company shall be replaced by a new independent director within a period of not more than 180 days from the day of such resignation or removal, as the case may be:

Provided that where the company fulfils the requirement of independent directors in its board even without filling the vacancy created by such resignation or removal, as the case may be, the requirement of replacement by a new independent director within the period of 180 days shall not apply.

(D) Code of Conduct

i. The board shall lay down a code of conduct for all board members and senior management of the company. The code of conduct shall be posted on the website of the company.

ii. All board members and senior management personnel shall affirm compliance with the code on an annual basis. The annual report of the company shall contain a declaration to this effect signed by the CEO.

Explanation:

For this purpose, the term 'senior management' shall mean personnel of the company who are members of its core management team excluding Board of Directors. Normally, this would comprise all members of management one level below the executive directors, including all functional heads.

II. Audit Committee

(A) Qualified and Independent Audit Committee

A qualified and independent Audit Committee shall be set up, giving the terms of reference subject to the following:

i. The Audit Committee shall have minimum three directors as members. Two-thirds of the members of Audit Committee shall be independent directors;

ii. All members of Audit Committee shall be financially literate and at least one member shall have accounting or related financial management expertise;

Explanation

i. The term 'financially literate' means the ability to read and understand basic financial statements, *i.e.,* balance sheet, profit and loss account, and statement of cash flows.

ii. A member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting or requisite professional certification in accounting or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a Chief Executive Officer, Chief Financial Officer or other senior officer with financial oversight responsibilities.

iii. The Chairman of the Audit Committee shall be an independent director;

iv. The Chairman of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries;

v. The Audit Committee may invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the Committee, but on occasions it may also meet without the presence of any executives of the company. The finance director, head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the Audit Committee;

vi. The Company Secretary shall act as the secretary to the Committee.

(B) Meeting of Audit Committee

The Audit Committee should meet at least four times in a year and not more than four months shall elapse between two meetings. The quorum shall be either two members or one third of the members of the Audit Committee, whichever is greater, but there should be a minimum of two independent members present.

(C) Powers of Audit Committee

The Audit Committee shall have powers, which should include the following:

1. To investigate any activity within its terms of reference.
2. To seek information from any employee.
3. To obtain outside legal or other professional advice.
4. To secure attendance of outsiders with relevant expertise, if it considers necessary.

(D) Role of Audit Committee

The role of the Audit Committee shall include the following:

1. Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.
2. Recommending to the board, the appointment, re-appointment and, if required, the replacement or removal of the statutory auditor and the fixation of audit fees.
3. Approval of payment to statutory auditors for any other services rendered by the statutory auditors.
4. Reviewing, with the management, the annual financial statements before submission to the board for approval, with particular reference to:
   a. Matters required to be included in the Director's Responsibility Statement to be included in the Board's Report in terms of clause (2AA) of Section 217 of the Companies Act, 1956;
   b. Changes, if any, in accounting policies and practices and reasons for the same;
   c. Major accounting entries involving estimates based on the exercise of judgment by management;
   d. Significant adjustments made in the financial statements arising out of audit findings;
   e. Compliance with listing and other legal requirements relating to financial statements;
   f. Disclosure of any related party transactions; and
   g. Qualifications in the draft audit report.
5. Reviewing, with the management, the quarterly financial statements before submission to the board for approval.

5A. Reviewing, with the management, the statement of uses/application of funds raised through an issue (public issue, rights issue, preferential issue, *etc.*), the statement of funds utilised for purposes other than those stated in the offer document/prospectus/notice and the report submitted by the monitoring agency monitoring the utilisation of proceeds of a public or rights issue, and making appropriate recommendations to the board to take up steps in this matter.

6. Reviewing, with the management, performance of statutory and internal auditors, adequacy of the internal control systems.
7. Reviewing the adequacy of internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure, coverage and frequency of internal audit.
8. Discussion with internal auditors any significant findings and follow-up thereon.
9. Reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board.
10. Discussion with statutory auditors before the audit commences, about the nature and scope of audit as well as post-audit discussion to ascertain any area of concern.
11. To look into the reasons for substantial defaults in the payment to the depositors, debenture-holders, shareholders (in case of non-payment of declared dividends) and creditors.
12. To review the functioning of the whistle-blower meschanism, in case the same is existing.
13. Carrying out any other function as is mentioned in the terms of reference of the Audit Committee.

Explanation

i. The term 'related party transactions' shall have the same meaning as contained in the Accounting Standard 18, *Related Party Transactions*, issued by the Institute of Chartered Accountants of India.

ii. If the company has set up an Audit Committee pursuant to provision of the Companies Act, the said Audit Committee shall have such additional functions/features as is contained in this clause.

(E) Review of Information by Audit Committee

The Audit Committee shall mandatorily review the following information:

1. Management discussion and analysis of financial condition and results of operations;
2. Statement of significant related party transactions (as defined by the Audit Committee), submitted by management;
3. Management letters/letters of internal control weaknesses issued by the statutory auditors;

4. Internal audit reports relating to internal control weaknesses; and
5. The appointment, removal and terms of remuneration of the Chief Internal Auditor shall be subject to review by the Audit Committee.

III. Subsidiary Companies

i. At least one independent director on the BoD of the holding company shall be a director on the BoD of a material non-listed Indian subsidiary company.

ii. The Audit Committee of the listed holding company shall also review the financial statements, in particular, the investments made by the unlisted subsidiary company.

iii. The minutes of the board meetings of the unlisted subsidiary company shall be placed at the board meeting of the listed holding company. The management should periodically bring to the attention of the Board of Directors of the listed holding company, a statement of all significant transactions and arrangements entered into by the unlisted subsidiary company.

Explanation

i. The term 'material non-listed Indian subsidiary' shall mean an unlisted subsidiary, incorporated in India, whose turnover or net worth (*i.e.* paid-up capital and free reserves) exceeds 20 per cent of the consolidated turnover or net worth respectively, of the listed holding company and its subsidiaries in the immediately preceding accounting year.

ii. The term 'significant transaction or arrangement' shall mean any individual transaction or arrangement that exceeds or is likely to exceed 10 per cent of the total revenues or total expenses or total assets or total liabilities, as the case may be, of the material unlisted subsidiary for the immediately preceding accounting year.

iii. Where a listed holding company has a listed subsidiary which is itself a holding company, the above provisions shall apply to the listed subsidiary insofar as its subsidiaries are concerned.

IV. Disclosures

(A) Basis of related party transactions

i. A statement in summary form of transactions with related parties in the ordinary course of business shall be placed periodically before the Audit Committee.

ii. Details of material individual transactions with related parties which are not in the normal course of business shall be placed before the Audit Committee.

iii. Details of material individual transactions with related parties or others, which are not on an arm's length basis should be placed before the Audit Committee, together with Management's justification for the same.

(B) Disclosure of Accounting Treatment

Where in the preparation of financial statements, a treatment different from that prescribed in an Accounting Standard has been followed, the fact shall be disclosed in the financial statements, together with the management's explanation as to why it believes such alternative treatment is more representative of the true and fair view of the underlying business transaction in the Corporate Governance Report.

(C) Board Disclosures – Risk management

The company shall lay down procedures to inform board members about the risk assessment and minimisation procedures. These procedures shall be periodically reviewed to ensure that executive management controls risk through means of a properly defined framework.

(D) Proceeds from public issues, rights issues, preferential issues, *etc.*

When money is raised through an issue (public issues, rights issues, preferential issues *etc.*), it shall disclose to the Audit Committee, the uses/applications of funds by major category (capital expenditure, sales and marketing, working capital, *etc.,*), on a quarterly basis as a part of their quarterly declaration of financial results. Further, on an annual basis, the company shall prepare a statement of funds utilised for purposes other than those stated in the offer document/prospectus/notice and place it before the Audit Committee. Such disclosure shall be made only till such time that the full money raised through the issue has been fully spent. This statement shall be certified by the statutory auditors of the company. Furthermore, where the company has appointed a monitoring agency to monitor the utilisation of proceeds of a public or rights issue, it shall place before the Audit Committee the monitoring report of such agency, upon receipt, without any delay. The Audit Committee shall make appropriate recommendations to the board to take up steps in this matter.

(E) Remuneration of Directors

i. All pecuniary relationship or transactions of the non-executive directors *vis-à-vis* the company shall be disclosed in the Annual Report.

ii. Further the following disclosures on the remuneration of directors shall be made in the section on the corporate governance of the Annual Report.

   a. All elements of remuneration package of individual directors summarised under major groups, such as salary, benefits, bonuses, stock options, pension, *etc.*

   b. Details of fixed component and performance linked incentives, along with the performance criteria.

   c. Service contracts, notice period, severance fees.

   d. Stock option details, if any – and whether issued at a discount as well as the period over which accrued and over which exercisable.

iii. The company shall publish its criteria of making payments to non-executive directors in its Annual Report. Alternatively, this may be put up on the company's website and reference drawn thereto in the Annual Report.

iv. The company shall disclose the number of shares and convertible instruments held by non-executive directors in the Annual Report.

v. Non-executive directors shall be required to disclose their shareholding (both own or held by/for other persons on a beneficial basis) in the listed company in which they are proposed to be appointed as directors, prior to their appointment. These details should be disclosed in the notice to the general meeting called for appointment of such director.

(F) Management

i. As part of the directors' report or as an addition thereto, a Management Discussion and Analysis Report should form part of the Annual Report to the shareholders. This Management Discussion and Analysis should include discussion on the following matters within the limits set by the company's competitive position:

1. Industry structure and developments.
2. Opportunities and Threats.
3. Segment–wise or product-wise performance.
4. Outlook
5. Risks and concerns.
6. Internal control systems and their adequacy.
7. Discussion on financial performance with respect to operational performance.
8. Material developments in Human Resources/Industrial Relations front, including number of people employed.

ii. Senior management shall make disclosures to the board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (for e.g. dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives, *etc.,*)

Explanation:

For this purpose, the term 'senior management' shall mean personnel of the company who are members of its core management team excluding the Board of Directors). This would also include all members of management one level below the executive directors including all functional heads.

(G) Shareholders

i. In case of the appointment of a new director or re-appointment of a director, the shareholders must be provided with the following information:

a. A brief resume of the director;

b. Nature of his expertise in specific functional areas;

c. Names of companies in which the person also holds the directorship and the membership of Committees of the Board; and

d. Shareholding of non-executive directors as stated in Clause 49 (IV) (E) (v) above

ia. Disclosure of relationships between directors inter-se shall be made in the Annual Report, notice of appointment of a director, prospectus and letter of offer for issuances and any related filings made to the stock exchanges where the company is listed.

ii. Quarterly results and presentations made by the company to analysts shall be put on company's web-site, or shall be sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own web-site.

iii. A board committee under the chairmanship of a non-executive director shall be formed to specifically look into the redressal of shareholder and investors complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends *etc.* This Committee shall be designated as 'Shareholders/ Investors Grievance Committee'.

iv. To expedite the process of share transfers, the board of the company shall delegate the power of share transfer to an officer or a committee or to the registrar and share transfer agents. The delegated authority shall attend to share transfer formalities at least once in a fortnight.

V. CEO/CFO certification

The CEO, *i.e.* the Managing Director or Manager appointed in terms of the Companies Act, 1956 and the CFO *i.e.* the whole-time Finance Director or any other person heading the finance function discharging that function shall certify to the board that:

a. They have reviewed financial statements and the cash flow statement for the year and that to the best of their knowledge and belief:

i. these statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading;

ii. these statements together present a true and fair view of the company's affairs and are in compliance with existing accounting standards, applicable laws and regulations.

b. There are, to the best of their knowledge and belief, no transactions entered into by the company during the year which are fraudulent, illegal or violative of the company's code of conduct.

c. They accept responsibility for establishing and maintaining internal controls for financial reporting and that they have evaluated the effectiveness of internal control

systems of the company pertaining to financial reporting and they have disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of such internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify these deficiencies.

d. They have indicated to the auditors and the Audit Committee,

   i. significant changes in internal control over financial reporting during the year;

   ii. significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and

   iii. instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the company's internal control system over financial reporting.

VI. Report on Corporate Governance

i. There shall be a separate section on corporate governance in the Annual Reports of company, with a detailed compliance report on corporate governance. Non-compliance of any mandatory requirement of this clause with reasons thereof and the extent to which the non-mandatory requirements have been adopted should be specifically highlighted. The suggested list of items to be included in this report is given in **Annex I C** and list of non-mandatory requirements is given in **Annex I D.**

ii. The companies shall submit a quarterly compliance report to the stock exchanges within 15 days from the close of quarter as per the format given in **Annex I B**. The report shall be signed either by the compliance officer or the Chief Executive Officer of the company.

VII. Compliance

1. The company shall obtain a certificate from either the auditors or practicing company secretaries regarding compliance of conditions of corporate governance as stipulated in this clause and annex the certificate with the directors' report, which is sent annually to all the shareholders of the company. The same certificate shall also be sent to the Stock Exchanges along with the Annual Report filed by the company.

2. The non-mandatory requirements given in **Annex I D** may be implemented as per the discretion of the company. However, the disclosures of the compliance with mandatory requirements and adoption (and compliance)/non-adoption of the non-mandatory requirements shall be made in the section on corporate governance of the Annual Report.

Annex I A

Information to be Placed Before Board of Directors

1. Annual operating plans and budgets and any updates.
2. Capital budgets and any updates.
3. Quarterly results for the company and its operating divisions or business segments.
4. Minutes of meetings of Audit Committee and other committees of the board.
5. The information on recruitment and remuneration of senior officers just below the board level, including appointment or removal of Chief Financial Officer and the Company Secretary.
6. Show cause, demand, prosecution notices and penalty notices which are materially important.
7. Fatal or serious accidents, dangerous occurrences, any material effluent or pollution problems.
8. Any material default in financial obligations to and by the company, or substantial non-payment for goods sold by the company.
9. Any issue, which involves possible public or product liability claims of substantial nature, including any judgement or order which, may have passed strictures on the conduct of the company or taken an adverse view regarding another enterprise that can have negative implications on the company.
10. Details of any joint venture or collaboration agreement.
11. Transactions that involve substantial payment towards goodwill, brand equity, or intellectual property.
12. Significant labour problems and their proposed solutions. Any significant development in Human Resources/Industrial Relations front like signing of wage agreement, implementation of Voluntary Retirement Scheme, *etc.*
13. Sale of material nature, of investments, subsidiaries, assets, which is not in normal course of business.
14. Quarterly details of foreign exchange exposures and the steps taken by management to limit the risks of adverse exchange rate movement, if material.
15. Non-compliance of any regulatory, statutory or listing requirements and shareholders service such as non-payment of dividend, delay in share transfer, *etc.*

Annex I B

Format of Quarterly Compliance Report on Corporate Governance

Name of the Company:
Quarter ending on:

	Particulars	Clause of Listing Agreement	Compliance Status Yes/No	Remarks
	1	2	3	4
I.	**Board of Directors**	491		
	(A) Composition of Board	49 (IA)		
	(B) Non-executive Directors' compensation and disclosures	49 (IB)		
	(C) Other provisions as to Board and Committees	49 (IC)		
	(D) Code of Conduct	49 (ID)		
II.	**Audit Committee**	49 (II)		
	(A) Qualified and Independent Audit Committee	49 (IIA)		
	(B) Meeting of Audit Committee	49 (IIB)		
	(C) Powers of Audit Committee	49 (IIC)		
	(D) Role of Audit Committee	49 II(D)		
	(E) Review of Information by Audit Committee	49 (IIE)		
III.	**Subsidiary Companies**	49 (III)		
IV.	**Disclosures**	49 (IV)		
	(A) Basis of related party transactions	49 (IV A)		
	(B) Disclosure of Accounting Treatment	49 (IV B)		
	(C) Board Disclosures	49 (IV C)		
	(D) Proceeds from public issues, rights issues, preferential issues *etc.*	49 (IV D)		
	(E) Remuneration of Directors	49 (IV E)		
	(F) Management	49 (IV F)		
	(G) Shareholders	49 (IV G)		
V.	**CEO/CFO Certification**	49 (V)		
VI.	**Report on Corporate Governance**	49 (VI)		
VII.	**Compliance**	49 (VII)		

Note: 1. The details under each head shall be provided to incorporate all the information required as per the provisions of the Clause 49 of the Listing Agreement.

2. In the column No.3, compliance or non-compliance may be indicated by Yes/No/N.A. For example, if the board has been composed in accordance with the Clause 49 I of the Listing Agreement, 'Yes' may be indicated. Similarly, in case the company has no related party transactions, the words 'N.A.' may be indicated against 49 (IV A).

3. In the remarks column, reasons for non-compliance may be indicated, for example, in case of requirement related to circulation of information to the shareholders, which would be done only in the AGM/EGM, it might be indicated in the 'Remarks' column as – 'will be complied with at the AGM'. Similarly, in respect of matters which can be complied with only where the situation arises, for example, 'Report on Corporate Governance' is to be a part of Annual Report only, the words 'will be complied in the next Annual Report' may be indicated.

Annex I C

Suggested List of Items to be Included in the Report on Corporate Governance in the Annual Report of Companies

1. A brief statement on company's philosophy on code of governance.

2. Board of Directors:
   i. Composition and category of directors, for example, promoter, executive, non-executive, independent non-executive, nominee director, which institution represented as lender or as equity investor.
   ii. Attendance of each director at the board meetings and the last AGM.
   iii. Number of other Boards or Board Committees in which he/she is a member or Chairperson.
   iv. Number of board meetings held, dates on which held.

3. Audit Committee:
   i. Brief description of terms of reference.
   ii. Composition, name of members and Chairperson.
   iii. Meetings and attendance during the year.

4. Remuneration Committee:
   i. Brief description of terms of reference.
   ii. Composition, name of members and Chairperson.
   iii. Attendance during the year.
   iv. Remuneration policy.
   v. Details of remuneration to all the directors, as per format in main report.

5. Shareholders' Committee:
   i. Name of non-executive director heading the committee.
   ii. Name and designation of compliance officer.
   iii. Number of shareholders' complaints received so far.
   iv. Number not solved to the satisfaction of shareholders.
   v. Number of pending complaints.

6. General Body meetings:
   i. Location and time, where last three AGMs held.
   ii. Whether any special resolutions passed in the previous three AGMs.
   iii. Whether any special resolution passed last year through postal ballot – details of voting pattern.

iv. Person who conducted the postal ballot exercise.

v. Whether any special resolution is proposed to be conducted through postal ballot

vi. Procedure for postal ballot.

7. Disclosures:

   i. Disclosures on materially significant related party transactions that may have potential conflict with the interests of company at large.

   ii. Details of non-compliance by the company, penalties, strictures imposed on the company by stock exchange or SEBI or any statutory authority, on any matter related to capital markets, during the last three years.

   iii. Whistle-Blower policy and affirmation that no personnel has been denied access to the Audit Committee.

   iv. Details of compliance with mandatory requirements and adoption of the non-mandatory requirements of this clause.

8. Means of communication:

   i. Quarterly results.

   ii. Newspapers wherein results normally published.

   iii. Any website, where displayed.

   iv. Whether it also displays official news releases.

   v. The presentations made to institutional investors or to the analysts.

9. General Shareholder information:

   i. AGM: Date, time and venue.

   ii. Financial year.

   iii. Date of Book closure.

   iv. Dividend Payment Date.

   v. Listing on Stock Exchanges.

   vi. Stock Code.

   vii. Market Price Data: High, Low during each month in last financial year.

   viii. Performance in comparison to broad-based indices such as BSE Sensex, CRISIL index, *etc.*

   ix. Registrar and Transfer Agents.

   x. Share Transfer System.

   xi. Distribution of shareholding.

   xii. Dematerialisation of shares and liquidity.

   xiii. Outstanding GDRs/ADRs/Warrants or any Convertible instruments, conversion date and likely impact on equity.

   xiv. Plant Locations.

   xv. Address for correspondence.

Annex I D

Non-mandatory Requirements

1. The Board

   The board – A non-executive Chairman may be entitled to maintain a Chairman's office at the company's expense and also allowed reimbursement of expenses incurred in performance of his duties. Independent Directors may have a tenure not exceeding, in the aggregate, a period of nine years, on the board of a company. The company may ensure that the person who is being appointed as an independent director has the requisite qualifications and experience which would be of use to the company and which, in the opinion of the company, would enable him to contribute effectively to the company in his capacity as an independent director.

2. Remuneration Committee

   i. The board may set up a remuneration committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference, the company's policy on specific remuneration packages for executive directors including pension rights and any compensation payment.

   ii. To avoid conflicts of interest, the remuneration committee, which would determine the remuneration packages of the executive directors may comprise of at least three directors, all of whom should be non-executive directors, the Chairman of committee being an independent director.

   iii. All the members of the remuneration committee could be present at the meeting.

   iv. The Chairman of the remuneration committee could be present at the Annual General Meeting, to answer the shareholder queries. However, it would be up to the Chairman to decide who should answer the queries.

3. Shareholder Rights

   A half-yearly declaration of financial performance including summary of the significant events in last six months, may be sent to each household of shareholders.

4. Audit qualifications

   Company may move towards a regime of unqualified financial statements.

5. Training of Board Members

   A company may train its board members in the business model of the company as well as the risk profile of the business parameters of the company, their responsibilities as directors, and the best ways to discharge them.

6. Mechanism for evaluating non-executive Board Members

   The performance evaluation of non-executive directors could be done by a Peer Group comprising the entire Board of Directors, excluding the director being evaluated; and Peer Group evaluation could be the mechanism to determine whether to extend/continue the terms of appointment of non-executive directors.

7. Whistle-blower Policy

   The company may establish a mechanism for employees to report to the management concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy. This mechanism could also provide for adequate safeguards against victimisation of employees who avail of the mechanism and also provide for direct access to the Chairman of the Audit Committee in exceptional cases. Once established, the existence of the mechanism may be appropriately communicated within the organisation.

Annex B

Corporate Governance – A Peer Review of the Advisory Panel Report

Sir Andrew Large

Introductory comment

It is clear from a brief scrutiny of the history of its evolution, that the Corporate Governance environment and processes in India have been greatly enhanced in recent years from quite a strong base. This enhancement seems to have gathered pace since the ROSC-2004. This has no doubt arisen in response to the main findings of the ROSC in relation to better sanctions/ enforcement; problems of fragmented structure; need for strengthened board practices and the need for an enhanced role of institutional investors.

I approach the subject with both humility and some trepidation. The territory is immensely broad (witness the definition of Corporate Governance given in the Report). The Report itself has addressed the OECD principles and their implementation in an excellent and meticulous way. In addition my own detailed knowledge of the scene in India is inevitably limited. In particular this limits the extent to which I can judge fairly the degree of implementation or outcomes of what appears to be a basically sound framework of Corporate Governance.

For the above reasons I have not dwelt on whether I agree or not with the 'status' accorded in the Report to the various aspects of compliance with the OECD principles. Rather I have taken the stance – as encouraged by the OECD documents themselves – of a 'reasonable observer'. Accordingly I have commented on situations where either I would have welcomed a deeper or wider focus than that evidenced in the Report, or where trends and developments of significance to Corporate Governance in the global environment might usefully merit mention.

I have relied too on the fact that there are a number of areas in the Report which show that although process is in place, actual compliance with the process is less certain, either because the processes are new or for lack of observation. The Report rightly recognises that there would be value in enhancing compliance, ultimately as a means of minimising the cost of capital.

Stance of the Panel: No comments. General observations.

I. International Context

The implications of the international dimension are referred to both in the OECD literature, and in the Report:

- India's corporate activity is becoming significantly more visible in a global context. Accordingly, more scrutiny is to be expected not just from suppliers of capital, but also from customers of and suppliers to those corporations. The significance of the international dimension and forces of globalisation as an external determinant is

mentioned in several places in the Report. Less is said about the hugely increasing scope and magnitude of Indian corporations internationally both in the services sector and in manufacturing.

- Many such corporations have significant activities, both on the supply and customer side as well as in manufacture outside India. Given the increasing significance of these corporations in the overall Indian economy much is at stake, therefore, in terms of the approach which they take to Corporate Governance given the inevitably enhanced focus on how they conduct themselves. This point seems of particular relevance to OECD principles 1 [the duties of government policy-makers to ensure a satisfactory Corporate Governance framework] and 6 [the responsibilities of boards].

Stance of the Panel: The aforesaid observations have been appropriately incorporated in paras 12.2 and 12.3 of the Report.

- What seems clear from the history outlined in the Report is that the authorities in India have recognised the value of continuing review of Corporate Governance standards. One suggestion not made in the Report is that this might be assisted by side by side analysis of governance requirements in other countries. Beneath a set of ethical principles, Corporate Governance standards are in constant need for updating as the environment alters. So scrutiny of how they work in practice elsewhere (or indeed fail) can inform that adjustment process.
- This suggests that initiatives to learn in a practical sense from both successes and mistakes of other jurisdictions internationally in relation to Corporate Governance may be of some value. Naturally policymakers could still recognise the essentially local cultural and other factors which are relevant. There has been particular experience in Europe and USA in this respect.
- Relevant to this are the rather different drivers of corporate governance in the financial sector – a useful distinction made through the separate commentary on the banking and insurance arenas within the Report. International experience and standards in this area have been developed rapidly in response to the global nature of these activities – just as they have been sorely tested by recent events.

Stance of the Panel: The aforesaid observations have been appropriately incorporated in paragraph 3.5 of the Report. Further a recommendation to the effect has been given at para 12.4 (xviii) of the Report.

In the context of cultural diversity and its impact on valid approaches to Corporate Governance, the Report makes reference to three models of Corporate Governance: namely the Anglo-Saxon, German, and East Asian models (2.3 to 2.5). The Indian model is stated to be closer to the third. On the other hand, the OECD principles themselves seem closer to some amalgam of the Anglo-Saxon and German models. And whilst it is probably true that in an increasingly global marketplace, a gradual convergence of the models may be expected to take place, it would have been of interest if the Report had pursued the concept of the East Asian model further, given its relevance to India, so as to highlight areas where we might expect to see valid differences of approach to governance in India, compared to approaches elsewhere.

Conclusion: In pursuit of principle 1 [enhancement of the framework] there would be value in highlighting the importance of continued emphasis being given by policymakers to the global dimension in relation to Indian corporate activity.

II. Listed *vs* Unlisted Companies

The Report makes the distinction between listed and unlisted companies. It, however, focuses little on the governance aspects of the unlisted sector. This may be unsurprising given the relative emphasis which is accorded to the listed sector within the OECD principles.

It is certainly true that unlisted companies tend to be 'lower profile'. They are often, in many countries, subject to less stringent Corporate Governance oversight. On the other hand as the Report emphasises:

- the unlisted sector is a significant part of the corporate world in India.
- in addition, a number of Indian groups have deliberately moved into the unlisted sector, attracted by less onerous requirements and presumably not deterred by potentially lower access to capital.

Other factors too underline the importance of Corporate Governance in the unlisted arena;

- International pressures towards high standards of Corporate Governance are likely to come from stakeholders other than core investors, though they too cannot be indifferent to the issues.
- Although unlisted companies may not directly seek equity capital from international sources, major entities certainly do seek out credit from those sources. Credit providers will themselves demand high standards of Corporate Governance.
- Expectations of wider stakeholders in relation to their Corporate Governance processes rise as organisations become larger and more powerful. This certainly is relevant in the case of India.

The above analysis suggests that the importance of Corporate Governance standards in the unlisted sector in India may be high, and rising. There is little doubt in my mind that over time high standards in the unlisted sector will be good for the cost of capital. Certainly experience in mature economies shows that for larger unlisted companies, ignoring the tenets of good Corporate Governance may be perilous, including an increased prospect of Government intervention. Major companies in private hands are still subject to demands for fair treatment by customers and suppliers, even if they may feel no short-term shortage of capital as such. In this respect, the Report might have benefited from a somewhat deeper analysis of the factors, trends and aspirations of Corporate Governance in the unlisted sector, despite the references.

Stance of the Panel: This has been appropriately incorporated in paragraph 9.3 of the Report. Further, paragraph 12.4(xi) of the Report has been appropriately amended to this effect.

A good example of the above may be seen in respect of attitudes towards the activities of the Private Equity (PE) sector. For sure companies purchased by PE groups move from listed to unlisted (or private) status. But major companies, in private hands, are still subject to demands for

fair treatment of stakeholders, based on principles of good Corporate Governance, particularly if these differ from the shorter term interests of shareholders.

- For this reason the PE industry itself created a code of standards which cover a number of areas of Corporate Governance, some of which deliberately go beyond what is required in corporate law, (in the UK for example the Companies Act, 1956 requirements for disclosures by unlisted companies are less stringent than for those which are listed) 'Guidelines for Disclosure and Transparency in Private Equity' by Sir David Walker, website: www.walkerworkinggroup.com/files/wwg_report_final.pdf .
- By way of example, an organisation such as the British Airports Authority, which is now unlisted and in private ownership, does not escape public scrutiny from Government and customers who are capable of exerting significant pressure. Powerful organisations, private or public, cannot expect to be immune from such scrutiny.

Conclusion: As per OECD principles 1 and 6 there would be value in ensuring that adequate emphasis is placed on Corporate Governance in the unlisted arena by policymakers. In this respect, I note the reference in the Report to a potential code which seems to indicate that the view may be shared by the authors of the Report. Equally it is for directors (as per principle 6) to reflect on the needs of companies to take account of the proper expectations of stakeholder groups (principle 4) on whom the success of corporations ultimately depend.

Stance of the Panel: This has been appropriately elaborated in paragraph 9.2 and 9.3 of the Report.

III. Insider dealing and market abuse

There are several observations in this area. The Report comments on the fact that necessary processes are in place to mitigate insider dealing dangers. It also comments on the difficulty of bringing enforcement proceedings that is experienced in more mature markets (including the UK and US). India is unlikely to experience a different set of issues in this respect, and the Report makes reference to the efforts that are underway. However:

- One area the Report does not focus on is ways in which overall levels of market integrity may be enhanced as a result of enforcement. One way to approach this is to consider two facets: stick and carrot.
  - The stick aspect relates to active enforcement itself.
  - The carrot aspect partly relates to social and cultural pressures. Attitudes of what is right and wrong can alter over time, based on changes in peer group thinking supported or not as the case may be by changes in law.
  - A good example in Europe has been the change in attitude towards insider dealing. It seems surprising today that until quite recently in certain countries this was regarded as both acceptable and normal.
  - Facilitation of cultural adaptation can be enhanced by making whistle-blowing easier: the fact that this area is not perhaps as well-catered for or protected as might be desirable is referred to in the Report, where the 'non-mandatory' nature of present procedures is mentioned.
- Equally the Report might have given added emphasis to other areas of market abuse such as market manipulation, front-running *etc.* Such practices may become more prevalent as more complex instruments and techniques are introduced.

- There are very tricky areas to confront here. Firstly, the spreading of rumours, which can have an international dimension, can enable perpetrators to profit. Yet detection is difficult and even harder to prosecute. This is particularly the case given the potential international dimensions of market mischief, and the fact that the enforcement efforts of national authorities are inevitably blunted by jurisdictional issues, however good the efforts at co-operation.
- Secondly, the possibility of parties acting in concert so as to profit can also arise. Ingenuity and effort will be required if confidence in markets is not to suffer globally over the long term.

Conclusion: The Report might have given more emphasis on the value of international co-operation both between enforcement agencies, as well as standard-setters in the area of market abuse. In the financial arena, policymakers no doubt do benefit from the body of work undertaken by IOSCO and other standard-setting bodies in this difficult arena when addressing the Corporate Governance framework under OECD principle 1. In addition, this would help focus on areas where actions and attitudes are capable of being handled by standards and codes as opposed to law.

Stance of the Panel: This has been appropriately elaborated under Principle IIIB and IVE of the Report. Further a paragraph 12.4(xiv) has been added in the Report.

IV. The importance of stakeholders. Investors: what role can they play?

The Report mentions in several places the fact that fiduciary investors may be less active than desirable in helping both to create standards of governance and to enforce them. It also rightly points to the key role which investors can play. Whilst there are some notable exceptions, this is a common issue (*i.e.,* that they do not always play a sufficient role) in mature markets. Perhaps this arises due to the very wide array of disparate investors who often lack a common voice. Although they all may have fiduciary duties, there may be insufficient common bonds between them for them to forge the necessary will to engage, and become a significant force for action. (Certainly too the ease of attending meetings *etc.* can play a role as the Report mentions).

Several recent examples of investor-driven activity in global markets may be worthy of mention. The thought processes arising from them are capable of being applied more generally, and potentially, suitably adapted, to Corporate Governance standards in India.

- Firstly, a group of powerful hedge fund managers has both created standards of conduct, and realised that the most effective way to encourage compliance is through the investors who are their customers. In other words, the activity was significantly encouraged by attitudes of investors, website: www.hfsb.org.

- And secondly, under the auspices of the President's Working Group in the USA a powerful group of investors themselves have in fact drawn up their own standards for investors who are considering investment in hedge funds. *Mutatis mutandis*, such an approach might lend itself to investment in equities more generally as opposed to the more specialist area of hedge fund investment itself. If investors really insist on good Corporate Governance as a factor in their investment decisions, the potential impact on compliance with Corporate Governance standards could be significant. And although the channels for exerting pressure may differ, this would hold good for both listed and unlisted sectors. website: www.treas.gov/press/releases/reports investors committeereportapril152008. pdf.

Conclusion: The significance of principle 4 [role of stakeholders] cannot be underestimated within the corporate governance framework. The Report also correctly highlights the need for dialogue with corporations. All that policymakers can do to encourage investors to exercise their proper interests in multiple ways is likely to enhance standards of corporate governance.

Stance of the Panel: The main ideas presented under the preceding heading 'The importance of stakeholders...' relate to role of investors, significance of good corporate governance and its linkages with capacity to attract investment, need for encouraging investors' activism etc. These have been adequately covered in the Report. Hence, no change is proposed.

V. Stakeholder interests: Corporate social responsibility

In addition, increasing pressures are likely to arise for internationally active organisations, listed or unlisted, to abide by high standards of Corporate Social Responsibility. Governance processes are therefore likely to rise up in the agenda to ensure that this wider 'stakeholder' area is taken seriously by entities. I note the reference of the Report which broadly encourages firms to reflect on this reality.

Conclusion: [See also comments under listed/unlisted companies above]. The above issue is of relevance to principle 4 [role of stakeholders] and worthy of further thought by policymakers given their responsibilities under Principle 1.

Stance of the Panel: This has been elaborated under Principle IVA of the Report. Further, a paragraph 12.4(xvi) has been added in the Report to this effect.

VI. Disclosures: Accounts and Accounting Standards

Mention is made in the Report of the satisfactory nature of the framework for presenting accounts. But understandably, perhaps, in view of the fact that less emphasis is placed on them under the OECD principles, the implications of the Accounting Standards themselves is neglected. Yet in terms of adequate disclosure as per principle 5 of OECD principles this aspect is crucial. Inadequacy of explanation of the implications of Accounting Standards can lead to significant difficulties. It is the job of a good Corporate Governance approach to ensure that this is not overlooked. The Report is silent in this area. By way of example, the highly topical area of fair value accounting and valuation issues seems pertinent.

- The debate may be of more direct significance in the financial sector than more generally. It nonetheless raises important questions from a Corporate Governance perspective, including the question as to who the accounts are intended for, and

what the readers of the accounts are able to take away from scrutinising them. Above all, the Corporate Governance framework needs to encourage readers of accounts to be able to understand and interpret them.

- From a Corporate Governance standpoint, the accounts are for the benefit of investors in the first instance. The fair value approach is designed to reflect more accurately the 'economic realities' within the entity than was the case with full historic accounting.
- However, the move has brought about a series of unexpected consequences that are significant from the point of corporate governance. The main one is that in times of financial stress, such as those in evidence today, there may be no market for sales of assets other than at distressed levels which the going concern would have no intention or need to realise.
- Yet these distressed values may well be used in the accounts despite the fact that the entity is a healthy, solvent, going concern.

Conclusion: In the interest of principle 5 [disclosure and transparency] there would be merit within the Corporate Governance framework to encourage disclosure of an 'educational' nature, to offset the potential dangers of misunderstanding which can act to the detriment of shareholders and other stakeholders alike. And although this debate may appear somewhat academic at present, the increased attention being displayed towards, in particular, the valuation of assets on an international basis is likely to become of increasing relevance for standard-setters in relation to Corporate Governance in future.

Stance of the Panel: The current position has been elaborated under principle VB of the Report.

VII. Disclosures: Risks

Encouraged by principle 5 [disclosure and transparency], the Report mentions several times that it is for boards, within the context of good Corporate Governance, both to understand risks and to ensure that approaches to thinking about risk are materially disclosed. I would suggest, however, that this area could be given more emphasis. Boards have to understand the risks, both external to the firm as well as internal. But they also have to set the 'appetite' or 'tolerance' that the entity accepts for different types of risk. This may be an area of particular relevance to insurance companies and banks: but the same issues are important in relation to Corporate Governance generally. For this reason more and more entities have created a Risk Committee of the board of directors to complement the existing Audit Committee. The split of activity tends to be thus: the Risk Committee of the board take responsibility for the overall approach and thinking about risk within the entity, as well as recommending the appetite that the board accepts as being within its comfort zone. The Audit Committee takes responsibility for assurance to the board that the

necessary controls are in place and fit for purpose to ensure that the entity can operate within the agreed tolerances. Whilst it cannot be said that this point is general best practice yet, the trend seems to me to be clear and there might be value in considering the implications for Indian entities.

Conclusion: The importance of thinking about risk and the disclosure aspects of this have never been more important. As per principle 1, enhanced recognition of this by policymakers, when considering the Corporate Governance framework, could be of value.

Stance of the Panel: This has been elaborated under principle VID of the Report. Further a paragraph 12.4(xv)has been added in the Report to this effect.

VIII. Codes of corporate governance

Countries need to adopt their own approach to the framework for Corporate Governance. Leaving all aspects of Corporate Governance to statutes in the various areas of company law, listing regulations and the like can certainly get you a long way. To supplement the statutory situation however, some countries, like the UK, have adopted non-statutory (or perhaps semi-statutory) codes. Indeed there may be explicit recognition of the value of such codes as reinforcing mechanisms of self-regulation under a corpus of law and statute. As much as anything, such codes are designed to encourage positive behaviours with respect to the areas in which Corporate Governance is relevant – where the law on its own may be inadequate.

Despite the non-statutory nature of such codes, they can often prove to be effective, and there are various mechanisms by which compliance may be encouraged. These range from peer group pressure, market mechanisms of one sort or another, to techniques such as 'comply or explain' which enable flexibility where more prescriptive arrangements may become exercises in box-ticking.

Conclusion: I have been much impressed by the careful attention to the tenets of Corporate Governance as outlined in the Report under the OECD principles, even though the Report might have emphasised this type of mechanism rather more. But I feel there would be merit for policymakers to consider under 'framework' Principle 1 how further activities of this sort might be encouraged in different sectors of the corporate scene.

Stance of the Panel: A paragraph 12.4(xiii) has been added to the Report.

Pre-emption Rights and Rating Agencies

Finally, two small further points are worthy of mention.

Firstly, reference is made in several places to pre-emption rights. It is clearly important to ensure that managements and boards cannot dilute the interests of shareholders without their agreement. But taking the principle to extreme in effect can lead to a higher cost of capital if the only shares on offer to non-shareholders are those which existing shareholders do not want.

Stance of the Panel: The point made is well taken. However, apparently it does not necessitate any change with reference to the position explained in the Report.

Secondly, reference is made to the regulation of rating agencies. Rating agencies exist because other parties prefer to outsource the credit evaluation process. But undue reliance on ratings, without a commensurate understanding of the processes they use, can itself lead to moral hazard.

So I would suggest encouraging a better understanding of the ratings process by their customers as much as seeking to regulate the agencies themselves.

Stance of the Panel: The suggestion refers to the need to encourage for a better understanding of the rating process. This apparently relates to larger issue of need for investor education and its impact on corporate governance. A recommendation in this regard has already been made in the Report. Therefore, no further change is proposed.

Summary of conclusions

page 2	Importance of continued emphasis being given by policy-makers to the global dimension in relation to Indian corporate activity.
page 3	Ensuring adequate emphasis is placed on corporate governance in the unlisted arena.
page 4	Added emphasis on the value of international co-operation between policy-makers and standard-setters in the area of market abuse.
page 5	Need to emphasise the role of stakeholders other than shareholders in the corporate governance framework, as well as to encourage investors to exercise their proper interests.
page 5	Added significance of corporate social responsibility.
page 6	Added focus on 'education' disclosure in relation to Accounting Standards.
page 7	Focus on disclosure of risk framework.
page 8	Possible added attention by policy makers in relation to non-statutory codes.

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28/05/2008

Chapter V

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Chapter V

Assessment of Payment and Settlement Systems

1. Introduction

The Panel has assessed the adherence to the extant standards and codes in payment and settlement systems prescribed by the Committee on Payment and Settlement Systems (CPSS) for the Systemically Important Payment Systems (SIPS) and CPSS-International Organisation of Securities Commission (IOSCO) Recommendations for the Securities Settlement Systems (SSS) and Central Counterparties (CCPs).

Although no specific standards have been prescribed for retail payment systems by CPSS, taking into account the wide usage of these systems by the public at large in India, including pensioners, the Panel has also attempted a review of the status of India's Retail Payment Systems, and their adherence to the extent feasible, the guidelines issued for Magnetic Ink Character Recognition (MICR) cheque processing centres and minimum standards of operational efficiency for computerised clearing houses.

1.1 Structure of the Report

The Report is organised as follows: Section 2 briefly covers the various international standards and codes in payment and settlement systems and reviews the earlier Reports on the adherence to these standards, *viz.*, the Financial Sector Assessment Programme (FSAP) of the IMF and Word Bank and the Advisory Group Report on Payment and Settlement Systems in 2001. Section 3 gives an overview of the structure of the payment and settlement systems in India and the roles played by each system. This section also highlights the operational links between various SIPS and summarises the broad responsibilities and powers of relevant regulators. Section 4 gives the summary of assessment for each payment and settlement system against the relevant international standard. The summary of assessment highlights the gaps identified during the assessment and areas where further work is required to fully comply with standards and Section 5 provides a summary of recommendations of the Panel. The detailed assessments are provided in the Annexes.

2. Methodology of Assessment and Earlier Assessments of Payment And Settlement Systems

2.1 Introduction

The payment and settlement systems were assessed earlier as a part of the FSAP of the IMF and World Bank in 2001 and by the Advisory Group constituted by the Committee on International Financial Standards and Codes around the same period. Significant developments have since taken place in the development of standards in this area. Based on these developments, the scope of the current

assessment has been made wider and more intensive. In the current context, the Panel considered that compliance with the standards (described in subsequent paragraphs) prescribed by CPSS for the SIPS and CPSS-IOSCO principles for the SSS and CCPs would serve as institutional benchmarks for assessing the payment and settlement systems, including securities settlement systems in India. Accordingly, the Panel attempted the following assessments:

i) Adherence to CPSS *Core Principles for Systemically Important Payment Systems*;

ii) Adherence to CPSS-IOSCO *Recommendations for Securities Settlement Systems* in (i) Government Securities Markets and (ii) Corporate Debt and Equities Market; and

iii) Adherence to CPSS-IOSCO *Recommendations for Central Counterparties.*

As no specific international standards for retail payment systems are available, the Panel has attempted to review the retail payment systems against the guidelines issued for MICR cheque processing centres and the standards for computerised clearing houses.

2.2 Standards of Assessment

Set up by G-10 central banks in January 2001, the CPSS formulates broad supervisory standards and guidelines that cover the relationship between payment and settlement arrangements, central bank payment and settlement services and the major financial markets. The CPSS formalised the '*Core Principles of Systemically Important Payment Systems*' and, along with IOSCO, released a Report containing recommendations on SSS. These developments set the broad framework for adoption of international financial standards and codes in the area of payment and settlement and securities settlement systems. CPSS-IOSCO Task Force on Securities Settlement Systems (SSS), building on the earlier work, has made *Recommendations for Securities Settlement Systems* in November 2002. Taking into account the systemic importance of the CCP and its role in the SSS, the CPSS-IOSCO brought out in November 2004, *Recommendations for CCPs* which strives to set out comprehensive standards for risk management of CCPs.

2.3 CPSS Core Principles for Systemically Important Payment Systems

The CPSS defines payment systems as '*a set of instruments, procedures* and *rules for the transfer of funds among system participants*'. The most important payment system, which is referred to as SIPS, is further defined by CPSS as 'the payment system which, if it is insufficiently protected against credit, liquidity, legal, operational and other risks, the disruptions within the system could trigger or transmit further disruptions among its participants, or generate systemic disruptions in the financial markets or more widely across the economy'. Against this backdrop, a system would be considered to be a SIPS, if at least one of the following conditions are met:

i) It is the only or the principal payment system or the principal system in terms of the aggregate value of payments;

ii) It handles mostly payments of high individual value; and

iii) It is used for the settlement of financial market transactions (like money market, foreign exchange market and securities market transactions) or for the settlement of other payment systems.

The CPSS published the Report on Core Principles for SIPS in January 2001. The Report outlines ten core principles for SIPS and four principles on the responsibilities of central banks.

The assessment by the Panel of the observance of the CPSS Core Principles for SIPS was carried out based on the Guidance Notes for assessing the observance of the Core Principles formulated by the CPSS and IOSCO for the assessment. The assessment has been carried out taking into account the prevalent laws in the payment and settlement systems, various internal Reports related to the area of assessment and detailed discussions with relevant departments within the Reserve Bank handling these SIPS.

2.4 CPSS-IOSCO Recommendations for Securities Settlement Systems

In November 2001, the CPSS and the Technical Committee of IOSCO published the 19 recommendations for Securities Settlement Systems (SSS). These sought to enhance the safety and efficiency of the SSS. The recommendations for SSS broadly cover the legal framework, settlement cycles, central counterparties, operational reliability, governance, transparency, regulation and oversight. While the responsibility for the implementation of the recommendations rests with the operator of the SSS, the recommendations stress the role of the regulators and central banks in promoting their implementation by undertaking self-assessments. The securities' regulators, central banks and other relevant authorities can determine the range of securities and systems to be covered.

The assessment of the adherence to *the Recommendations*[1] *for Securities Settlement Systems* by the Panel took into account the prevalent laws in the payment and settlement systems, *viz.,* the RBI Act, the Government Securities Act, the Securities Contract and Regulations Act, *etc.* The assessment has also been based on various internal Reports related to the area of assessment published by the Reserve Bank and detailed discussion with relevant departments within the Reserve Bank and SEBI as also the central counterparties, depositories and stock exchanges.

2.5 CPSS-IOSCO Recommendations for Central Counterparties

A CCP interposes itself between the counterparties to financial contracts traded in the markets. The CCP has the potential to significantly reduce the risk to market participants by imposing risk controls and enhancing liquidity. Although CCPs have the potential to reduce risks to market participants significantly, it needs to be recognised that it may also contribute to concentration of risks and responsibilities. A risk management failure by a CCP could disrupt the markets and spill over to payment systems and other settlement systems. Considering the potential for disruption to securities, including derivatives, market and to payment and settlement systems, the regulators and central banks have a strong interest in CCP's risk management practices. Thus, taking into account the growing role of the CCPs and potential for risk management failure by CCPs, the CPSS-IOSCO brought out 15 recommendations for CCPs in November 2004. The recommendations for CCPs broadly cover the legal and participation requirements, risk management procedures, operational reliability, efficiency, governance, transparency, regulation and oversight.

The assessment by the Panel of the adherence to *the Recommendations for Central*

[1] 'Recommendations' constitute standards effectively.

Counterparties has been carried out for CCIL, National Securties Clearing Corporation Ltd. (NSCCL) and Bank of India Shareholding Ltd. (BOISL)/Bombay Stock Exchange (BSE). The functioning of CCIL as a CCP in the three markets has been assessed against these recommendations. NSCCL functions as CCP in case of NSE and in case of BSE, it is the exchange which serves as a CCP and has been assessed against these recommendations. The assessment has been carried out based on the self-assessments carried out by these CCPs and the assessment by the regulators.

2.6 Financial Sector Assessment Programme – 2001

The observance of CPSS Core Principles for SIPS was assessed as part of the IMF and World Bank's FSAP and the Report was released in May 2001. The FSAP assessment stated that, though the Reserve Bank played a pivotal role in the payment system, both as a participant and as a regulator, India's compliance with the core principles was only partial, particularly with regard to the lack of legal and contracted framework relevant to the payment and settlement systems, multilateral netting arrangements used in clearing were not backed by legislation and real-time finality was not assisted by bankruptcy legislation. The FSAP Report highlighted that procedures in the event of a default – 'partial unwind' of transactions of defaulting institutions – could have serious systemic implications. Though the limits on the maximum amount of risk that could be taken by the participants in the payment system were clearly defined, it said that they did not meet the required standards. The Report also stated that the security of the SIPS in India was low. It concluded that the introduction of Real Time Gross Settlement (RTGS), which would handle all large value payments, would greatly enhance compliance, boost efficiency and lower the risks in the payment system.

2.7 Advisory Group on Payment and Settlement Systems – 2000/2001

The Standing Committee on International Financial Standards and Codes set up by the Reserve Bank and Government of India in 1999 constituted an Advisory Group to assess the observance of standards and codes relevant to the payment and settlement systems. The Advisory Group submitted its Report in three parts in September 2000, December 2000 and July 2001, covering clearing house operations, settlement in equity and debt markets and foreign exchange transactions. In respect of SIPS, the focus of the Group was on introduction of Lamfalussy standards as a minimum benchmark and to develop appropriate mechanisms for a RTGS system. Compliance with G-30 recommendations on SSS was the focus for equity and debt segments, while for forex segment, the Group made recommendations entailing actions that could facilitate CCIL in conforming to international practices and principles.

Based on the assessment, the Group recommended a set of actions which could be initiated by the CCIL. Some of the important measures suggested included establishment of a Clearing Agent abroad by the CCIL, institution of a separate guarantee fund for forex clearing and appropriate integration between the participating banks and the CCIL and their interface with the RTGS system.

A Review of the implementation of the recommendations of the Advisory Group was undertaken by the Reserve Bank and the review was published in December 2004. It noted that significant progress has been made in the implementation of the recommendations of the Advisory Group Report. Enactment of the legislation covering payment and settlement systems could help strengthen the legal framework covering the payment and settlement systems and help make further advances towards meeting the best practices advocated as part of the international financial standards and codes. The Committee noted that the operationalisation of RTGS marked a significant progress in respect of some important recommendations made by the Advisory Group. The introduction of same day and intra-day settlement helped in significantly complying with the international standards.

3. Payment and Settlement Systems and Financial Market Infrastructure In India

3.1 Payment Systems in India

Payment systems in India comprise electronic payment systems as well as paper-based systems. This system can be segregated as Large Value Payment Systems and Retail Payment Systems. The large value payment infrastructure comprises RTGS, High Value clearing, and CCIL. The retail payment systems include the MICR/non-MICR cheque clearing, National Electronic Funds Transfer system (NEFT), Electronic Clearing Service (ECS) and payment channels like card (also known as plastic), internet and mobile phone-based products. Based on the criteria outlined by CPSS, the RTGS system and the High Value Clearing system have been identified as SIPS. The funds leg of the CCIL-operated clearing systems covering government securities, foreign exchange and money market settle in the RTGS system. The following paragraphs provide a brief introduction to the payment systems and the clearing and settlement infrastructure in India.

3.2 Real Time Gross Settlement System

The Indian RTGS System was operationalised in March 2004. The system started operations with four banks and settled only inter-bank transactions. Subsequently, the system was opened for settlement of customer transactions. It was operationalised for settlement of Multilateral Net Settlement Batch (MNSB) files from September 2006. There are currently 105 members in the system (Table 1).

The RTGS system is owned and operated by the Reserve Bank. The system works on a mainframe computer. Members are provided with a Participant Interface (PI), using which the participants connect to the system at the Reserve Bank through the INFINET. The message flow architecture in the RTGS system uses the 'Y' topology. The members communicate through their PI to the Inter-bank Funds Transfer Processor (IFTP) which validates all communication and also does the 'strip and store' function. Upon successful completion of a transaction and receipt of confirmation from

Table 1: Volume of Transactions in SIPS

System	Name of the System	Number of Participants	Daily volume of transactions handled (Number)	Average value per transaction settled (in Rs. lakh)	Daily value of transactions handled (in Rs. crore)
1.	High Value	All participants in paper-based clearing systems	91,438	284	26,042
2.	RTGS	105	23,481	4,620	1,08,700

Source: Reserve Bank of India.

the RTGS, the IFTP forwards the complete credit information to the beneficiary member's PI. All communication between the PI and IFTP and IFTP to RTGS uses digital signatures (Public Key Infrastructure) to ensure security.

The membership of RTGS is open to all Scheduled Commercial Banks (SCBs), Primary Dealers (PDs) others, as may be decided by the Reserve Bank. The SCBs are provided with Type 'A' membership, Primary Dealers Type 'B' and Clearing Houses Type 'D' membership. Except Type 'A' members, customer-based transactions cannot be submitted by other members. Type 'D' members are permitted to submit only net settlement batches for settlement under the RTGS system. Other banks and financial institutions can participate as customers of the direct members.

The RTGS operations are governed by the RTGS Membership Regulations, 2004 and RTGS (Membership) Business Operating Guidelines, 2004. The members of the system agree to abide by the RTGS (Membership) Regulations, 2004 and RTGS (Membership) Business Operating Guidelines, 2004 and any subsequent amendments to these documents.

The settlement of RTGS transactions takes place in the books of the Reserve Bank. For this purpose, members have to open a 'RTGS Settlement Account' with the Reserve Bank at Mumbai. This account is to be funded at the beginning of each RTGS processing day from the member's current account with the Reserve Bank, and at the end of the day, the balance in the settlement account is transferred back to the current account of the member.

Members are provided with collateralised Intra-day Liquidity (IDL) facility to tide over their IDL mis-matches. This facility is provided to Type 'A' and Type 'B' members only. The IDL facility utilised by the members has to necessarily be reversed by them at the end of RTGS day. Failure to do so attracts penal action.

In addition to IDL, the system provides many features for effective liquidity management by the members. These include Message Release Method, Queueing Management and Queue Visibility. The Indian RTGS has adopted the FIFO rule for queueing. The system has a centralised queueing arrangement with priorities assigned by the system participant. The participant/system operator can change the priority of messages/ revoke the messages in the queue. The system operator would alter the queue only in extreme situations. At the end of the day, all pending unsettled messages are cancelled by the system. The system has a multilateral offsetting algorithm to resolve any gridlock situations that may arise. This process can be configured to be invoked manually or automatically by the system. Since it is mainly a large-value funds transfer system, a floor of Rs. one lakh has been prescribed for minimum value of transactions that can be settled through RTGS.

There has been a substantial increase in the volume of transactions settled through RTGS. The inter-bank clearing at all the Reserve Bank centres have been migrated to the RTGS system. Further, multilateral net settlements from CCIL, *viz.,* rupee leg of US dollar–Indian rupee settlement, funds leg of government securities settlement and funds leg of CBLO, and the retail net settlement systems operated by National Clearing Cell, Mumbai, *viz.,* MICR cheque clearing, High Value clearing, NEFT and

ECS are settled in RTGS as Multilateral net settlement batch (MNSB) files. The liquidity management operations of the Reserve Bank are also settled through the RTGS system.

3.3 High Value Clearing

This is a paper-based clearing for large value payments. This clearing is held at 27 major cities. Cheques of Rs.1 lakh and above and payable locally are exchanged by banks during a time slot of half an hour (12:00 noon to 12:30 PM) and unpaid returns, if any, are exchanged during 3:00 to 3:30 PM, completing the clearing process on the same day. The multilateral net settlement positions are settled in the settlement bank by 4.30 PM. The beneficiary's account is credited on the same day, withdrawal is permitted on the same day in branches with extended working hours and with ATM facilities. While the number of cheques cleared in this clearing is very small, the value of cheques is substantial and forms 41.8 per cent of the value of cheques cleared (Tables 2 and 3).

The settlement in this clearing happens at the locations were the clearing facility is provided. At 17 centres where the Reserve Bank manages the clearing house, the settlement takes place in the current accounts maintained by the participating banks at the Reserve Bank, and at the other centres, the settlement banks are commercial banks. The settlement banks in these cases are major public sector banks.

3.4 Retail Payment Systems

The retail payment systems in India consist of the paper-based clearing systems, electronic clearing systems and those systems relating to payment cards (credit and debit).

Table 3: Volume and Value of High Value Cheques Cleared

(Volume in lakh and Value in Rs. crore)

	2005-06	2006-07	2007-08
Volume	159.2	187.3	219.2
Value	49,81,400	50,34,000	55,00,018

Source: Reserve Bank of India.

3.4.1 Paper-Based Systems

Cheques: Cheques as payment instruments are the most popular mode of non-cash payment in India. The clearing and settlement of cheques drawn on different banks require the coming together of the banks in that area for transfer of instruments and the final settlement of funds. This process is facilitated by the clearing houses at these centres. As on March 31, 2008 there were 1,089 operational clearing houses. Of these, at 60 centres, the clearing and settlement processes have been automated by the introduction of MICR technology-based sorter machines. Eighty per cent of the total cheque clearing volume and value are accounted for by these centres. The clearing and settlement cycle is completed in two days – on day 1, the cheques are presented at the clearing house and on day 2, the funds settlement and return clearing are accounted for.

Paper-based systems still constitute the major part of retail payment systems in India. Steps taken by the Reserve Bank to improve the availability of this facility have resulted in an increase in the number of clearing houses from 860 in 2001 to 1,089 as on March 31, 2008. The number of High Value cheque clearing centres increased from 13 in 2001 to 27 in March 2008. With the introduction of RTGS, a decision has

Table 2: Volume and Value of Cheques Cleared

(Volume in lakh and Value in Rs. crore)

	2003-04	2004-05	2005-06	2006-07	2007- 08
Volume	10,228	11,669	12,868	13,673	14,606
Value	1,15,95,960	1,04,58,895	1,13,29,133	1,20,42,426	1,33,96,066

Source: Reserve Bank of India.

been taken that no new High Value clearing centres would be opened. Further, in order to increase the spread of computerised clearing houses, Magnetic Media-based Clearing System (MMBCS) technology is also being implemented in cities and towns where the process is carried out manually at present. This system has already been implemented at 996 clearing houses of the total 1,029 non-MICR cheque clearing houses. With this, 1,057 clearing houses constituting 96 per cent of the clearing houses, have been computerised. At the remaining centres where the volume of cheques is low, manual clearing will continue. Also, currently new Clearing Houses are required to use MMBCS technology for settlement.

The introduction of cheque truncation systems is yet another step for increasing the efficiency of retail payment system. This system has already been implemented in New Delhi. As on date, all member banks of the New Delhi clearing house are participating in the system. Once the system is successfully implemented in New Delhi, it is proposed to use this system for improving the efficiency of collection of outstation cheques.

Consequent to the increase in the number of cheque clearing centres, the volume of cheques being cleared has also increased. Table 2 gives the yearly increase in volume and value of cheques starting from the period 2003-04. While there has been growth in the volume and value of cheques cleared, the increased use of electronic payment instruments have resulted in the growth rate declining over the years. The percentage increase in the volume and value of cheque cleared decelerated from 10.23 per cent and 11.98 per cent during the period 2005-06 to 6.8 per cent and 11.2 per cent during the period 2007-08.

3.4.2 Electronic Retail Payment Instruments

The retail electronic payment systems in India are National Electronic Funds Transfer System and the Electronic Clearing Service.

3.4.2(a) Electronic Funds Transfer System (EFT)/National Electronic Funds Transfer (NEFT)

The EFT system was introduced in the mid-1990s. EFT facilitates transfer of funds from one bank account to another. The EFT system is currently only permitted to be used for government transactions and Reserve Bank-initiated payments. This system is now progressively being replaced with the NEFT. NEFT is an electronic message-based payment system, and was introduced in November 2005 to replace the existing EFT system which was public key infrastructure (PKI)-enabled and the settlements were effected on a decentralised mode. NEFT provides a nation-wide, secure one-to-one funds transfer facility for customers of banks with centralised settlement of all transactions taking place at Mumbai. This has facilitated the availability of electronic payment modes at more centres. NEFT is available at 42,700 branches and processed on an average 55,000 transactions amounting to Rs. 550 crore on a daily basis, as at the end of March 2008. There are six daily settlements during weekdays. The banks are to credit the accounts of the customers for the first four settlements on the same day and for the fifth and sixth settlements, the customers' accounts are to be credited not later than T+1(next working day). The volumes and value of transactions settled in EFT and NEFT are given in Table 4.

Table 4: Volume and Value Processes in EFT/NEFT Systems

(Volume in lakh and Value in Rs. crore)

Year	2003-04	2004-05	2005-06	2006-07	2007- 08
Volume	8.2	25.5	30.7	47.8	133
Value	17,100	54,600	61,200	77,400	1,40,300

Source: Reserve Bank of India.

3.4.2(b) Electronic Clearing Services (ECS):

ECS is a retail payment system which facilitates bulk payments that can be classified as one-to-many and receipts that are many-to-one. The two components of this system are ECS (Credit) and ECS (Debit). This facility is now available at 74 major centres.

- **ECS (Credit)**: ECS (Credit) facilitates the bulk payments whereby the account of the institution remitting the payment is debited and the payments remitted to beneficiaries' accounts. This facility is mostly used for making multiple payments, like payment of dividend to investors, payment of salaries of employees by institutions, *etc.* For this purpose, the company or entity making the payment has to have the bank account details of the individual beneficiaries (Table 5).
- **ECS (Debit)**: ECS (Debit) facilitates the collection of payments by utility companies (Table 6). In this system the account of the customers of the utility company in different banks are debited and the amounts are transferred to the account of the utility company. The company providing this facility has to receive the mandate to collect funds from its customer. On receipt of the mandate, the company advises the consumer's bank to debit the payment due from the account on the due dates.

Settlement in this system currently takes place on T+0 basis and the cycle gets completed on T+1 basis. The clearing and settlement transactions through ECS occur at the respective centres. A centralised facility is available at the Reserve Bank, Mumbai to receive the ECS (Credit) files meant for credit at the other 14 Reserve Bank centres. State Bank of India (SBI) and Punjab National Bank (PNB) have been advised to commence such service of centralised receipt of ECS (Credit) files for 17 SBI centres and 13 PNB centres where the ECS facility is provided by the respective banks.

3.4.2 (c) Deficiencies in Retail Payment Systems

The deficiencies in retail payments mainly pertain to the inefficient outstation cheque collection process. In this regard, it is difficult to prescribe a standard time-frame for collection in view of large disparities at various centres, in terms of their location, availability of infrastructure, communication facilities, *etc.* In respect of Metropolitan Cities and other State Capitals/A Class Cities, most banks have a policy of collecting instruments within a period of 7 to 10 days. In respect of other cities including States in the North-eastern region, most banks

Table 5: Volume and Value Processes in ECS (Credit)

(Volume in lakh and Value in Rs. crore)

Year	2003-04	2004-05	2005-06	2006-07	2007- 08
Volume	203	400	442.2	690.2	784
Value	10,228	20,179	32,324	83,273	7,82,222

Source: Reserve Bank of India.

Table 6: Volume and Value Processes in ECS (Debit)

(Volume in lakh and Value in Rs. crore)

Year	2003-04	2004-05	2005-06	2006-07	2007- 08
Volume	79	153	359.6	752	1,271
Value	2253	2921	12,986	25,440	48,937

Source: Reserve Bank of India.

have declared in their policies that the instruments will be collected within a maximum period of 14 days. It may be endeavoured to use the cheque truncation process once the system is successfully implemented in New Delhi, for streamlining the outstation cheque collection process.

The usage of ECS has seen rapid increase during the period of the assessment. The main deficiency in ECS system has been the decentralised model of transaction processing in the system. While a centralised ECS has been provided, this is available only at the Reserve Bank centres. To address this deficiency, a National Electronic Clearing Platform has been implemented in September 2008. To begin with, the system has been implemented for the credit system. On stabilisation of the system and feedback, debit clearing would be operationalised.

The benefits of electronic payment infrastructure are not yet trickling down to the lower end of the customer segment which still largely uses services like Money Order and informal channels for transferring money of small value which has much higher cost and time lag for transferring money. There is a need to develop solutions using newer technologies which would allow all segments of the society to gain access to the benefits offered by these facilities. There are examples of such facilities being provided to the marginally banked and the un-banked segments in other developing countries that can be studied for guidance.

3.4.2 (d) Position of India in Cheque Clearing *vis-à-vis* Other Countries

In most countries, the general trend has been to reduce the use of cheques as a payment instrument and introduce cheque truncation systems to reduce the settlement cycle. The cheque clearing system in India ranks above all countries in terms of the settlement cycle. It takes only two days for the deposit of a cheque to realisation of the proceeds in local clearing systems, whereas in the UK, the cheque and credit clearings both operate on a three-day payment and settlement cycle, although an additional day is sometimes necessary for items requiring cross-border clearing between England and Scotland. In the US, the finality of settlement is not achieved on completion of the process as the banks can return the cheques within 30 days. Further, the High Value cheque clearing operated in India is unique. No country provides a system which provides same day settlement of high value cheques.

3.5 Clearing and Settlement Infrastructure

3.5.1 Securities Settlement Systems in India

i) Government Securities Settlement

The infrastructure for the government securities settlement systems in India is

provided by the Reserve Bank. The Public Debt Office (PDO) in the Reserve Bank functions as the depository. The PDO has well-laid-down guidelines for opening Subsidiary General Ledger Accounts (SGL) for recording all purchase and sales transactions in government securities. Secondary market transactions in government securities are settled in the books of the Reserve Bank for both securities leg and funds leg on Delivery vs Payment (DvP) basis.

ii) Equities Market

The Indian equity markets have witnessed sweeping changes over the last two decades. The Bombay Stock Exchange (BSE) was set up in 1875 as 'The Native Share and Stock Brokers Association'. Several other stock exchanges have been established since then. In 1956, the Government of India notified the Securities Contracts (Regulation) Act (SCRA) for trading and governance of exchanges. Setting up of Securities and Exchange Board of India (SEBI) in 1992 gave a major thrust to reforms in the securities market. The market has undergone a major transformation in terms of its structure, products, practices, spread, institutional framework and other important aspects like transparency, integrity and efficiency since then. The size of the market has also grown manifold. The major reforms in the securities market since 1992 are given in Chart 1. Some of the key statistics presented in Table 7 are indicators of the size of the market. The statistics presented in Table 8 reflect the growth in volumes of trading over the last three years.

3.6 Central Counterparties

3.6.1 Clearing Corporation of India Limited

CCIL was incorporated on April 30, 2001 to provide clearing and settlement services in government securities, foreign exchange and money market instruments. The Reserve Bank took the initiative of setting up the CCIL with SBI, Industrial Development Bank of India (IDBI), Life Insurance Corporation of India (LIC), ICICI Bank Ltd., Bank of Baroda and HDFC Bank Ltd. as its core promoters. This initiative was taken recognising the need for upgrading the country's financial infrastructure in respect of clearing and settlement of debt instruments and

Chart 1: Major Reforms in Indian Equities Market

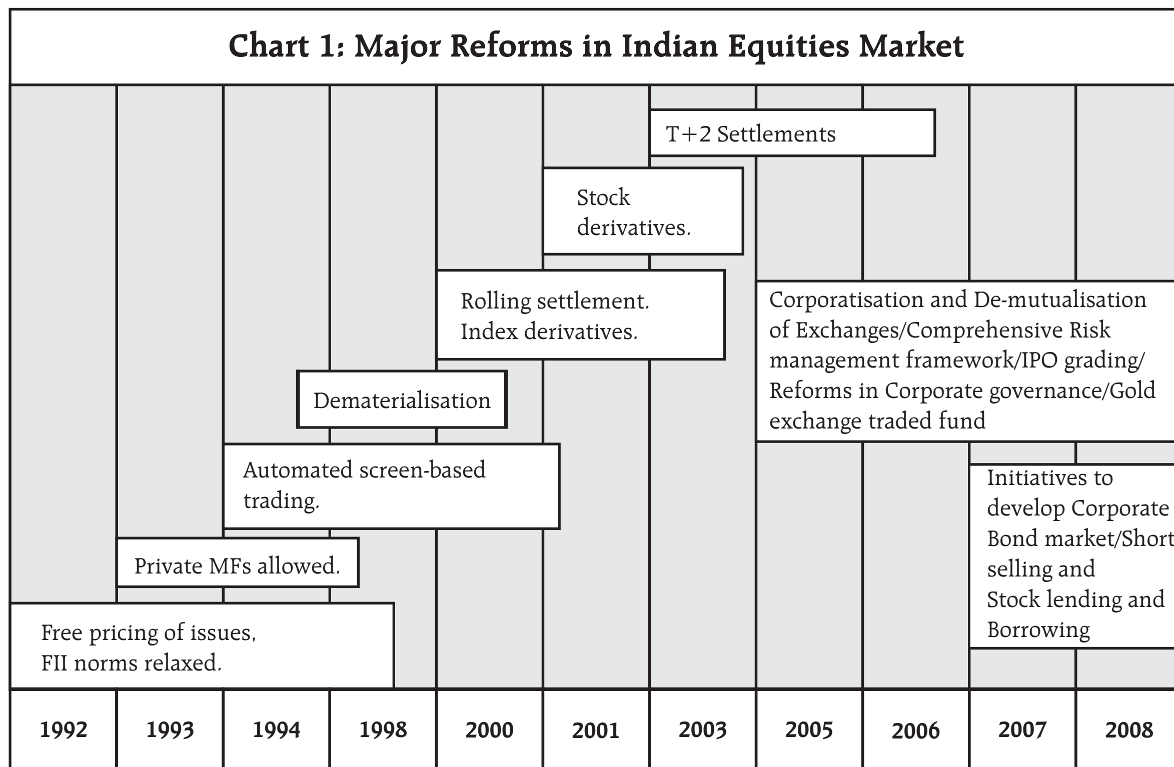


Table 7 : Statistics Pertaining to Equities and Derivatives Market (As on December 31, 2008)

Market capitalisation[2] (as on December 31, 2008) (Rs. crore)		
	NSE	29,16,768
	BSE	31,44,767
GDP at market prices – 2007-08 (Rs. crore)		47,13,148
Market capitalisation as per cent to GDP		
	NSE	61.88 per cent
	BSE	66.72 per cent
		Number
Stock Exchanges		19
Depositories		2
Stock-brokers		
Cash segment		9,609
Derivative segment		1,557
Sub-brokers (cash)		56,585
Depository Participants		696
Custodians		16
Mutual Funds		43
Foreign Institutional Investors		1,594
Merchant Bankers		132
Portfolio Managers		230

Source: SEBI Bulletin

forex transactions. CCIL currently provides guaranteed settlement facility for government securities clearing, clearing of Collateralised Borrowing and Lending Obligations (CBLO) and foreign exchange clearing.

3.6.2 CCIL-operated Systems

3.6.2 (a) Government Securities Segment

During 1996-2002, a quasi-DvP system was in place with the book-entry system in government securities not directly linked with the funds accounts, with no mechanism to prevent a gridlock in the system. In 2002, CCIL was constituted by the banks to play the role of a CCP and for providing a settlement guarantee mechanism. The government securities settlement system has evolved since then and transactions are now settled on a net basis. Settlement through CCIL provides assurance of settlement to the members on the settlement date as also, reduction in counterparty exposure, operational efficiency and improved liquidity. There are now 151 members in the secondary settlement system with a daily average turnover of about Rs. 181 billion.

CCIL provides guaranteed settlement of all secondary market outright sales and repo transactions in government securities by the process of novation. All trades reported on the Reserve Bank's NDS platform or contracted on

[2] Represents the equity market, which dominates trading on stock exchanges at present. The concerned authorities are trying to promote trading in the corporate debt market.

Table 8 : Volume of Trades in Equities and Derivative Segments						
	2005-06		2006-07		2007-08	
	NSE	BSE	NSE	BSE	NSE	BSE
Cash Segment:						
No. of trades (in lakh)	6,080	2,640	7,850	3,460	11,727	4,440
Total traded quantity (in crore)	8,444	6,644	8,554	5,607	14,984	9,860
Turnover (Rs. crore)	15,69,558	8,16,074	19,45,287	9,56,185	35,51,038	15,78,857
Percentage deliverable value to total turnover	26.90	33.24	28.02	31.13	27.58	30.16
Derivative segment:						
No. of contracts	15,76,19,271	103	21,68,83,573	15,45,169	42,50,13,200	74,53,271
Turnover (Rs. crore)	48,24,250	6	73,56,271	59,006	1,30,90,478	2,42,309

Source: SEBI Bulletin

the online anonymous, trading platform NDS-OM, are accepted by CCIL for settlement after the necessary validations. These trades are settled on a DvP-III basis, *i.e.*, the funds leg as well as the securities leg are settled on a net basis. Table 9 shows the outright and repo volumes settled at CCIL.

3.6.2. (b) CBLO Segment

The CBLO is a money market product developed by CCIL and launched on January 20, 2003. The product was initially developed with a view to providing entities that have been phased out from the unsecured inter-bank call money market with an avenue for their funds operations. A repo variant, CBLO enables borrowing/lending of funds of various maturities up to one year, fully backed by collaterals in the form of central government securities/treasury bills. CCIL provides guaranteed settlement facility for trades in this instrument as a central counterparty. The funds leg of the trades in this instrument is settled in the current account maintained by these entities with the Reserve Bank. There are now 151 members in the CBLO segment with a daily average turnover of about Rs.39.48 lakh crore. The borrowing and lending takes place through an electronic anonymous order matching platform. CBLO operates in an Straight-through Processing (STP) enabled environment, seamlessly encompassing dealing to settlement.

Table 9: Volume of Transactions in Government Securities Clearing		
Year	Amount (Rs. crore)	
	Outright	Repo
2002-03	10,76,147	4,84,144
2003-04	15,75,133	9,43,190
2004-05	11,34,222	15,57,907
2005-06	8,64,751	16,94,509
2006-07	10,21,536	25,56,501
2007-08	16,53,851	39,48,751

Source: CCIL

The CBLO market has now become the preferred option for participants in the money market. The volume in this market is now significantly higher than the combined volumes in the call and the repo market. The significant growth in this segment of the money market over the past five years is shown in Table 10.

3.6.2 (c) Forex Segment

CCIL provides a guaranteed settlement facility for all US dollar-Indian Rupee inter-bank Cash, Tom, Spot and forward transactions (from S–2). The matched and accepted forward deals are guaranteed for settlement from S–2 day (two days previous to settlement) and the Spot, Tom,

Table 10: Volume of Transactions in CBLO

Year	Amount (Rs. crore)
2002-03	852
2003-04	76,851
2004-05	9,76,790
2005-06	29,53,134
2006-07	47,32,271
2007-08	81,10,829

Source: CCIL

Cash deals are guaranteed for settlement from the trade date as the CCIL becomes the central counterparty to every accepted trade through the process of novation. The rupee-leg of the transaction is settled through the member's current account with the Reserve Bank and the US dollar leg through CCIL's account with the Settlement Bank at New York. There are now 71 members in the forex market with a daily average trade value of 12.5 billion US dollars.

CCIL also provides continuous-linked settlement (CLS) settlement services for banks in India by availing of third party services of a settlement bank. Banks participating in this segment of CCIL report their cross-currency trades to the settlement bank directly or through CCIL. The settlement is made through the nostro accounts of CCIL with the settlement bank in CLS settlement currencies (of 17 CLS settlement currencies, CCIL provides services only in 14 currencies)

The settlement of forex transactions by CCIL has resulted in a reduction in counterparty exposure, increased operational efficiency and overall lower operational costs. Forex settlement volumes in CCIL have been rising consistently through the years and have witnessed substantial growth since it commenced operations. The growth in the forex settlement volumes in CCIL is given in Table 11.

3.6.3 National Securities Clearing Corporation Ltd (NSCCL) and BOISL

The National Securities Clearing Corporation Ltd. (NSCCL), a wholly-owned subsidiary of NSE, was incorporated in August 1995 and commenced operating as a clearing corporation in April 1996 (refer **Box 1**). It was the first clearing corporation to provide novation/settlement guarantee that revolutionised the entire concept of settlement system in India. It was set up to bring and sustain confidence in clearing and settlement of securities; to promote and maintain short and consistent settlement cycles; to provide counterparty risk guarantee, and to operate a tight risk containment system. NSCCL functions as CCP in the case of NSE and in the case of BSE, the exchange itself serves as a CCP.

The settlement of trade in the equities market (both cash and derivative segments are settled in the BSE by Clearing House (CH), Bank of India Shareholding Ltd (BOISL) which is a company jointly promoted by BSE (49 per cent) and Bank of India (51 per cent). On the other hand, clearing and settlement operations of the

Table 11: Volume of Settlement in Forex Market

Year	Amount (US dollar billion)
2002-03	136.10
2003-04	501.34
2004-05	899.78
2005-06	1,179.68
2006-07	1,776.98
2007-08	3,133.66

Source: CCIL

Box 1: Emergence of Clearing Corporation

The Securities Contract (Regulation) Act (SCRA), enacted in 1956, dealt with trading of securities and governance of exchanges. It considered clearing (C) and settlement (S) as an integral part of trading. The members of the exchanges, called brokers, acted as trading-cum-clearing members. They knew each other and traded and settled trades among themselves. The SCRA did not explicitly provide for C and S, which was left to be dealt with by the bye-laws of the exchanges. The bye-laws generally provided for clearing houses and the exchanges traditionally set up departmental clearing houses to facilitate settlement. All exchanges, except the NSE, use clearing houses to clear and settle trades.

With the advent of the anonymous screen-based trading system, which does not allow participants to assess the counterparty risk of others, and in the interest of better risk management through novation and counterparty guarantee, the modern markets started using the services of a clearing corporation for C and S. Besides, unbundling of activities made economic sense with the exchanges and CCs specialising in trading and clearing, respectively. While many exchanges modified the structural design of the clearing house to address the emerging concerns, NSE set up a wholly-owned subsidiary to provide C and S services. It, however, continued to have trading-cum-clearing membership which allowed brokers to trade on exchange and settle the trades through CC. Its bye-laws suitably provided for use of CC for C and S of its trades. Thus, both the models of C and S, namely clearing House and Clearing Corporation, are in use today within the extant legal framework in the cash segments of exchanges.

Source: *Discussion Paper of Ministry of Finance (See Annex VII)*

NSE are managed by its wholly-owned subsidiary NSCCL, which is also known as the Clearing Corporation (CC). All other stock exchanges use clearing houses to clear and settle trade; however, there are either no transactions on these exchanges or transactions are negligible.

NSCCL undertakes clearing of transactions executed on the National Stock Exchange for Automated Trading (NEAT) system of National Stock Exchange of India Ltd. (NSEIL). It carries out clearing and settlement functions as per the settlement cycles of different sub-segments in the equities segment. BOISL *inter alia* handles some of the settlement-related activities of BSE as per instructions and directions of BSE. Responsibility of the clearing house is to handle such settlement activities including co-ordination with the market participants, *viz.,* depositories, clearing banks, *etc.* (refer **Box 2**). However, the overall responsibility of settlement and risk management functions, *viz.,* collection of margins, collateral management, *etc.* pertaining to transactions done on BSE Online Trading (BOLT) System lies with the BSE.

3.7 Reforms in the Area of Clearing and Settlement

The area of clearing and settlement has witnessed substantial progress in Indian securities market over the last decade as a result of the various reforms initiated by the regulatory authorities. Implementation of advanced information technology, at every stage, has played a crucial role in the entire process. Some of the key developments, in this regard are mentioned below:

- Screen-based trading
- Dematerialisation and electronic transfer of securities
- Introduction of rolling settlement
- Compression of settlement cycle to T+2
- Multilateral Netting
- Delivery versus Payment
- Robust risk management
- Emergence of clearing corporation to assume counterparty risk
- Real Time Gross Settlement/ Electronic Fund Transfer facility
- Limited Straight-through processing (STP)

Box 2: Participants in the Clearing and Settlement Process

Clearing Corporation: The clearing corporation is responsible for post-trade activities such as the risk management, confirmation, delivery and settlement of trades executed on a stock exchange.

Clearing Members: Clearing members are responsible for settling these obligations as determined by the clearing house/clearing corporation. They do so by making available funds and/or securities in the designated accounts with clearing bank/depositories on the date of settlement.

Custodians: Custodians are clearing members but not trading members. They settle trades on behalf of trading members, when a particular trade is assigned to them for settlement. The custodian is required to confirm whether he is going to settle that trade or not. If he confirms to settle the trade, then clearing corporation assigns that particular obligation to him.

Clearing Banks: Clearing banks are a key link between the clearing members and Clearing Corporation/house to effect settlement of funds. Every clearing member is required to open a dedicated clearing account with one of the designated clearing banks. Based on the clearing member's obligation as determined through clearing, the clearing member makes funds available in the clearing account for the pay-in and receives funds in case of a pay-out.

Depositories: Depository holds securities in dematerialised form for the investors in their beneficiary accounts. Each clearing member is required to maintain a clearing pool account with the depositories. He is required to make available the required securities in the designated account on settlement day. The depository runs an electronic file to transfer the securities from accounts of the custodians/clearing member to that of clearing corporation/house and viceversa as per the schedule of allocation of securities.

Professional Clearing Member: NSCCL admits special category of members known as professional clearing members (PCMs). PCMs may clear and settle trades executed for their clients (individuals, institutions, *etc.*). In such cases, the functions and responsibilities of the PCM are similar to that of the custodians. PCMs also undertake clearing and settlement responsibilities of the trading members. The PCM in this case has no trading rights, but has clearing rights, *i.e.,* he clears the trades of his associate trading members and institutional clients.

The reforms in the securities settlement systems have resulted in:

- Reduction and mitigation of systemic, structural and operational risks
- Increase speed of transaction, execution and settlement of trade and quicker settlement of transactions with finality
- Safety of the settlement process
- Reduction of transaction costs and, thereby, making market more efficient and transparent for investors and participants.

4. Summary of Assessments

4.1 Assessment of Systemically Important Payment Systems

4.1.1 Summary of Assessment of Indian RTGS System

The Reserve Bank seeks to ensure that the SIPS fully observe the Core Principles for SIPS prescribed by the CPSS set up under the aegis of the BIS. Subsequent to the formation of the Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) in India, a number of steps have been taken under the guidance of the Board to make the SIPS in

India fully compliant to the core principles. The assessment of Indian RTGS system against the ten Core Principles for SIPS showed that out of the ten Core Principles, the system 'Observed' six principles, three were 'Broadly Observed' and one principle was 'Not Applicable'. Out of the four Responsibilities for Central Banks as applicable to SIPS, three have been assessed as 'Observed' and one as 'Broadly Observed' (Table 12). The detailed assessment matrix is given in **Annex I**.

4.1.2 Summary of Assessment of High Value Clearing System

It is observed from the assessment of the High Value Clearing System that, the system 'Observed' eight of the Core Principles, one was 'Broadly Observed' and one 'Partly Observed'. The detailed assessment matrix is given in **Annex II.**

4.1.3 Summary of Assessment against Individual Principles

Legal Basis of SIPS: The Payment and Settlement Systems Act, 2007 provides a sound and well-founded legal basis for regulation and oversight of payment and settlement systems. The Act clearly defines settlement finality and provides an explicit legal basis for multilateral netting.

Rules and Procedures for SIPS: RTGS (Membership) Regulations, 2004 and RTGS (Membership) Business Operating Guidelines, 2004 recognised by the Payment and Settlement Systems Act, 2007 provides for responsibilities of the operator and the participants in RTGS. High Value Clearing is guided by the Uniform Regulations and Rules for Bankers' Clearing Houses (URRBCH) which defines the rights and obligations of participating banks. The URRBCH is recognised by the Payment and Settlement System Act, 2007. To a great extent, the system operators are taking the responsibility to ensure that the settlements go through smoothly. However, in respect of the settlement which takes place in the commercial bank money, the risk management measures need further review.

Finality of Payments: The Payment and Settlement Systems Act, 2007 provides legal recognition to finality of payments (**Box 3**).

Settlement Risk: The High Value Clearing system settles on a multilateral netting basis.

Table 12: Summary Assessment – Systemically Important Payment Systems

		Assessment	
	Principle	RTGS	High Value Clearing
CP I	Legal Basis	O	O
CP II	Clarity of Rules and Procedures	O	O
CP III	Risk Management	BO	BO
CP IV	Finality of Settlement	O	O
CP V	Timely Completion of Multilateral Net Settlement	NA	PO
CP VI	Settlement in Central Bank Money	O	O
CP VII	Security and Operational Reliability	BO	O
CP VIII	Efficiency	BO	O
CP IX	Public Disclosure of Participation Criteria	O	O
CP X	Transparency in Governance Arrangements	O	O
Responsibilities of Central Banks			
A	Transparency of Roles and Major Policies	O	O
B	Compliance with Core Principles	BO	BO
C	Oversight of Payment Systems	O	O
D	Co-operation with Other Central Banks	O	O

O – Observed; BO – Broadly Observed; PO – Partly Observed; NA – Not Applicable.

Box 3: Finality of Payments

By 'finality of payment' it is meant that 'a payment can be considered final only if there is no further possibility that it will be unwound, once the settlement procedure is complete'. A system which does not achieve this can pose systemic risk, as there remains the uncertainty regarding the payments received. Legal recognition of netting is the pre-condition for recognising settlement finality under the netting schemes. Settlement finality provision is useful during insolvency proceedings. Legally defined settlement finality is also required for systems where gross settlement takes place. As the financial markets are acquiring sophistication, need for such explicit law is important. Even internationally, such developments are relatively new. It is only during the last 10 years that countries with developed financial markets have gone for specific netting legislation or recognised netting under their payment system laws.

A settlement which is not final, and can be unwound, would be a source of financial system instability. In multilateral net settlement systems, the net positions arrived at after netting reflects only a very small percentage of the actual gross amount. The failure of participants in such systems would result in the system provider re-working the settlement obligations of the participants. The new position so arrived at could result in the failure of the participants, who were otherwise able to honour their funds obligations to the system. The failure of a participant in one system may have implications for other systems also. Since the participants in payment systems manage their funds positions taking into consideration their funds requirement in all the systems, failure in one system would have a cascading effect, which could result in financial system instability.

Core Principle IV for Systemically Important Payment Systems

The Core Principle IV, for Systemically Important Payment Systems, of the Committee on Payment and Settlement Systems states that – A *system should provide prompt final settlement on the day of value, preferably during the day* and *at a minimum at the end of the day.* As per the principle, the system's rules and the legal framework within which they function generally determine finality. The legal regime governing payments, the payment system and insolvency law must acknowledge discharge of any obligation to transfer money between system participants for transfers to be considered final. The compliance to the principles require a clearly defined time of final settlement, which clearly states, when settlement of the payment obligation would be both irrevocable and unconditional. As removal of any transaction which has been submitted to the system and has passed all its risk management tests and other requirements is 'accepted by the system for settlement' and cannot be removed from the settlement process without violating *Core Principle IV.*

Systems that provide finality of value at the end of the day, avoid the extension of financial risk overnight and so satisfy *Core Principle IV*, but a shorter interval between the system's acceptance of a payment for settlement and the final settlement of that payment may be highly desirable.

Payment Systems in India – Settlement Finality

The multilateral net settlement systems in India, till recently, did not satisfy the conditions for finality laid-down by the *Core Principle IV, as* there was no law which ensured settlement finality. Most payments – made either by cheque or electronic funds transfer were being settled through 'multilateral netting' – where mutual claims and obligations between banks or financial institutions are made by a single payment or receipt. The contracts entered into by the clearing house participants with the members were the basis on which the netting of settlements were undertaken.

With the notification of the Payment and Settlement System Act, 2007 settlement finality is legally recognised for net settlement systems. Since

settlement finality is specifically addressed in the Act, in case of insolvency, the liquidator would not be able to unwind the transactions which are covered by the Payment and Settlements Act. If a participant in a payment system, as envisaged under the Act, turns insolvent, the net position worked out by the payment system provider would be deemed 'final' and 'irrevocable' even if the settlement were to take place after declaration of the time of insolvency. The liquidator would be legally bound to honor the obligation of the defaulting participant declared as insolvent.

This settlement does not have any arrangement to ensure completion in the event of an inability to settle by the participants with the largest single settlement obligation.

Security and Operational Reliability of SIPS: A high degree of security and reliability is achieved in the High Value Cheque Processing System. In the case of RTGS system, the on-city hot back-up site is in place while a dedicated off-site DR site is in the final stages of implementation. Once implemented, the site will provide high degree of security and operational reliability.

Efficiency: The Reserve Bank as the overseer of the payment system has taken several initiatives to increase efficiency of the system by inducting technology and changes in procedures. The commercial banks as participants are effective partners in this process.

All large value payments (HV clearing and RTGS) are settled on value date leading to immediate turnover of funds. Though the Reserve Bank is not levying any processing charges, the RTGS system charges are still priced relatively higher by banks for customer transactions as compared to charges for clearing paper-based instruments. The level of utilisation of the electronic payments infrastructure has been sub-optimal. The Panel recommends that steps may be taken to optimise the utilisation of electronic payments infrastructure and reduce the charges for the same.

Transparency: The access criteria laid-down for becoming members of the clearing house are explicit and publicly disclosed. The criteria for participation in RTGS are also available in the public domain. The clearing houses have various standing committees where all major decisions are discussed and approved by the members. The Panel suggests that the decisions taken at the standing committees of various SIPS should be communicated to the members more promptly.

Central Bank Responsibilities

The RTGS Regulations and Rules detailing the responsibility of the participants in the RTGS systems are available on the Reserve Bank's website. The systems the Reserve Bank operates have been assessed against the Core Principles for SIPS and the Report published on the Reserve Bank's website in November 2007. The Reserve Bank has now started publishing its oversight report and documents highlighting its vision of payment and settlement system, but is yet to clearly disclose publicly its role with respect to SIPS. The Panel recommends that a document on this be published by the Reserve Bank.

4.2 Assessment of Government Securities Settlement Systems against CPSS-IOSCO Recommendations for Securities Settlement Systems

(i) Government Securities Settlement System in India

The laws, rules and regulations governing the Securities Settlement System in India pertaining to government securities are laid-down comprehensively in the SCRA and the Government Securities Act (GS Act). The GS Act has been passed by the Parliament, the rules and regulations framed under it have also been notified.

Settlement systems in India have evolved over a period of time from physical settlement systems with considerable amount of risks to the current electronic systems with central

counterparty with emphasis on risk mitigation. During the early 1990s, government securities market was opaque with limited information dissemination and inefficient pricing. The securities were held in physical form requiring execution of physical transfer forms for transfer of securities in any trade leading to inefficiencies in settling the trades. Settlement of securities and funds legs were independent of each other (non-DvP), leading to considerable settlement risks. Moreover, pre-settlement comparison and confirmation of trades was not systematised. Settlement cycles were not uniform with settlements happening on T+0 and T+1 basis. However, a series of measures taken by the Reserve Bank, as detailed below, have changed the way the government securities settle currently in India:

- **July 1995 – Delivery Vs Payment Introduced**

The system was DvP I, wherein securities and funds were settled on a gross basis. Through this, settlement risk has been greatly reduced.

- **February 2002 – Clearing Corporation of India Established**

Acting as a central counterparty through novation, the CCIL provides guaranteed settlement and has put in place risk management systems to limit settlement risk and operates a settlement guarantee fund backed by lines of credit from commercial banks. The netting of funds by CCIL reduces the liquidity requirements of the market and thereby liquidity risk of the system. All the transactions in government securities market, concluded or reported on NDS and NDS-OM have to be necessarily settled through the CCIL.

- **February 2002 – Negotiated Dealing System (NDS) Introduced**

Besides enabling electronic dealing and transparency in the system, the NDS-enabled 'paperless' settlement of transactions in government securities with electronic connectivity to CCIL and the DvP settlement system at the Public Debt Office through electronic SGL transfer form. All entities having SGL Accounts with the Reserve Bank were advised to join the NDS-CCIL system by March 31, 2003. In phase I B of PDO-NDS Project, NDS was integrated with the securities settlement system and primary market operations. Further, all the regional PDOs were interconnected and automated which resulted in electronic maintenance of record of ownership of stock in physical and SGL form. This has facilitated electronic transfer of record of ownership to any PDO. Further, an electronic order matching (NDS-OM) platform has also been developed which is completely anonymous and facilitates real time dissemination of trade information to the market. All such trades are settled through CCIL in STP environment.

- **May 2002 – Compulsory holding of government securities in demat form**

Compulsory holding of government securities in demat form for the Reserve Bank-regulated entities was introduced to prevent possibility of fraudulent transactions in government securities held in physical form. This improved the efficiency of security settlements by reducing the time taken and aided in simplification of settlement procedures.

- **March 2004 – Real Time Gross Settlement System (RTGS) Introduced**

Introduction of RTGS system was an important measure in improving the stability of settlements in all inter-bank transactions including the government securities. The netted settlement files are also currently being submitted on RTGS for settlement. The system has integrated module for IDL against government securities. Towards the end of 2006, the Total Solution Release (TSR) of RTGS has been implemented in which the Security Settlement System (SSS) has been integrated facilitating 'on-demand' IDL facility for the market participants.

- **May 2005 – Standardised Settlement Cycle of T+1**

The settlement cycle for all outright OTC and NDS-OM trades in government securities has been standardised to T+1 cycle for better fund management and risk management by the participants.

(ii) Treatment of Settlement Failures

Prior to introduction of DvP mode of settlement systems, banks had the practice of issuing Banker's Receipts (BR) for settling the securities transactions. Although there were guidelines in place guiding the issuance of BR, non-adherence to the guidelines and misuse of the facility showed up in the form of irregularities in securities transactions in 1992. Based on the recommendations of the Joint Parliamentary Committee, set up to investigate the securities scam in 1992. the Reserve Bank put in place a mechanism to deal with settlement failures in government securities transactions by issuing suitable instructions on SGL bouncing.

Currently, any instance of default on account of shortfall of securities or funds during settlement of trades carried out by a market participant is treated as an instance of 'SGL bouncing' which is subject to penal measures. If the bouncing of the SGL form occurs thrice in a half-year, the SGL account-holder will be debarred from trading with the use of the SGL facility for a period of 6 months from the occurrence of the third bouncing. If, after restoration of the facility, any SGL form of the bank concerned bounces again, the bank will be permanently debarred from the use of the SGL facility in the PDO.

A process flow chart relating to clearing and settlement of government securities transactions is given in **Annex IX**.

(iii) Summary of Assessment

The CPSS-IOSCO *Recommendations for Securities Settlement Systems* is intended to enhance the safety and efficiency of the SSS. These recommendations help in assessing the SSS for its legal basis, settlement practices, risk management, governance, efficiency and accessibility, transparency and regulation and oversight.

The Securities Settlement System – Government Securities Market is compliant with the CPSS-IOSCO Recommendations for SSS. Out of the 19 Recommendations, 17 have been assessed as 'Observed' while 2 are 'Not Applicable' (Table 13). The detailed assessment matrix is given in **Annex III**.

Legal Basis: The laws, rules and regulations governing the SSS are contained in the SCRA and the GS Act. The government securities transactions are governed by SCRA, and GS Act and rules framed under them. The secondary market transactions are on a contractual basis and are covered by the Contract Act and enforceability is under it. The netting by novation performed by the CCP is covered by the Contract Act. The GS Act supports dematerialisation of securities.

Settlement of Trades: All secondary market transactions are submitted to settlement systems electronically and confirmations are completed on the trade date itself on NDS. All the outright securities transactions are settled on T+1 rolling basis. Repo transactions can have

Table 13: Summary Assessment – Government Securities Settlement System	
Recommendation	**Assessment**
1. Legal Basis	O
2. Confirmation of Trades	O
3. Rolling Settlement	O
4. Benefits and Costs of Central Counterparties	O
5. Securities Lending and Borrowing	O
6. Dematerialisation of Securities	O
7. Elimination of Principal Risk	O
8. Final Settlement	O
9. Risk Management in Deferred Net Settlements	O
10. Credit Risk in the Cash Leg of Securities Transactions	O
11. Operational Risk	O
12. Accounting Practices	O
13. Governance Arrangements for CSDs and CCPs	O
14. Participation Criteria for CSDs and CCPs	O
15. Safety, Security and Efficiency of Systems	O
16. Communication Procedures	NA
17. Information on Risks and Costs	O
18. Disclosure of Responsibilities and Objectives of Settlement Systems	O
19. Risks in Cross-border Settlement	NA

O – Observed; NA – Not Applicable.

T+0 and T+1 settlement. The settlement cycle is the same for direct as well as indirect participants and the settlement cycle is not longer than T + 1.

Risk Management: CCIL is the CCP for settling transaction in government securities. All government securities are settled through CCIL on net basis on DvP III. CCIL has established detailed mechanisms and procedures through prescriptions of margining system, to control the risks it is exposed to as CCP. The CCIL's risk management practices are periodically evaluated against recommendations for CCP.

Full dematerialisation of government securities (with the exception of a small quantum of the stock certificates) has been achieved for wholesale transactions. The funds and securities are cleared by the CCIL and sent to SSS for settlement. The funds legs are settled by the SSS in RTGS. The final settlement for the securities transactions takes place in the books of the Reserve Bank as at the end of the settlement day. Since all the transactions are settled through CCIL, the risk control measures are operated by the CCIL.

The settlement system is fully automated with regular Business Continuity Plan (BCP) testing. There are internal guidelines and procedures including security measures designed to limit operational risk.

Only the securities which are in dematerialised form are held with custodians. The physical securities are held by the beneficial holders themselves. The GS Act confers the ownership of the securities in custodian accounts with the beneficial owners in case of insolvency of the custodian.

Governance: The SSS is operated by the Reserve Bank and its Board members are appointed by the Government of India.

Cost Efficiency: The Reserve Bank does not impose any fee/service charges for using the trading and reporting system. However, the CCIL levies charges in consultation with the market participants/user groups.

Transparency: All relevant information is made available to the participants and are also available in the public domain. The application for opening and maintaining the SGL contains all the terms and conditions of the account. The guidelines detail the rights and obligations of the member. The balance standing to the credit of the account holder is periodically confirmed to the holder.

Roles and Responsibilities of the Central Bank: The SSS for government securities is an integral part of the Reserve Bank's operations and is subject to internal oversight. The Reserve Bank assesses the SSS through its Inspection Department regularly in a pre-determined schedule and also through concurrent audit appointed by the Bank and Control and Self Assessment Audit. The CCIL as a CCP is subjected to periodic oversight by the Reserve Bank based on CPSS-IOSCO standards. There is, at present, no other security settlement system for government securities outside the Reserve Bank.

4.3 Assessment of CCIL against CPSS-IOSCO Recommendations for Central Counterparties

Summary of Assessment

The CCIL broadly complies with the CPSS-IOSCO Recommendations for Central Counterparties. Out of the fifteen Recommendations, six have been assessed by the Panel as 'Observed', six have been assessed as 'Broadly Observed', one recommendation is 'Partly Observed' and 2 are 'Not Applicable' (Table 14). The detailed assessment matrix is given in **Annex IV**.

Legal Risk: CCIL through its bye-laws, rules and regulations which have been recognised under the Payment and Settlement Systems Act, 2007 and the contract between itself and its members within this framework constitutes the legal basis for CCIL to act as the central counterparty (**Box 4**).

Participation Requirements: CCIL has a well-laid-down procedure for admission and periodical review of membership criteria. The CCIL Board has constituted a Membership Approval Committee to consider the applications for admission of new members as per the laid-down criteria and participation requirements are clearly and comprehensively stated in the bye-laws, rules and regulations and notifications issued there-under from time to time and such information is posted in the public domain through CCIL's website.

Measurement and Management of Credit Exposures: There is no counterparty credit exposure limit in the government securities segment fixed by CCIL. However, CCIL has set up a margin system to limit its credit exposures and also the market risk. The margin requirements are calculated on mark-to-market basis on outstanding positions and the valuation is done on a daily basis. In addition, the rules also provide for collection of volatility margin in case of unusual volatility in the market but this has not yet been operationalised. In the CBLO segment, at CCIL, margin computation for acceptance of any new trade happen trade-by-trade on a post-trade basis, in the trading system but there is no provision for re-computation of margin requirement for outstanding trades by intra-day valuation of outstanding trades. In forex trading, acceptance of new trade happens in batches, after running exposure check.

Table 14: Summary Assessment of Central Counterparties – CCIL	
Recommendation	**Assessment**
1. Legal Risk	O
2. Participation Requirements	O
3. Measurement and Management of Credit Exposures	BO
4. Margin Requirements	BO
5. Financial Resources	PO
6. Default Procedures	BO
7. Custody and Investment Risks	O
8. Operational Risk	O
9. Money Settlements	BO
10. Physical Deliveries	NA
11. Risks in Links between CCPs	NA
12. Efficiency	BO
13. Governance	O
14. Transparency	BO
15. Regulation and Oversight	O

O – Observed; BO – Broadly Observed; PO – Partly Observed; NA – Not Applicable.

Margins are collected for covering market risk under normal circumstances and for covering a portion of credit exposure based on CCIL margining algorithm. However, a system for re-computation of exposure on an intra-day basis is yet to be put in place.

Box 4: Strengthening the Legal Framework for Payment and Settlement Systems

Current Status

A host of payment systems are in operation in India ranging from manual paper-based clearing to the Real Time Gross Settlement (RTGS) System for facilitating non-cash mode of payments. The various retail payment systems in operations include, the manual paper based clearing, MICR Clearing, Electronic Funds Transfer Systems (including the Electronic Clearing Services), Card-based Payment Systems, *etc.* The paper-based cheque processing is operated and managed by the Reserve Bank at the four metro centres; at twelve other centres it is operated by public sector banks, but managed by the Reserve Bank; and in the remaining centres, it is operated as well as managed by public sector banks. Clearing houses and the rules and regulation for the functioning of clearing houses are recognised under the Payment and Settlement Systems Act, 2007.

2. Real Time Gross Settlement system is operated by the Reserve Bank and the inter-bank Government Securities and Foreign Exchange Clearing systems are at present operated by CCIL. A new National Payments Corporation of India would eventually be taking over the operations of retail payment systems. With the notification of the Payment and Settlement System Act, these corporate entities will now be under the regulatory purview of the Reserve Bank.

3. The Reserve Bank, under Section 58(2) (p) of the RBI Act, 1934 is empowered to frame

regulations of clearing houses for banks and under 58(2) (pp) of the same Act, it can frame regulation of funds transfer through electronic means. These regulations are adopted by the members of the clearing house by way of a contractual agreement.

4. The procedure of netting (arriving at the multilateral net settlement) and settlement finality has also attained legal recognition with the notification of the Payment and Settlement Systems Act.

5. With the Payment and Settlement System Act, 2007 now coming into effect, all existing payment systems and the evolving payment and settlement systems in country will be approved under the Act and will be on legally sound footing.,

7. *Payment* and *Settlement Systems Act*

The Payment and Settlement Systems Act empowers the Reserve Bank to act as the designated authority with the following powers and functions, namely:

(a) to regulate and oversee the various payment and settlement systems including those operated by non-banks like CCIL, card companies, other payment system providers and the proposed separate organisation for retail payments;

(b) to lay down the procedure for authorisation of payment systems as well as revocation of authorisation;

(c) to lay down operational and technical standards for various payment systems;

(d) to call for information and furnish returns and documents from the service providers;

(e) to issue directions and guidelines to system providers;

(f) to audit and inspect the systems and premises of the system providers;

(g) to lay down the duties of the system providers;

(h) to levy fines and impose penalties for not providing information or documents or wrongfully disclosing information, *etc.*; and

(i) to make regulations for carrying out the provisions of the proposed legislation.

The Act, inter alia, would also provide for the following matters, namely:

(a) to designate the Reserve Bank as the designated authority for the regulation and supervision of payment systems in India for their smooth operations;

(b) to give legal recognition to the netting procedure and settlement finality; and

(c) to empower the Securities Appellate Tribunals to settle disputes between the Reserve Bank and the system providers.

Legal recognition *of electronic payments/cheque truncation*

Amendments to the IT Act/RBI Act/NI Act

8. The Information Technology Act, 2000 provides a legal basis for activities related to electronic transaction processing. The said Act also stipulates the security features that are necessary to maintain the confidentiality, integrity and authenticity of such transactions. It provides legality for digital signatures and encryption of data and enables electronically-stored information to be equivalent to documentary evidence in a court of law.

9. Consequent to the IT Act, 2000 recognising electronic payments, an amendment to the RBI Act was made by enabling the Reserve Bank to regulate fund transfer through electronic means between the banks or between the banks and other financial institutions and the conditions and manner of their participation in such fund transfers.

10. Similarly, amendments were made to the Negotiable Instruments Act, 1881 (NI Act) so as to provide for electronic cheques and cheque truncation, thereby enhancing the coverage of the Act to instruction-based payment systems, besides non-cash paper-based payment systems.

11. All the related laws including the Bankers' Book Evidence Act, IT and the Negotiable Instruments Act have been amended to support the cheque truncation process, enabling the bankers to pay or reject the images of the cheques in lieu of the physical paper.

As stated above, there is no provision for re-computation of margin requirements for outstanding trades by intra-day valuation of outstanding trades for the CBLO and forex segments. The Panel recommends that CCIL should try to develop capacity to measure intra-day exposure and margin requirement (based on intra-day exposures) for government securities, CBLO and forex segments.

Margin Requirements: In the government securities segment, CCIL follows a daily back-testing for having comfort of adequacy of its margining process in all situations. It also undertakes stress-testing of its risk-model assuming the yield-curve movement both ways, upward as well as downward, the results of which are monitored by the top management on a regular basis and reported to the Board's Committee on Risk Management on quarterly basis. Based on these stress-testing results, the margining process adequately covers CCP for possible market risk. In the CBLO segment, CCIL accepts Government of India dated securities, T-bills and funds in Indian Rupees as collaterals. Borrowing limit for the members is fixed everyday after marking to market and applying appropriate hair-cuts on the securities deposited in the CSGL account. However, back-testing model is not in place for CBLO segment. In the forex segment, funds in US dollars are accepted as collateral. Market risk incidental in the settlement is sought to be covered using market risk factor which is equal to 3-day value-at-risk at 99 per cent confidence level. Validation of models and parameters used to determine the margin levels consistent with the intended coverage is done through daily back-testing.

As back-testing for CBLO segment is a must for assessing the associated risks as well as adequacy of margins, the Panel recommends that, CCIL develop a model for back-testing for margining to ascertain the adequacy of margins collected.

Financial Resources: In the government securities and CBLO segments, CCIL receives collaterals from its members for providing guaranteed settlement of trades in government securities. The collaterals are collected partly in cash and partly in government securities to meet the funds/securities shortages. In addition to these, CCIL has also arranged for a Line of Credit (LoC) to meet the liquidity requirement. As regards sufficiency of financial resources in the event of default by the participant with the largest exposure, it was observed in the past that, on certain occasions, the largest exposures to some participants exceeded the amount of liquid financial resources available with CCIL. The Panel, therefore, recommends:

1. CCIL can arrange for additional liquidity, *i.e.,* additional lines of credit.
2. A debit cap already exists in the US dollar leg of US dollar-Indian rupee segment of CCIL. A similar cap can be fixed for the exposure of CCIL in the government securities and CBLO segments. The amount exceeding the debit cap can be settled by CCIL on a DvP I basis, directly on RTGS. However, in view of the quantum increase in the volume of trades in the government securities market and the fact that banks are mandated to operate through CCIL, the implementation of this recommendation should duly consider that the debit cap does not hamper smooth trade and settlement operations in the government securities market.

3. CCIL can settle through continuous settlement on the RTGS. This would require that CCIL is granted full membership of RTGS with IDL support.

4. CCIL may be granted a limited purpose banking license, so that they would be able to approach the Reserve Bank or the market for liquidity through repo arrangements.

In the forex segment, stress-test is conducted at monthly intervals for outstanding trade positions of the members. As in the case of government securities and CBLO segments, at times, the lines of credit available with CCIL are not enough to provide adequate liquidity to meet a default by the member on whom CCIL had highest exposure though the collateral available as margins along with the value of the counter-currency to be withheld in case of a default are adequate to cover the shortfall. The Panel recommends that CCIL needs to develop stress-testing models for the CBLO segment. Further, in the forex segment, CCIL should evolve a clear and transparent policy to ensure prompt action (like calling for additional resources, time and manner of collection, *etc.*) is taken in cases when the stress-test indicates that resources are inadequate.

Default Procedures: Default procedures are clearly laid out in the CCIL's bye-laws, rules and regulations. The intended actions in this regard are well-supported by the bilateral contract between the members and CCIL which is legally enforceable. Though default procedures are in place, they are required to be supported by a policy. Further, there is a lack of clarity on the eventuality of liquidating US dollar assets or other securities, in the case need arises. The Panel recommends that CCIL may evolve an objective policy on the modalities of liquidating the default position to reinforce the established default procedure for both CBLO and forex segments.

Custody and Investment Risks: In the government securities and CBLO segments, the margin contributions from members are collected in the form of cash and government securities. These are held in account with the Reserve Bank. The LoC provided by the banks are also maintained separately in the Reserve Bank having no custody and liquidity risks. In the forex segment, US dollar funds are mostly in US government T-Bills. A small portion of these US dollar funds are, however, kept as deposits with certain selected banks.

Operational Risk: CCIL has identified various critical components of the processes and has put in place appropriate security policy and business continuity plan.

Money Settlements: In the government securities and CBLO segments, the settlement takes place in central bank money (Reserve Bank, RTGS), while in the forex segment**,** the settlement of rupee leg is in books of the Reserve Bank. Settlement of US dollar leg happens through a settlement bank. The selected settlement bank enjoys a very good credit standing. Internal processes are being developed to monitor their creditworthiness, access to liquidity and operational reliability, *etc.* on an ongoing basis. However, detailed processes for monitoring exposures are not in place. The Panel recommends that CCIL may develop processes for monitoring of settlement bank risk for CBLO and forex segments.

Efficiency: Though there is no other CCP, providing equivalent services for comparing the cost, CCIL operations can be assessed as cost-effective and has achieved risk reduction with quite minimal cost.

Governance: The Board of Directors of CCIL has representatives from several banks. Independent Directors on the Board of CCIL are drawn from various professional fields like law, finance, Forex, IT, *etc.*

Transparency: CCIL has made available its procedures, rules, bye-laws, *etc.* to market participants on its website. To identify the risks and costs associated with counterparty

guarantee activity, the CCIL conducts stress-tests and determines the adequacy of various margins to control market risk. Stress-test methodology and the results of stress-tests done by the CCIL are not disclosed to the members/public. The Panel suggests that CCIL may consider making public the stress-test methodology and if feasible, also the results. Further, they may endeavour to provide public information apart from English, in local languages also.

4.4 Assessment of CPSS-IOSCO Recommendations for Securities Settlement Systems and Central Counterparties – Equities Market Settlement Systems

The present assessment is based on the study of payments and securities settlement systems followed by two leading stock exchanges, *viz.*, the National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE) which together account for more than 99 per cent of the stock market trading. Inputs received from both the exchanges and also the two depositories, *viz.*, National Securities Depositories Ltd. (NSDL) and Central Depository Services Ltd. (CDSL) have been relied on for the assessment.

4.4.1 Regulatory Framework

Clearing and Settlement systems for securities is primarily governed by:

- Securities Contracts (Regulation) Act,1956 (SCRA)
- Securities Contracts (Regulation) Rules, 1957 (SCRR)
- SEBI Act, 1992 and Regulations, guidelines framed there under
- Bye-laws of Stock Exchanges and Clearing Corporations.

SCRA, as enacted in 1956, essentially dealt with trading and governance of exchanges and considered clearing and settlement as integral part of trading. SCRR deals with listing and trading of securities on stock exchanges. The Securities Laws (Amendment) Act, 2004 enacted on January 7, 2005 inserted a new section (Section 8A) in the SCRA, which *inter alia* provides for:

- segregation of broking firms into trading membership and clearing membership;
- transfer of duties and functions of a clearing house of an Exchange to a clearing corporation; and
- clearing and settlement of trades by a Clearing Corporation (CC) (also refer Box 1).

Further, under the amended SCRA,

- Exchanges need approval of SEBI for transfer of functions to CC.
- CC is to be recognised by SEBI.
- CC is to be a company incorporated under Companies Act,1956 for the purpose of settlement of contracts
- CC is to prepare bye-laws for the transfer of duties and functions of a clearing house to CC and get them approved by SEBI.
- CC is to be governed by rules and regulations made under SCRA,1956; and
- Relevant provisions of SCRA, as applicable to Stock Exchanges are, *mutantis mutandis*, applicable to CC.

Bye-laws of stock exchanges and CC cover aspects such as:

- settlement principles, training of employees of clearing members on settlement systems;
- not to misrepresent the nature of transaction, not to misuse clients funds in settlement process *etc.,;*
- deposit of margin with respect to management of risk;
- monitoring of payment obligations in settlement process; and
- penalties for failure of settlement obligations *etc.*

The Ministry of Finance had issued discussion paper (**Annex VII**) on the Regulatory Framework for Clearing Corporation in the year 2007 *inter alia* proposing for:

- Principles for evolving the regulatory framework for the CC; and
- Amendment in provisions of SCRR in that respect under three heads viz.

i. *Recognition of Clearing Corporations*: covers aspects such as:

- recognition of CC in accordance with rules at par with stock exchanges;
- minimum net worth required for recognition;
- fulfillment of criteria for fit and proper person;
- proper infrastructure;
- Settlement Guarantee Fund;
- dedicated resources to meet the exigencies of settlement; and
- inspection of books and records.

ii. *Regulation of Clearing Members* covers aspects such as:

- Clearing Corporations to have only clearing members;
- registration of clearing members with SEBI;
- inspection, disciplinary action and dispute resolution;
- only corporate members to become clearing members; and
- Inspection of Clearing Corporations by SEBI *etc.*

iii. *Bye-laws for Clearing Corporations* include

- manner of registration;
- clearing and settlement;
- eligibility criteria for admission and code of conduct;
- maintenance of books of accounts and records;
- submission of report to SEBI;
- appointment of compliance officer;
- risk management norms; and
- arbitration and penalties.

The discussion paper thus give rise to following issues:

- emergence of clearing corporations as specialised institution with adequate infrastructure to deal with settlement of securities;
- evolution of more than one Clearing Corporation to enthuse healthy competition;
- role of clearing members *vis-à-vis* trading members and their stake in the clearing corporation;
- appropriate risk management systems;
- setting up of operational standards for clearing corporations; and
- regulatory control on clearing corporations and clearing members including powers of Clearing Corporations and increased responsibility of stock exchanges to ensure market safety and integrity.

The Rules[3] drafted pursuant to the Discussion Paper are under consideration.

4.4.2 Clearing and Settlement Procedure

4.4.2 (a) Cash Segment

Trading members execute transactions on behalf of clients or on a proprietary basis. All trades executed on the exchange are electronically transferred to CC/CH on the T-day itself for clearing and settlement and are settled on a T+2 basis. Trading/clearing members receive their provisional obligations-clearing statements shortly after trading hours on T day. Client transactions executed by trading members could be in respect of institutional and non-institutional clients. Custodians need to confirm the transactions by 1 p.m on T+1 day. Final settlement obligations are received by trading/clearing members and custodians by 2:30 p.m on T+1 day. CC becomes the legal counterparty to the net settlement obligations of every member. This principle is called 'novation' and CC is obligated to meet all settlement obligations, regardless of member defaults, without any discretion. The NSCCL/ BSE interposes itself as a central counterparty between the counterparties to trades and nets the positions so that a member has security-wise net obligation to receive or deliver a security and has to either pay or receive funds. A multilateral netting procedure is adopted to determine the net settlement obligations (delivery/receipt positions) of the clearing members. Obligations are also arrived on a trade-for-trade basis for certain securities as specified by the relevant authority.

Securities Settlement

The exchanges carries out settlement of securities through two depositories, NSDL and CDSL. The trading/clearing members are required to make securities available at either of the depositories by the defined cut-off time for facilitating pay-in. During pay-in, the delivering participant's account is debited and the exchange account is credited by way of electronic instructions to the depositories. Pay-out commences after completion of pay-in and penal action is taken against members who have delivered short. The exchanges have introduced the facility of direct pay-out to clients' accounts with both depositories. Based on the information received from members, pay-out instructions are sent to the depositories, so that the clients receive the pay-out of securities directly to their accounts on the pay-out day.

Securities Shortages

On the securities pay-in day (T+2), CCP identifies short deliveries and the respective trading/clearing member is debited by an amount equivalent to the securities not delivered by him. This is the valuation debit. CCP conducts a buying-in auction for security shortages on the day after the pay-out day (T+3) through the exchange trading system. If the buy-in auction price is more than the valuation price, the member is required to make good the difference.

The settlement of auction trades follows the same settlement cycle as normal (T+2 day). The securities procured in the auction trading are passed on to the short receiving member.

[3] Amendment to Securities Contracts (Regulation) Rules, 1957.

Funds Settlement

Each clearing member is required to maintain and operate a clearing account with any one of the empanelled clearing banks at the designated clearing bank branches. The clearing account is to be used exclusively for clearing and settlement operations. Trading/clearing member balances are provided by each of the clearing banks on the T+2 day by the pay-in cut off time of 1100 hrs. Based on these balances, electronic instructions are given to the banks for debit of members' accounts and credit of Clearing Corporation accounts. Reverse instructions are given for effecting pay-out. The process flow chart relating to clearing and settlement at NSCCL is at **Annex VIII**.

Funds Shortages

Members are required to ensure that adequate funds are available in the clearing account towards all obligations, on the scheduled date and time. Trading and/or clearing facility of members failing to fulfill their funds obligations are withdrawn. Further, securities pay-out, due to such trading/clearing member is also withheld.

4.4.2 (b) Derivatives Segment[4]

There are three categories of clearing members in the Derivatives Segment; i) Self Clearing members (SCM), ii) Trading member-cum-clearing member (TMCM) and iii) Professional Clearing member (PCM). Clearing members are responsible to the CCP for the obligations arising from their own trades, their clients' trades and the trades of trading members for whom they provide a clearing service, depending on their membership category. All futures and options contracts are cash settled, *i.e.,* through exchange of cash. The settlement amount for a clearing member (CM) is netted across all their TMs/clients. For the purpose of settlement, all CMs are required to open a separate bank account with CCP-designated clearing banks for F&O segment.

Settlement of Futures Contracts on Index and Individual Securities

Futures contracts have two types of settlements, the mark-to-market (MTM) settlement, which happens on a continuous basis at the end of each day, and the final settlement, which happens on the last trading day of the futures contract.

MTM Settlement for Futures

All futures contracts for each member are marked-to-market to the daily settlement price of the relevant futures contract at the end of each day. The CMs who have suffered a loss are required to pay the MTM loss amount in cash. This is known as daily mark-to-market settlement. CMs are responsible to collect and settle the daily MTM profits/losses incurred by the TMs and their clients clearing and settling through them.

Final Settlement for Futures

On the expiry day of the futures contracts, after the close of trading hours, CCP marks all positions of a CM to the final settlement price and the resulting profit/loss is settled in cash. Final settlement loss/profit amount is debited/credited to the relevant CM's clearing bank account on the day following expiry day of the contract.

Settlement of Options Contracts on Index or Individual Securities

Options contracts have three types of settlements: daily premium settlement, interim exercise settlement in the case of option contracts on securities and final settlement.

Daily Premium Settlement for Options

Buyer of an option is obligated to pay the premium towards the options purchased by

[4] Presently, NSE accounts for bulk of the trading in futures and options segment. Further, turnover in index futures and stock futures predominates in this segment.

him. Similarly, the seller of an option is entitled to receive the premium for the option sold by him. The premium payable amount and the premium receivable amount are netted to compute the net premium payable or receivable amount for each client for each option contract. CMs are also responsible to collect and settle for the premium amounts from the TMs and their client's clearing and settling through them. The premium payable amount and premium receivable amount are directly credited/debited to the CMs clearing bank account.

Interim Exercise Settlement

Interim exercise settlement takes place only for option contracts on individual securities. Exercise request can be placed at any time during trading hours through the trading system. Interim exercise settlement is effected for such options at the close of the trading hours, on the day of exercise. Valid exercised option contracts are assigned to short positions in the option contract with the same series (*i.e.,* having the same underlying, same expiry date and same strike price), on a random basis, at the client level. The CM who has exercised the option receives the exercise settlement value per unit of the option from the CM who has been assigned the option contract.

Final Exercise Settlement

Final exercise settlement is effected for option positions at in-the-money strike prices existing at the close of trading hours, on the expiration day of an option contract. All long positions at in-the-money strike prices are automatically assigned to short positions in option contracts with the same series, on a random basis.

4.5 Assessment of Equities Market Settlement Systems against CPSS-IOSCO Recommendations for Securities Settlement Systems

The Securities Settlement System – Equities market is compliant with the CPSS-IOSCO Recommendations for Securities Settlement Systems. Out of the 19 Recommendations set by CPSS-IOSCO, 17 have been assessed as 'Observed', 1 observation as 'Broadly Observed' and the remaining 1 as 'Not Applicable' (Table 15). The detailed assessment matrix is given at **Annex V.**

Legal Risk: The main laws, rules, regulations, procedures and contractual provisions governing securities settlement arrangements are contained in the SCRA, SCRR, SEBI Act, 1992, rules, bye-laws and regulations of NSE and BSE, guidelines, *etc.* issued by SEBI under SEBI Act, 1992 Depositories Act, 1996 and Bye-Laws & Operating Instructions of the depository. These are public and readily accessible to system participants.

The Depositories Act, 1996, in SEBI (Depositories and Participants) Regulations, 1996, Bye-laws and Business Rules of the Central Securities Depositories (CSD) contain various provisions for facilitating dematerialisation and transfer of securities. SEBI Regulations provide for the regulatory requirements and procedure for dematerialisation and transfer of securities. The Bye-laws & Business Rules provide for the operating guidelines & procedures in this regard.

Pre-settlement Risk: With the screen-based online trading system, trades between direct market participants are confirmed online at the time of trade. For transferring the settlement

Table 15: Summary Assessment – Equities Market Settlement Systems	
Recommendation	**Assessment**
1. Legal Basis	O
2. Confirmation of Trades	O
3. Rolling Settlement	O
4. Benefits and Costs of Central Counterparties	O
5. Securities Lending and Borrowing	BO
6. Dematerialisation of Securities	O
7 Elimination of Principal Risk	O
8. Final Settlement	O
9. Risk Management in Deferred Net Settlements	O
10. Credit Risk in the Cash Leg of Securities Transactions	O
11. Operational Risk	O
12. Accounting Practices	O
13. Governance Arrangements for CSDs and CCPs	O
14. Participation Criteria for CSDs and CCPs	O
15. Safety, Security and Efficiency of Systems	O
16. Communication Procedures	O
17. Information on Risks and Costs	O
18. Disclosure of Responsibilities and Objectives of Settlement Systems	O
19. Risks in Cross-border Settlement	NA

O – Observed; BO – Broadly Observed; NA – Not Applicable.

obligation from a trading member to indirect market participants, the participants use an interface. The use of electronic trading system obviates the need for direct market participants to confirm the terms of the trade. The trades are settled on a rolling basis of T+2 days' settlement cycle.

CCP provides full novation and guarantees settlement, eliminating counterparty risk entirely. On a T+2 cycle, all scrips are electronically cleared fully through a CCP on a rolling settlement. The dynamic and comprehensive risk management system comprises of capital adequacy norms, trading and exposure limits, index-based market-wide circuit breakers, margin requirements, *etc.* The encashability of underlying of margins, comprising cash, bank guarantees & securities is evaluated periodically. The real time monitoring of broker positions, margins & automatic disablement of terminals with Value-at-risk (VaR) margining has reduced the operational risk.

A Trade Settlement Guarantee fund has been set up to ensure settlement of transactions. Investor and Customer Protection Funds are maintained by stock exchanges to compensate investors in case of default by members of the exchange. In addition, an Integrated Market Surveillance System (IMSS) has been put in place by SEBI across the exchanges (BSE & NSE) and depositories (NSDL & CDSL) for monitoring exposures across market segments (cash & derivatives) with effect from December 2006.

Settlement Risk: CCPs and the CSDs in India are two different entities. The Depositories Act, 1996 introduced a multi-depository framework for dematerialised settlement in India. It is designed to provide a legal framework for the establishment of depositories to record ownership details in book entry form. It also gives an option to the investors to hold the

securities either in dematerialised form or in physical form

CSDs do not extend credit or operate settlement systems in India. The settlements are carried out by the CCP. CCP ensures DvP for its direct participants (clearing members). It acts as central counterparty for all netted transactions and effects pay-out of securities on receipt of funds. The CSD processes and completes transfer of securities to the receiving members account only upon receipt of instructions from the CCP**.**

The timing of settlement is clearly defined for transactions within the CSD as well as for transactions over a link to another CSD, *i.e.,* between NSDL and CDSL. Transfers by CSD are done at designated times during the day, based on instructions from the CCP. All settlements once carried out are final and there can be no revocation of transfers at any stage.

For CCPs, a comprehensive Risk Management framework of upfront collection of VaR margins (instead of margin collection on T+1 basis), as prescribed by SEBI, is being followed. With the primary focus of addressing the market risks, operational risks and systemic risks, SEBI has been continuously reviewing its policies and drafting risk management policies to mitigate these risks, thereby enhancing the level of investor protection and catalysing market development.

The CCP as well as the clearing members maintain accounts with the designated clearing banks. These clearing banks transfer funds from the members' account to the CCP's account, based on electronic instructions from the CCP. During pay-out, funds are transferred from CCP's account to the receiving members account with the respective banks. Transfer of funds between CCP's accounts with the multiple clearing banks are through RTGS and hence, instantaneous. The payment system used for inter-bank transfers among settlement banks observes CP-SIPS.

Operational Risk: The exchanges and CCPs have well-maintained back-up facilities pertaining to trading, clearing and settlement and the contingency plan for timely recovery of data.

Considering the importance of systems audit in a highly technology-driven securities market, exchanges have been advised by SEBI to conduct a comprehensive audit of their systems and processes related to examination of Trading Systems, Clearing and Settlement Systems (Clearing Corporation/Clearing House), Risk Management, Databases, Disaster Recovery Sites, Business Continuity Planning, Security, Capacity Management and Information Security Audit by a reputed independent auditor on an annual basis.

Custody Risk: Custodians holding customer securities are required to be registered with SEBI and follow the rules and regulations specified by SEBI for protecting customer securities. Participants' operations are subject to periodic inspection by the CSD and SEBI. Internal and external auditors as well as regulators also conduct regular audit inspection of the collateral deposits.

Governance: The exchanges, CSDs and CCPs have well-laid-down rules, bye-laws and regulations regarding their operations describing their duties and obligations. The ownership and financial information is available

with the statutory and regulatory authorities and is also publicly available. Periodical reports containing operational and financial information and major decisions are periodically sent to the members of the board, shareholders, participants, issuers and regulatory authorities.

Access: The exchanges and CCPs have well-laid-down norms and guidelines pertaining to admission and exit of the market participants, *viz.,* broker members, custodians and clearing members which are publicly available and disclosed to all the potential applicants.

Efficiency: SEBI has taken measures to rationalise costs of account-opening charges, custody charges and transaction charges, through a committee which compared costs across jurisdictions. There are no charges levied by CCPs for carrying out basic settlement activities. The charge structure is reviewed regularly by the CSD taking into consideration the movement in the volume of transactions and costs of operations, and the benefit of increase in the volumes by way of reduction in the fee structure, is regularly passed to the users of the CSD system.

Depository Participant (DP) inspections are carried out by both SEBI and depositories to, *inter alia*, evaluate operational reliability, including capacity levels against projected demand of the DP and action is recommended based on the audit findings.

Communication Procedure and Standards: CCPs use International Securities Identification Numbers (ISINs) for communication with depositories and for settlement procedure. STP has been implemented for institutional transactions with effect from July 2004. In India, at present, there are no transactions involving direct flow of funds/securities across borders through the settlement/depository system.

Transparency: CSDs and CCPs notify their market participants about various operational, systemic requirements, rules regarding risk management and other relevant rules, regulations and procedures by way of circulars and other announcements/publications in electronic as well as in hard copies, in English. All policy-related circulars, rules and regulations are displayed on the website of CSDs and CCPs.

Regulation & Oversight: CCPs' operations are governed by the provisions contained in Companies Act, SEBI Act, SCRA, Depositories Act, Income-tax Act, *etc.* and the rules, regulations, bye-laws, notifications, circulars and directives issued thereunder.

4.6 Assessment of NSCCL and BOISL/BSE against CPSS-IOSCO Recommendations for Central Counterparties

The NSCCL and the BOISL/BSE are compliant with the CPSS-IOSCO Recommendations for Central Counterparties. Out of the 15 Recommendations set out by CPSS-IOSCO, 14 have been assessed as 'Observed' and the remaining 1 observation as 'Not Applicable' (Table 16). The detailed assessment matrix is given at **Annex VI.**

Legal Risk: There are well-laid-down rules, regulations, bye-laws and circulars of exchanges/ CCPs as well as various laws governing transfer of funds/securities, risk management, default procedures and various other aspects of the trading and settlement system. These are clearly stated, internally coherent and approved by SEBI and the same are readily accessible to participants and public in printed form and on the website.

CCP's rules, procedures and contracts are enforceable when the participant defaults or becomes insolvent/bankrupt. Laws in force in India supports that the actions taken under such rules and procedures may not later be stayed, avoided or reversed as rules, bye-laws and regulations are approved under SCRA, 1956 and have force of law.

Participation Requirements: CCPs have well-established requirements for participants' financial resources and creditworthiness which are monitored on an ongoing basis. There is a

Recommendation	Assessment
1. Legal Risk	O
2. Participation Requirements	O
3. Measurement and Management of Credit Exposures	O
4. Margin Requirements	O
5. Financial Resources	O
6. Default Procedures	O
7. Custody and Investment Risks	O
8. Operational Risk	O
9. Money Settlements	O
10. Physical Deliveries	O
11. Risks in Links between CCPs	NA
12. Efficiency	O
13. Governance	O
14. Transparency	O
15. Regulation and Oversight	O

Table 16: Summary Assessment of Central Counterparties – NSCCL & BOISL/BSE

O – Observed; NA – Not Applicable.

stringent mechanism to review the net worth and the trading exposures of members and also take necessary action against the failing members. The participation requirements limit the access mainly on grounds of risk. Non-adherence to the criteria as stipulated in the rules and bye-laws of exchange and CCPs can lead to suspension of membership. The conditions and the procedure for suspension as well as the procedure for orderly exit of the participants are laid out clearly in the said rules and bye-laws.

Measurement and Management of Credit Exposure: Risk containment measures for members include capital adequacy requirements, monitoring of performance and track record, stringent margin requirements, position limits based on capital, online monitoring of positions and automatic disablement from trading when limits are breached. CCPs perform risk monitoring on an online real-time basis. In addition, an IMSS has been put in place by SEBI across the exchanges (NSE & BSE) and depositories (NSDL & CSDL) for monitoring exposure across market segments (cash and derivatives). Also, NSE and BSE have their own surveillance systems to generate appropriate alerts.

Margin Requirements: A comprehensive risk management framework, based on VaR model, as prescribed by SEBI as well as CCPs own norms, as applicable from time to time, are followed by the exchanges and CCPs. The core of the risk management system is the liquid

assets deposited by members with the exchange/clearing corporation which cover the four requirements, *viz.,* MTM losses, VaR margins, Extreme Loss margins and Base Minimum Capital. The collateral securities are taken from the member-brokers for their exposure requirements. Margins required are to cover the maximum potential losses arising out of a participant's position over a one-day time horizon using the VaR concept.

A comprehensive risk containment mechanism for the F & O segment has been developed by CCPs, the most critical component being the online position monitoring and margining system. The actual margining and position monitoring is done online, on an intra-day basis using the SPAN (Standard Portfolio Analysis of Risk) system for the purpose of margining, which is a portfolio-based system

Financial Resources: CCP has well-established procedures to stress-test its exposures in extreme but plausible market conditions. A stress-test considering settlement failures by all the top 10 members and a percentage of loss in liquidation of positions is computed and compared with Guarantee Fund for adequacy, periodically by CCPs, on the basis of the criteria stipulated by SEBI.

Given the robust risk management system, the funds shortages are observed to be very insignificant and arise mainly due to the time involved in fund movements. These small and temporary shortages are always recovered subsequently from the members. The securities shortages are also observed to be very small and insignificant

Default Procedures: CCPs' bye-laws clearly state circumstances under which the participant is declared as defaulter. The bye-laws, rules and regulations of the CCPs provide for prompt close-out or to manage the positions of a defaulting participant and to apply the defaulting participants' collateral or other resources. The procedure empowers the CCPs to promptly draw the funds from the Guarantee Fund and other sources like overdraft from banks, *etc.* Defaulters Committee (a statutory committee) handles various aspects related to the defaults on the Exchange.

Custody and Investment Risks: Operations & procedures in respect of custody of collaterals are mandated by the agreement entered between the custodian & the CCP. Periodic reconciliation and audit of the collateral securities deposited by the member-brokers is done. CCPs interest in such collateral can be enforced and the CCP has prompt access to such collateral in the event of a participant's default. The Depositories Act also provides for invoking of pledged securities

CCP considers its overall exposure to an obligor in choosing investments. The prudential norms specify the extent in absolute/percentage terms to which investments can be made. Overall exposure limits are fixed for each class of investments, institutions and schemes.

Operational Risk: No operations of the CCPs are outsourced. The contingency plan, back-up facilities and disaster recovery site pertaining to trading, clearing, settlement and other vital processes are in place. CCP has capacity plans for key systems and they are tested periodically to determine handling of stress volumes.

Money Settlement: CCPs are directly responsible for day-to-day monitoring/ supervision of clearing and settlement system and their operators subject to overall supervision of the exchanges and SEBI. The clearing members, custodians and the clearing banks are governed by the bye-laws/contractual arrangement with CCPs. The clearing banks are required to provide the minimum stipulated services as a single window to all clearing members of CCP. CCPs legal agreements with its settlement banks provide that funds transfers to its accounts are final when effected.

Physical Deliveries: Presently, there are no physical deliveries; however, there are rules in place which state the obligations of CCP with regard to physical deliveries. CCP has identified the liquidity, storage and delivery risks. Demat

deliveries addresses these risks. The CCP has well-laid-down procedures for handling physical deliveries and bad deliveries as per its rules, bye-laws and regulations and various circulars issued from time to time.

Transparency: All relevant information is available to the participants in rules, regulations and bye-laws of CCPs as well as the exchanges through their various circulars/press-releases/ publications and websites.

Regulation & Oversight: SEBI has laid directions which the clearing and settlement system must satisfy such as establishing linkages with depositories, arrangement for T+2 rolling settlement, EFT, establishment of Guarantee Fund, *etc.* SEBI conducts annual or routine inspection of CCPs' which include inspection of settlement systems, risk management, *etc.* The exchanges are also required to conduct system audit of clearing and settlement and risk management system and submit periodical reports including compliance reports to SEBI.

5. Summary of Recommendations

While the Panel has no specific recommendations for Securities Settlement System for the government securities market, the Panel recommends the following based on the assessment of SIPS, CCP (CCIL) and equity market.

5.1 Systemically Important Payment Systems

Settlement in Central Bank Money

At present, High Value clearing takes place at 27 places. At 17 centres where the Reserve Bank manages the clearing, the settlement of High Value clearing takes place in the current accounts maintained by the participant banks with the Reserve Bank. At the other centres, the settlement banks are commercial banks managing the clearing houses. The settlement banks in these cases are major public sector banks. In respect of the settlement which takes place in the commercial bank money, the risk management measures need further review.

Completion of Daily Settlements in the Event of an Inability to Settle by the Participant with the Largest Single Settlement Obligation

The High Value clearing which settles on a multilateral net settlement basis does not have any arrangement to ensure completion in the event of an inability to settle by the participant with the largest single settlement obligation. Settlement risk in this system is addressed through a mechanism of partial unwind.[5] The Reserve Bank should consider migrating all high value transactions to secure electronic channels like RTGS and NEFT.

Security and Operational Reliability of the SIPS

In the case of RTGS system, the on-city hot back-up site is in place. BCP and DR arrangements are in the process of implementation. Data centre of Tier IV standard of Uptime Institute is being set up at three different sites. The RTGS system currently does not have a dedicated off-site DR site. Once implemented, the site would provide high degree of security and operational reliability.

[5] In partial unwind, the defaulting bank receives all the credits due to it while its account is not debited for whatever it owes.

Efficient Use of SIPS

Though the Reserve Bank is not charging any processing fees, the RTGS system charges are still priced relatively higher by banks for customer transactions as compared to charges for clearing paper-based instruments. The level of utilisation of the electronic payments infrastructure has been sub-optimal. The service charges being levied by banks from general public are relatively high. The Reserve Bank has initiated steps to collect the details of charges from banks and place them on the website to bring transparency and encourage competition among banks. It has issued a directive under the Payment and Settlement Systems Act indicating the maximum charges which could be levied on the customers by banks for electronic payments and collection of outstation cheques. Steps may be taken to optimise the utilisation of electronic payments infrastructure and reduce the charges for the same.

Governance Arrangements for SIPS

The Reserve Bank has published a document highlighting its vision of payment and settlement systems, but is yet to clearly disclose publicly its role with respect to SIPS. A document on this may be published by the Reserve Bank.

The decisions taken at the Standing Committees of various SIPS should be communicated to the members more promptly.

Retail Payment Systems

The current low utilisation of the electronic payments infrastructure can be increased with the use of technology to make the facilities more accessible to the customers. Enabling usage of these facilities on mobile devices, which have high penetration levels, could result in a large portion of the population gaining access to these facilities. Mobile devices are used for small value money transfers. Development of fund transfer or payment system through mobile phones would not only allow reduction in the transaction costs, but would potentially also allow use of these facilities by a large unbanked segment. The solution will be to expand the network connectivity of branches in rural and semi-urban areas so that customers in these areas can utilise the electronic payment infrastructure. This would allow the benefits of technology to trickle down the pyramid and allow the banking community to develop products which currently might be unfeasible or un-profitable. The Panel notes that the Reserve Bank has issued operating guidelines on mobile payments in India in October 2008.

5.3 Central Counterparties (CCIL)

Measurement and Management of Credit Exposures

There is no provision for re-computation of margin requirement for outstanding trades by intra-day valuation of outstanding trades for the CBLO and forex segments. CCIL may endeavour to develop capacity to measure intra-day exposure and margin requirement (based on intra-day exposures) for government securities, CBLO and forex segments.

Margin Requirements

Under the Recommendation 4, CCPs need to validate that the models and parameters used to determine the margin levels are consistent with the intended coverage and that the same should be reviewed and validated frequently. Back-testing for CBLO is a must to assess the associated risks as well as adequacy of margins. However, back-testing model is not in place for the CBLO segment. In the CBLO segment, CCIL needs to develop a model for back-testing for margining to ascertain the adequacy of margins collected.

Adequacy of Financial Resources

On occasions, the largest exposure in the government securities, CBLO and forex settlements exceed the liquid financial resources at the command of CCIL. Hence, there is a need for the CCIL to have adequate financial resources. The Panel recommends that:

1. CCIL can arrange for additional liquidity, *i.e.*, additional lines of credit.
2. A debit cap already exists in the US dollar leg of US dollar-INR segment of CCIL. A similar cap can be fixed for the exposure of CCIL in the government securities and CBLO segments. The amounts exceeding the debit cap can be settled by CCIL on a DvP I basis, directly on RTGS. However, in view of the quantum increase in the volume of trades in the government securities market and the fact that banks are mandated to operate through CCIL, the implementation of this recommendation should duly consider that the debit cap does not hamper smooth trade and settlement operations in the government securities market.
3. CCIL can settle through continuous settlement on the RTGS. This would require that CCIL is granted full membership of RTGS with IDL support.
4. CCIL may be granted a Limited Purpose Banking license, so that they would be able to approach the Reserve Bank or the market for liquidity by repo arrangements.

CCIL needs to develop stress-testing models for CBLO segment. Further, in forex segment, CCIL may evolve a clear and transparent policy to ensure prompt actions (like calling for additional resources, time and manner of collection, *etc.*) are taken in cases when stress-test indicates that resources are inadequate.

Default Procedures

Though default procedures are clearly laid out in CCIL's bye-laws, rules and regulations and the intended actions in this regard are well-supported by the bilateral contract between the members and CCIL which is legally enforceable, the default procedures are required to be supported by a policy. Further, there is a lack of clarity on the eventuality of liquidating US dollar assets or other securities, in case the need arises. The Panel recommends that CCIL may evolve an objective policy on the modalities of liquidating the default position to reinforce the established default procedure for both CBLO and forex segments.

Money Settlements

The detailed processes for monitoring exposures are not in place. CCIL may develop processes for monitoring of settlement bank risk for CBLO and forex segments.

Transparency

Stress-test methodology and the results of stress-tests done by CCIL are not disclosed to the members/public. CCIL may consider making public stress-test-methodology and, if feasible, also the results. Further, they may endeavour to provide public information apart from English, in local languages also.

5.4 Equities Market

Legality of Netting and Settlement Finality – Need for Amendment in Securities Contracts (Regulation) Act, 1956

SCRA is a special statute for regulating contract in securities in the Recognised Stock Exchange (RSE). Section 9 of SCR Act empowers RSE (with the approval of SEBI) to make bye-laws for the regulation and control of contracts in securities. Section 9(2)(b), (k) and (n) of SCRA empowers RSE to make bye-laws for settlement of contracts, the delivery of and payment for

securities, the consequences of default or insolvency on the part of a seller or buyer or intermediary and procedure for the settlement of claims or disputes.

Section 8A(1) of SCRA empowers RSE with the prior approval of SEBI to transfer the duties and functions of a clearing house to a clearing corporation for the purpose of periodical settlement of contracts and differences thereunder and the delivery of, and payment for securities. The bye-laws and rules of the RSE made under the SCRA are required to be published in the Official Gazette. To that extent, in a way, they acquire the statutory flavour as held by the Supreme Court in the Bombay Stock Exchange vs Jaya I. Shah and another (2004) 1 Supreme Court Cases 160. The bye-laws and rules of the RSE or its clearing corporation provide under their framework, various operating rules of the governing the transactions that are taken up for settlement such as settlement on netted basis, rules regarding close-out of the transactions, default handling procedure, *etc.* Every contract note issued to a constituent contains a specific provision that 'the contract is made subject to the rules, bye-laws and regulations and usages of the RSE'. Thus, the contract in securities in RSE are governed by provisions of SCRA or bye-laws made thereunder, except the cases where the SCRA or bye-laws are silent, in such eventuality, the general law of contract will be applicable.

In the event of a winding-up of a stock-broking company, these rules of RSE in respect of settlement obligations are applied and collaterals of the failed entity, deposited with RSE towards its dues, are appropriated in terms of the provisions of the bye-laws of RSE and settled as against the claims of the liquidator. Since these transactions are netted, any unwinding of these transactions could lead to a catastrophic situation in the RSE. There is no express bar on liquidator under the extant insolvency laws, or income tax authorities to avoid such contracts and it is debatable whether the bye-laws of RSE could preclude the applicability of insolvency or priority provisions or provisions which bar fraudulent transfers under substantive laws, such as provisions of Companies Act, Income Tax Act, *etc.* This issue has become more pronounced, especially in the light of the recently passed legislation, the Payment and Settlement Systems Act, 2007 which specifically provide for legal recognition to the netting procedure and settlement finality by provisions made in the parent Act instead of leaving it to be made through sub-ordinate legislations such as bye-laws and regulations of RSE. However, there is hardly any case where the netting or finality of settlement in RSE has been successfully challenged. To put the matter beyond any doubt, it is felt that it may be desirable to incorporate a specific clarificatory provisions in the SCRA to provide for the following:

(i) The payment obligations and settlement instructions in respect of securities transactions in RSE/Clearing Corporation among the members or clients may be determined in accordance with netting (or gross) procedure as may be approved by the SEBI;

(ii) Such netting procedure shall have effect notwithstanding anything to the contrary contained in any other law;

(iii) A settlement affected under such procedure shall be final and irrevocable;

(iv) Where a member of RSE or Clearing Corporation is declared as insolvent or is dissolved or wound-up, then notwithstanding anything contained in any other law, the order of adjudication or dissolution or winding up, shall not affect any settlement that has become final and irrevocable and the right of the RSE or Clearing Corporation to appropriate any collaterals or deposits or margins contributed by the member or client towards its settlement or other obligations in accordance with bye-laws of RSE/Clearing Corporation; and

(v) Settlement, whether net (or gross), shall be final and irrevocable as soon as the money, securities, or derivatives or other transactions payable as a result of such settlement is determined, whether or not such money, securities, or derivatives or other transactions is actually paid.

Funds Settlement – Need for promoting electronic fund transfer mechanisms

Settlement for transactions is effected on T+2 basis. Most of the securities traded in stock exchanges are settled in demat form through electronic book entry. Funds settlement takes place though multiple clearing banks. Payment through cheques has been the conventional and more prevalent mode of transfer of funds. The efficiency[6] of the existing settlement system can be further enhanced by greater use of electronic fund transfer mechanisms like RTGS, NEFT, *etc.* Lack of knowledge, cost of operations[7] and lesser access and availablity appear to be the major reasons restricting larger use of electronic fund transfer mechanisms. There is a need for spreading awareness and encouraging use of high speed methods for movement of funds through the banking system. Incentivising the usage of the said methods as well as enhancing the reach and availability of these mechanisms (e.g., enabling more branches, extending the availability of service window at existing branches beyond 3 p.m. to facilitate timely pay-in, *etc.*) also need to be considered.

[6] During the market fall in January 2008, it was gathered from media reports that on days when indices witnessed extreme volatility, many brokers had disputes with respect to acceptance of client orders for transactions and mode of payment given by clients. The brokers seemed to be asking for demand drafts instead of cheques in order to get guarantee of timely client payment in uncertain situations. (Most cheques take two days to clear and 'high value' cheques, of over Rs. 1 lakh, can only be deposited in branches which are in the centre of town, and even these take several hours to clear.)

[7] Service charges for use of RTGS by banks, at present, is left to the discretion of banks. It can be checked whether the same are high, low or adequate, whether the same are a disincentive *vis-à-vis* the traditional cheque-writing option, *etc.*

Annex I

Assessment of Observance of CPSS Core Principles for Systemically Important Payment Systems – Indian RTGS System

CP I	**The system should have a well-founded legal basis under all relevant jurisdictions.**
Description	The agreement between the system operator (the Reserve Bank) and the members, individually, form the legal basis governing the operation of RTGS in India. As per the agreement, the members agree to abide by the RTGS (Membership) Regulations, 2004 and RTGS (Membership) Business Operating Guidelines, 2004 which have been recognised under the Payment and Settlement Systems Act, 2007. This agreement covers all the operational aspects related to RTGS including the irrevocability and finality of the payments and the granting and reversal of IDL facility. The exchange of payment instructions through RTGS is covered by the Indian Information Technology Act, 2000. The system has been designed incorporating the security features as required by this law.
Assessment	**Observed**
CP II	**The system's rules and procedures should enable participants to have a clear understanding of the system's impact on each of the financial risks they incur through participation in it.**
Description	The RTGS (Membership) Regulations, 2004 and RTGS (Membership) Business Operating Guidelines, 2004 which have been recognised under the Payment and Settlement System Act, 2007 clearly describe the roles and responsibilities of the system participants and the system operators. The main risk for a participant in a RTGS system is the liquidity risk. The system provides IDL support to the participants against the collateral of the Government of India securities and treasury bills. The documents describe the instances and conditions under which IDL may be granted and reversed.
Assessment	**Observed**
CP III	**The system should have clearly defined procedures for the management of credit risks and liquidity risks, which specify the respective responsibilities of the system operator and the participants and which provide appropriate incentives to manage and contain those risks.**
	Credit Risk: RTGS systems are designed to mitigate the credit risk in payment systems. Due to the real-time settlement facility, RTGS ensures that the payments are settled only if sufficient funds are available in the settlement account of the participants. This ensures that the participants in the system are not exposed to any credit risk. The settlement takes place at the settlement account at the Reserve Bank. The rules and procedure of the system further ensures that the payments cannot be repudiated.

	Further, the membership of the system is granted only to scheduled commercial banks and Primary Dealers who are regulated by the Reserve Bank.
Description	**Liquidity Risk:** The gross settlement feature of RTGS, while mitigating the credit risk for participants, creates IDL requirements, the management of which would only ensure smooth settlement of payments. The participants are individually responsible for managing their liquidity requirements. The RTGS (Membership) Business Operating Guidelines, 2004 lays down that the participants should ensure the availability of sufficient funds in their settlement account for the transactions initiated by them. Liquidity risk is mitigated by the design of payment queue. The participants are responsible for management of their payment queues. The payment queueing facility in RTGS facilitates the prioritisation and revocation of payment instructions. Further, for management of liquidity risk, the Reserve Bank provides the participants with IDL facility to participants. The central bank reduces its credit risk, due to provision of IDL by collecting collateral of Government of India securities/treasury bills. Further, to control the loss due to market risk, a haircut of 5 per cent is imposed on these securities, *i.e.,* 95 per cent of the face value of the security is provided as IDL to the participants. The system also provides gridlock resolution mechanism to handle situations where payment gridlocks arise. The liquidity risk to the system in respect of net settlement files of CCIL has not been addressed. There is no built-in mechanism to ensure that sufficient liquidity is available for settlement of these files, particularly the files relating to CBLO as the LoC arranged by CCIL (Rs 600 crore) has no relationship to the debit positions the files generate, sometimes to the tune of Rs 3,000 crore. As a result, the settlement bank (the Reserve Bank) gives clean accommodation to the entities with debit positions outside the RTGS system (in current accounts) to provide necessary liquidity for the settlement to go through. The monitoring of the transactions flowing through the RTGS system are carried out on a real time basis at three points, *i.e.,* at Deposit Accounts Department, by General Manager (Banking) and Regional Director level at Mumbai Regional Office. However, this monitoring is done alongside other responsibilities of the officials concerned and there is a need for closer monitoring by dedicated officials and also to put in place a well-documented monitoring procedure.

Assessment	**Broadly Observed**
CP IV	**The system should provide prompt final settlement on the day of value, preferably during the day and at a minimum at the end of the day.**
Description	The settlement of transactions in RTGS system takes place on a gross basis continuously during the working hours of RTGS. Payments pending settlement at the end of the settlement period are rejected by the system. The settlement of the transactions takes place by debit to initiating members and credit to the recipients members' settlement account in RTGS. This process ensures the finality of the payments. The finality of payments is clearly stated in the RTGS (Membership) Business Operating Guidelines, 2004 which have been recognised under the Payment and Settlement Systems Act, 2007. The agreement entered into by participants and the Reserve Bank under the guidelines forms the legal basis governing the operation of RTGS in India. The members in the systems have, as per the agreement entered into by them, agreed to abide by the RTGS (Membership) Business Operating Guidelines, 2004.
Assessment	**Observed**
CP V	**A system in which multilateral netting takes place should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single settlement obligation.**
Description	RTGS is a gross settlement system.
Assessment	**Not Applicable**
CP VI	**Assets used for settlement should preferably be a claim on the central bank; where other assets are used, they should carry little or no credit risk and little or no liquidity risk**.
Description	Settlement of all transaction in RTGS takes place at the settlement account in RTGS maintained at the Reserve Bank, Mumbai. The initial funding of these accounts is carried out by funds transfer from the current accounts of participants in the Reserve Bank.
Assessment	**Observed**
CP VII	**The system should ensure a high degree of security and operational reliability and should have contingency arrangements for timely completion of daily processing.**
Description	RTGS system has an on-city back-up site which is operational. Real-time data replication takes places at this centre. Steps are being taken to augment the BCM plan for RTGS systems along with other payment systems. In this connection, the Reserve Bank has initiated the process for setting up a Tier-4 data centre with architecture of primary, hot back-up and back-up centres.

	While the primary and hot back-up centres would be mirroring every transaction and the hot back-up centre can take over the work seamlessly, the back-up centre located in a different seismic zone can be activated within two hours. The Reserve Bank has prepared documents, approved by the top management, describing the action plan for live BCP drill activity for all payment system applications including RTGS. The document indicates activities from the beginning of the day to the end of day. This document is used when testing of BCP plan is carried out. In order to ensure that the BCP is in a readily executable form, the Reserve Bank conducts regular and periodical Disaster Recovery (DR) drills, where all banks, other entities, CCIL, *etc.* also participate. The DR exercise involves the following tasks: ● Operations switching from the Reserve Bank's primary production site to the DR site; ● Banks switching to their respective DR sites from their production sites; ● Conduct of live operations in the above set-up; ● Banks migrating back to their primary sites; ● The Reserve Bank migrating to its primary production site; ● Banks connecting their primary sites to the Reserve Bank's primary site; and ● Re-synchronisation of data at the primary site. While the Reserve Bank has prepared documents describing the action plan for live BCP drill activity for RTGS, these processes have not been effectively communicated at the operational level. BCP for the RTGS system should not only ensure the system availability, the process should also ensure the planning of the human resource aspect. Further, the operational primary site and secondary site are very proximate to each other and, hence, may not be able to withstand any natural disaster. This priniciple would be 'Observed' only when the new data centres are operational.
Assessment	**Broadly Observed**

Comments	The RTGS system currently does not have a dedicated off-site DR site. Once implemented, the site would provide high degree of security and operational reliability.
CP VIII	**The system should provide a means of making payments, which is practical for its users and efficient for the economy**.
Description	**Objective**: The objective of the Reserve Bank for implementing RTGS system in India is to mitigate the risk inherent in the large value inter-bank settlement systems which were being settled on a net basis at the end of the day. While the end-of-day net settlements, where advantages accrued to the participants from the liquidity perspective, the systemic risk inherent in the system far outweighed the advantages, The RTGS system provides the participants the facility to monitor their payments receipts individually and also monitor their liquidity requirements. To reduce the impact of the closure of net settlement system on the liquidity management aspects of banks, the Reserve Bank provides IDL facility to the participants. The facility, which is currently not being charged, is provided to the extent of collateral lodged by the participant and is limited to three times the Tier-I capital of the participants. **Liquidity**: While the system helped in mitigating the systemic risk in the large value payment, the liquidity requirements of the participants in this system have been increasing. The liquidity management tool currently available to the participant is only the queue management facility. While IDL is provided to the participants, the lack of availability of adequate acceptable collateral has resulted in participants not accessing the full IDL limit granted to them. This, at times, results in payments being held in queues, and especially during the settlement of large value transactions and Multi-lateral Net Settlement batches. In the inter-bank clearing system, the banks were managing their liquidity requirements at different centres separately, the excess/deficit funds then being moved from one centre to another centre. The implementation of RTGS resulted in a centralised settlement facility for all the inter-bank transactions of a bank, facilitating better liquidity management for banks. **Cost:** The Reserve Bank currently does not impose any charge on the participants for use of RTGS system. This is in comparison to the inter-bank clearing prior to RTGS systems where the participants were charged based on the number of instruments presented by them. The cost of implementing the system has not been recovered by the central bank. Though the central bank does not levy any charge on the RTGS member banks, most banks were levying high charges for use of these systems by their customers.
Assessment	**Broadly Observed**

Comments	The efficiency, costs (social and private), practical constraints (technology, infrastructure) related aspect of implementation of RTGS have not been examined by the Reserve Bank.
CP IX	**The system should have objective and publicly disclosed criteria for participation, which permit fair and open access.**
Description	The membership criteria for RTGS are stated in Chapter III of the RTGS (Membership) Regulations 2004. As per the document, the membership of RTGS would be open to – (i) the Reserve Bank, Mumbai and any other clearing agency managed by the Reserve Bank shall be a member of the RTGS system and (ii) all scheduled banks and (iii) to any other institution at the discretion of the Reserve Bank.
Assessment	**Observed**
CP X	**The system's governance arrangements should be effective, accountable and transparent.**
Description	The RTGS system is operated by the Reserve Bank. The functioning of the Bank is overseen by the Central Board of the Bank. A separate Board – the Board for Regulation and Supervision of Payment and Settlement Systems – a Committee of the Central Board, oversees the functioning of payment systems. This Board has the responsibility of the regulation and supervision of the payment and settlement systems. The decisions pertaining to the operations of the RTGS systems are taken by the respective departments of the Reserve Bank. The technological and technical aspects of the RTGS are looked after by the Department of Information Technology. The policy aspects of the RTGS are prescribed by Department for Payment and Settlement Systems in consultation with the other regulatory departments of the Reserve Bank. The Mumbai Regional Office of the Reserve Bank carries out the day-to-day operations of the RTGS system. Its role includes the grant of new memberships, cancellation of memberships, *etc.* based on the guidelines prescribed by the regulatory departments of the Reserve Bank. A Standing Committee for RTGS, with members from the participant institutions, has also been formed. This committee debates the policy changes in RTGS. The recommendations and suggestions of this committee is taken into consideration for implementing any new RTGS-related policies. Also, the decisions taken at the committee meetings are communicated to all RTGS members.

Assessment	**Observed**
Responsibility A	**The central bank should define clearly its payment system objectives and should disclose publicly its role and major policies with respect to systemically important payment systems.**
Description	The vision documents published by the Reserve Bank clearly states its payment system objectives. The mission of the Reserve Bank as stated in the vision document is 'the establishment of safe, secure, sound and efficient payment and settlement system for the country'. The vision document further states the objectives of the Reserve Bank to be achieved in the next few years. In addition, the other major policy decisions regarding the payment systems are communicated to the participants by means of circulars which are available on the Reserve Bank's website.
Assessment	**Observed**
Responsibility B	**The central bank should ensure that the systems it operates comply with the Core Principles.**
Description	Since the initial assessment of Indian payment system against the core principles in FSAP – 2001, wherein it was observed that the system does not fully comply with core principles for SIPS, the Payment and Settlement System Act, 2007 has been notified and the new sites for hosting RTGS systems have been completed.
Assessment	**Broadly Observed**
Comments	In the case of RTGS, the off-site back-up facility is not yet operational.
Responsibility C	**The central bank should oversee compliance with the Core Principles by systems it does not operate and it should have the ability to carry out this oversight.**
Description	The notification of Payment and Settlement Systems Act has provided the Reserve Bank the power to oversee the payment and settlement systems, not operated by the central bank.
Assessment	**Observed**
Responsibility D	**The central bank, in promoting payment system safety and efficiency through the Core Principles, should co-operate with other central banks and with any other relevant domestic or foreign authorities.**
Description	The only payment system with external links is the INR-US dollar clearing of CCIL. This segment was started with the concurrence of the Federal Reserve Bank. The process and risk mitigation systems implemented by this system was vetted by the Federal Reserve Bank and approved before the system was implemented finally. Any changes to the system's procedures are communicated to the Federal Reserve Bank.
Assessment	**Observed**

Annex II

Assessment of Observance of CPSS Core Principles for Systemically Important Payment Systems – High Value Clearing System

CP I	**The system should have a well-founded legal basis under all relevant jurisdictions.**
Previous Assessment (FSAP-2001)	Not Observed
Description	The High Value clearing is operated as per the Uniform Regulations and Rules for Bankers' Clearing Houses (URRBCH), which is recognised under the Payment and Settlement Systems Act, 2007. The URRBCH defines the rights and obligations of participating in the clearing house.
Assessment	**Observed**
CP II	**The system's rules and procedures should enable participants to have a clear understanding of the system's impact on each of the financial risks they incur through participation in it.**
Previous Assessment (FSAP-2001)	Broadly Observed
Description	The URRBCH define the rights and obligations of participating in this segment. Member banks agree to abide by the prescriptions contained in the URRBCH and are aware of their roles/responsibilities and the risks they incur by participating in the clearing/settlement systems. Access criteria for membership to Clearing Houses at MICR centres (which also run High Value clearing) implemented with effect from January 1, 2008 clearly lays down parameters (comprising financial/ regulatory compliance) for being eligible to become member.
Assessment	**Observed**
CP III	**The system should have clearly defined procedures for the management of credit and liquidity risks, which specify the respective responsibilities of the system operator and the participants and which provide appropriate incentives to manage and contain those risks.**
Previous Assessment (FSAP-2001)	Not Observed

Description	The system has procedures for management of credit risk and liquidity risk. Member banks are aware of the time zones for conduct of the presentation and return clearings as part of the High Value clearing. They are also aware of the 'time' at which their accounts will be debited/credited. Clear funds are made accessible to member banks only after completion of the relevant 'return' leg of High Value clearing. In Mumbai, the largest of the High Value centres, settlement is effected in MNSB mode on the RTGS and transactions are settled on a all-or-none basis. Recourse to IDL is available to member banks against eligible collateral. In case of failure of member banks to arrange for cover funds in their account to provide for 'debits', the recourse to 'partial unwind' is available to the clearing house. Clearing houses/member banks are aware of the course of action to be followed by them in such an eventuality. The system has been working satisfactorily across the 27 locations without the need for recourse to 'unwind' hitherto. In fact, the recourse to unwind has hardly been used even in remote locations. Regulatory/central bank interventions in the matter of permitting access or otherwise to High Value clearing of instruments up to/above a specified threshold is carried out as and when necessary.
Assessment	**Broadly Observed**
CP IV	**The system should provide prompt final settlement on the day of value, preferably during the day and at a minimum at the end of the day.**
Previous Assessment (FSAP-2001)	Partially Observed
Description	The settlement window provides for same day settlement of funds for cheques accepted in High Value clearing. The recently notified Payment and Settlement Systems Act establishes the finality of payments.
Assessment	**Observed**
CP V	**A system in which multilateral netting takes place should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single settlement obligation.**
Previous Assessment (FSAP-2001)	Not Observed
Description	The High Value clearing, which settles on a multilateral net settlement basis, does not have any arrangement to ensure completion of settlement in the event of an inability to settle by the participants with the largest single settlement obligation.

	Member banks are eligible to use the 'clear' funds only after completion of the relative 'return' leg. The settlement at Mumbai is effected through the MNSB mode, which settles on an all-or-none basis.
Assessment	**Partly Observed**
Comments	The High Value clearing should have an arrangement to ensure completion of settlement in the event of an inability to settle by the participant with the largest single settlement obligation.
CP VI	**Assets used for settlement should preferably be a claim on the central bank; where other assets are used, they should carry little or no credit risk and little or no liquidity risk.**
Previous Assessment (FSAP-2001)	Observed
Description	High Value clearing is presently conducted at 27 centres. Of these, 14 are Reserve Bank centres, *i.e.,* the accounts are finally settled in the books of the Reserve Bank. At the Reserve Bank centres, settlement finally takes place in the books of the Reserve Bank. At other centres, the settlement takes place in commercial bank money. The settlement banks in these centres are SBI, Associate banks of SBI or other public sector banks. Settlement risk is largely mitigated by virtue of the fact that the majority stake of these banks is owned by the Central Government. Thus, at all major High Value locations, the settlement is in central bank money only. At the remaining centres, the assets used for settlement carry little or no credit risk.
Assessment	**Observed**
CP VII	**The system should ensure a high degree of security and operational reliability and should have contingency arrangements for timely completion of daily processing.**
Previous Assessment (FSAP-2001)	Not Observed
Description	High Value clearing processing is carried out using a data processing package and cheques are physically exchanged by banks. There is a

	back-up processing bank at each centre and as such a high degree of security and reliability has been achieved in the processing systems. At all MICR centres, adequate back-up arrangements have been put in place.
Assessment	**Observed**
CP VIII	**The system should provide a means for making payments, which is practical for its users and efficient for the economy.**
Previous Assessment (FSAP-2001)	Partially Observed
Description	Central bank, as the overseer of the payment system has taken several initiatives to increase efficiency of the system by inducting technology and changes in procedures. The commercial banks as participants are effective partners in this process. High Value clearing ensures completion of clearing cycle on the same day. Customers are permitted to make use of the funds either the same or the next day. The system has been working efficiently and the usage is satisfactory. High Value clearing is extremely popular and there have been demands from various locations for operationalising a similar facility there. As of now, it has not been decided to increase the number of High Value centres. In fact, the success of High Value clearing is one of the main reasons for slow pick-up in migration from paper-based system to electronic system.
Assessment	**Observed**
CP IX	**The system should have objective and publicly disclosed criteria for participation, which permit fair and open access.**
Previous Assessment (FSAP-2001)	Observed
Description	The access criteria laid-down for becoming members of the clearing houses are explicit and are disclosed.
Assessment	**Observed**
CP X	**The system's governance arrangements should be effective, accountable and transparent.**
Previous Assessment (FSAP-2001)	Not Observed
Description	The clearing house is a voluntary association of the member banks governed by the URRBCH. It has a Standing Committee for day-to-day governance and a General Body where all major decisions are discussed and approved by the members.
Assessment	**Observed**

Annex III

Assessment of Observance of CPSS-IOSCO Recommendations for Securities Settlement Systems – Government Securities

Recommendation 1	**Legal Framework:** Securities settlement systems should have a well founded, clear and transparent legal basis in the relevant jurisdiction.
Description	The laws, rules and regulations governing the Securities Settlement System are contained in the SCRA and the GS Act (notified on December 1, 2007). The Government securities transactions are governed by SCRA, and GS Act and rules framed under them. The secondary market transactions are on contractual basis and are covered by the Contract Act and the enforceability is under the Contract Act. The netting by novation performed by the CCP is covered by Contract Act. The Government Securities Act supports dematerialisation of securities. All Government Securities transactions are settled under DvP mode of settlement. Further, at the SSS level, the Reserve Bank has defined penal clauses regarding the treatment of default in either funds leg or securities leg. Failure to deliver securities is treated as SGL bouncing and hence attracts penalty as laid-down by the Reserve Bank.
Assessment	**Observed**
Recommendation 2	**Trade Confirmation:** Confirmation of trades between direct market participants should occur immediately after trade execution, but no later than trade date (T+0). Where confirmation of trades by indirect market participants (such as institutional investors) is required, it should occur as soon as possible after trade execution, preferably on T+0, but no later than T+1.
Description	All secondary market transactions are submitted to settlement systems electronically and confirmations are completed on the trade date itself on the NDS. Only confirmed trades are sent to the settlement system.
Assessment	**Observed**
Recommendation 3	**Settlement Cycle:** Rolling settlement should be adopted in all securities markets. Final settlement should occur no later than T+3. The benefits and costs of a settlement cycle shorter than T+3 should be evaluated.

Description	All the outright securities transactions are settled on a T+1 rolling basis. Repo transactions can have T+0 and T+1 settlement. The settlement cycle is the same for direct as well as indirect participants. Settlement cycle is not longer than T + 1.
Assessment	**Observed**
Recommendation 4	**Central counterparties (CCPs):** The benefits and costs of a central counterparty should be evaluated. Where such a mechanism is introduced, the central counterparty should rigorously control the risks it assumes.
Description	CCIL has been set up as a CCP for settling transaction in government securities. All government securities transactions are settled through CCIL on net basis on DvP III. CCIL has established detailed mechanisms and procedures through counterparty credit exposures and margining system, *etc.* to control the risks it is exposed to as CCP. The CCIL's risk management practices are periodically evaluated against recommendations for CCP. Very few transactions between custodian and its client settle on gross basis.
Assessment	**Observed**
Recommendation 5	**Securities Lending:** Securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method for expediting the settlement of securities transactions. Barriers that inhibit the practice of lending securities for this purpose should be removed.
Description	A limited purpose securities lending has been approved to facilitate settlements at CCIL. Also, securities lending is carried out through repo agreements between counterparties.
Assessment	**Observed**
Recommendation 6	**Central Securities Depositories (CSDs):** Securities should be immobilised or dematerialised and transferred by book entry in CSDs to the greatest extent possible.
Description	Full dematerialisation of government securities (with the exception of a small quantum of the stock certificates) has been achieved for wholesale transactions. The physical certificates are settled directly with the Reserve Bank as book entry. The GS Act defines the procedure for all transactions relating to government securities.
Assessment	**Observed**
Recommendation 7	**Delivery versus Payment (DvP):** Securities settlement systems should eliminate principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment.

Description	All government securities transactions are settled only in DvP mode. DvP Model III is followed. The funds and securities are cleared by the CCP and sent to SSS for settlement. The funds leg are settled by the SSS in RTGS.
Assessment	**Observed**
Recommendation 8	**Timing of Settlement Finality:** Final settlement should occur no later than the end of the settlement day. Intra-day or real-time finality should be provided where necessary to reduce risks.
Description	The transactions submitted by CCIL are on DvP III basis. The transaction settlement times are communicated to all the participants of the system. The final settlement for the securities transactions take place in the books of the Reserve Bank as at the end of the settlement day.
Assessment	**Observed**
Recommendation 9	**CSD Risk Controls to Address Participants' Failures to Settle:** CSDs that extend intra-day credit to participants, including CSDs that operate net settlement systems, should institue risk controls that, at a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle. The most reliable set of controls is a combination of collateral requirements and limits.
Description	Since all the transactions are settled through CCP, the risk control measures are operated at CCP level. The CSD does not take any credit exposure on it and also no intra-day credit is extended by the CSD to any member.
Assessment	**Observed**
Recommendation 10	**Cash Settlement Assets:** Assets used to settle the ultimate payment obligations arising from securities transactions should carry little or no credit or liquidity risk. If central bank money is not used, steps must be taken to protect CSD members from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.
Description	The transactions involving members having SGL Account and current account with the Reserve Bank are settled in the books of the Reserve Bank.

Assessment	**Observed**
Recommendation 11	**Operational Reliability:** Sources of operational risk arising in the clearing and settlement process should be identified and minimised through the development of appropriate systems, controls and procedures. Systems should be reliable and secure, and have adequate, scalable capacity. Contingency plans and back-up facilities should be established to allow for timely recovery of operations and completion of the settlement process.
Description	The settlement system is fully automated with regular BCP testing. There are internal guidelines and procedures including security measures designed to limit operational risk. Contingency plans including back-up facilities are available.
Assessment	**Observed**
Recommendation 12	**Protection of Customers' Securities:** Entities holding securities in custody should employ accounting practices and safekeeping procedures that fully protect customers' securities. It is essential that customers' securities be protected against the claims of a custodian's creditors.
Description	Only securities, which are in dematerialised form, are held with custodians. The physical securities are held by the beneficial holders themselves. As per the instructions issued by the Reserve Bank, the custodians should hold in separate accounts its proprietary securities and those securities held as custodians. The GS Act confers the ownership of the securities in custodian accounts with the beneficial owners in case of insolvency of the custodian. The entities holding securities in custody are subjected to internal and external audit.
Assessment	**Observed**
Recommendation 13	**Governance:** Governance arrangements for CSDs and central counterparties should be designed to fulfill public interest requirements and to promote the objectives of owners and users.
Description	The SSS is operated by the Reserve bank. The Board members of the Reserve Bank are appointed by the Government of India.
Assessment	**Observed**
Recommendation 14	**Access:** CSDs and central counterparties should have objective and publicly disclosed criteria for participation that permit fair and open access.
Description	The rules have been clearly defined for direct members of the system and they are available to the members. The restrictions on access can be justified on the need to limit risk to the system.

Assessment	**Observed**
Recommendation 15	**Efficiency:** While maintaining safe and secure operations, securities settlement systems should be cost-effective in meeting the requirements of users.
Description	The Reserve Bank does not impose any fee/service charges for using the CSD or for using the trading and reporting system. However, the CCP levies charges in consultation with the market participants/user groups.
Assessment	**Observed**
Recommendation 16	**Communication Procedures and Standards:** Securities settlement systems should use or accommodate the relevant international communication procedures and standards in order to facilitate efficient settlement of cross-border transactions.
Description	Government securities settlement is domestic.
Assessment	**Not Applicable**
Recommendation 17	**Transperancy:** CSDs and CCPs should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using the CSD or CCP services.
Description	All relevant information are made available to the participants and are also in the public domain. The application for opening and maintaining the SGL contains all terms and conditions of the account. The guidelines detail the rights and obligations of the member. The balance standing to the credit of the account-holder is periodically confirmed to the holder. The CSD for the government securities is with the Reserve Bank. The CSD does not charge any custody fees for the service rendered. Although the CCP evaluates the risk arising out of its activities, it does not disclose the results of stress-test, *etc.* in public domain.
Assessment	**Observed**
Recommendation 18	**Regulation and Oversight:** Securities settlement systems should be subject to transparent and effective regulation and oversight. Central banks and securities regulators should co-operate with each other and with other relevant authorities.
Description	The SSS for the government securities is a part of the Reserve Bank and is subject to internal oversight. The Reserve Bank assesses the SSS through

	its Inspection Department regularly in a pre-determined schedule and also through concurrent audit appointed by the Reserve Bank and Control and Self-Assessment Audit. The responsibility of the Reserve Bank with regard to government security settlement is defined in the GS Act. There is no other security settlement system for Government Securities outside the Reserve Bank. The CCIL as a CCP is subjected to periodic oversight by the Reserve Bank based on CPSS–IOSCO standards.
Assessment	**Observed**
Recommendation 19	**Risks in Cross-border Links:** CSDs that establish links to settle cross-border trades should design and operate such links to reduce effectively the risks associated with cross-border settlement.
Description	Government securities settlement is domestic.
Assessment	**Not Applicable**

Annex IV

Assessment of Observance of CPSS-IOSCO Recommendations for Central Counterparties – Clearing Corporation of India

Recommendation 1	**Legal Risk:** A CCP should have a well-founded, transparent and enforceable legal framework for each aspect of its activities in all relevant jurisdictions.
Description	Bye-laws, rules and regulations of CCIL have legal recognition under the Payment and Settlement Systems Act, 2007. These rules and regulations are made available to all members and are also available in the public domain.
Assessment	**Observed**
Recommendation 2	**Participation Requirements:** A CCP should require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the CCP. A CCP should have procedures in place to monitor that participation requirements are met on an on-going basis. A CCP's participation requirements should be objective, publicly disclosed, and permit fair and open access.
Description	CCIL has a well-laid-down procedure for admission and periodical review of membership criteria. The CCIL Board has constituted a Membership Approval Committee to consider the applications for admission of new members as per the criteria laid-down. The Membership Approval Committee undertakes an annual review of the membership to ensure that criteria prescribed has been adhered to and deviations are carefully examined by and referred to the Board. Moreover, any exception either in meeting settlement obligation or margin liability, *etc.* is monitored through an exception report put up to the top management. Documentation of decisions in each stage from the admission of members, instances of default, membership review and its reporting to the Board have been put in place. Participation requirements are clearly and comprehensively stated in the bye-laws, rules and regulations and notifications issued thereunder from time to time and such information is posted in the public domain through the CCIL's website.
Assessment	**Observed**

Recommendation 3	**Measurement and Management of Credit Exposures:** A CCP should measure its credit exposures to its participants at least once a day. Through margin requirements, other risk control mechanisms or a combination of both, a CCP should limit its exposures to potential losses from defaults by its participants in normal market conditions so that the operations of the CCP would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control.
Description	**Government Securities** There is no counterparty credit exposure limit in the government securities segment fixed by the CCP. However, the CCP has set up a margin system to limit its credit exposures and also the market risk. Initial margin is collected to cover the likely adverse movement of prices of the security by applying a security-wise margin factor, based on VaR for three-day holding period (at 99 per cent confidence level); MTM margin is collected to cover the actual adverse price change since the deal time. Both the margins are computed trade-wise and then aggregated member-wise. The margin requirements are calculated on mark-to-market basis on outstanding positions and the valuation is done on daily basis. In addition, the rules also provide for collection of volatility margin in case of unusual volatility in the market but have not yet been operationalised. The CCIL accepts only the notified securities towards the margin contributions. The list of eligible securities drawn up with the approval of the top management is reviewed regularly. **CBLO** CPSS-IOSCO Recommendation 3 requires the CCP to measure its exposures to its participants frequently and the CCP should have the capacity to measure exposures on an intra-day basis. The information on prices and positions that is used in these calculations should be current. At CCIL, margin computation for acceptance of any new trade happens trade-by-trade on a post-trade basis, in the trading system but there is no provision for re-computation of margin requirement for outstanding trades by intra-day valuation of outstanding trades. **Forex** In forex trading, acceptance of new trade happens in batches, after running exposure check. Margins are collected for covering market risk under normal circumstances and for covering a portion of credit exposure based on the CCIL margining algorithm. Loss allocation mechanism provides cover for the balance of credit and market risk exposures. However, as required in Recommendation 3, the system for re-computation of exposure on an intra-day basis is yet to be put in place.
Assessment	**Broadly Observed**
Comments	Once the intra-day measurability of exposure is implemented, the CCIL system would become compliant with this Recommendation.

Recommendation 4	**Margin Requirements:** If a CCP relies on margin requirements to limit its credit exposures to participants, those requirements should be sufficient to cover potential exposures in normal market conditions. The models and parameters used in setting margin requirements should be risk-based and reviewed regularly.
Description	**Government Securities** The CCIL follows the regime of daily back-testing for having comfort of adequacy of its margining process in all situations. For margin calculations, the margin factor is computed on the last 1000 days data-based VaR (99 per cent) for 3-days holding period. CCIL also undertakes stress-testing of its risk-model assuming the yield-curve movement both ways, upward as well as downward. For this purpose, the outstanding trade positions of all members for the date are initially valued with model prices. Same portfolio is valued using model prices arrived by parallel shifting of the zero-coupon yield curve upwards and downwards. The results of stress-testing are monitored by the top management on a regular basis and reported to the Board's Committee on Risk Management on a quarterly basis. Based on these stress-testing results, the margining process adequately covers CCP for possible market risk. **CBLO** CCIL accepts Government of India dated securities, T-bills and funds in Indian Rupees as collaterals. Borrowing limit for the members is fixed everyday after marking-to-market and applying appropriate hair-cuts on the securities deposited in the CSGL account. The post hair-cut MTM value after adjusting for the amounts already borrowed by the members is the borrowing limit, which, in effect, denotes the drawing power up to which the members can borrow funds. Members are required to deposit initial margin generally in the form of cash/government securities and initial margin is computed at the rate of 0.50 per cent on the total amount borrowed/lent by the members. Intended coverage of margin requirements is at 1000 days data-based VaR (at 99 per cent) of the anticipated price change for a 3-day holding period. CPSS-IOSCO Recommendation 4 requires assessment on margin requirements. Under the Recommendation, CCPs need to validate that

	the models and parameters used to determine the margin levels are consistent with the intended coverage and that the same should be reviewed and validated frequently. Back-testing for CBLO is a must to assess the associated risks as well as adequacy of margins. However, back-testing model is not in place for the CBLO segment. **Forex** Funds in US dollar are accepted as collateral. Market risk, incidental in the settlement, is sought to be covered using market risk factor which is equal to 3-days VaR at 99 per cent confidence level. For coverage of the residual risk, loss allocation process is available and this procedure is considered enough to cover the risk in this segment. Time interval for potential price movements used is 3-days. Validation of models and parameters used to determine the margin levels consistent with the intended coverage is done through daily back-testing.
Assessment	**Broadly Observed**
Comments	The model for back-testing for margining is under development and in the absence of such a model, the adequacy of margins collected could not be ascertained as against intended coverage. Would be 'Observed' after the back-testing model is developed.
Recommendation 5	**Financial Resources:** A CCP should maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions.
Description	**Government Securities** For providing the guaranteed settlement of trades in government securities, the CCIL has received collaterals from its members. The collaterals are collected partly in the form of cash and government securities to meet the funds/securities shortages. In addition to these collaterals, the CCIL has also arranged for Line of Credit (LOC) to meet the liquidity requirement. There were few instances of default in government securities settlement observed in the past, which were handled by the CCIL using securities available in the Settlement Guarantee Fund or Securities' Line of Credit and settlement was completed. As regards sufficient financial resources in the event of default by the participant with the largest exposure, it was observed in the past that on certain occasions, the largest exposures to some participants exceeded the amount of liquid financial resources available with the CCIL. **CBLO** As a CCP, the CCIL receives collaterals from its members for providing guaranteed settlement of trades in government securities. The collaterals are collected partly in the form of cash and partly in government securities.

	In addition to these collaterals, the CCIL has also arranged for LoC to meet the liquidity requirement. It is observed that on some occasions, the net paying amount by a single member exceeds the LoC of Rs 400 crore available for the CBLO segment implying a potential gridlock in the settlement system. CPSS-IOSCO Recommendation 5 requires assessment of financial resources where CCP uses established procedures to stress-test its exposures in extreme but plausible market conditions under different scenarios. The recommendation prescribes the scenarios to include the most volatile periods that have been experienced by the markets for which the CCP provides services. It is observed that the models for stress-testing and back-testing are yet to be operationalised. **Forex** Stress-test is conducted at monthly intervals for outstanding trade positions of the members in this segment. The impact of shift in exchange rate by 1.10 per cent or Rs 1.03 per US dollar (maximum 1 day change in past 6 years), whichever is higher, is used as basis. Scenarios include most volatile period in past six years that have been experienced by the markets. Impact of default by the member on whom the CCIL had highest exposure on such dates is being considered. At times, the LoC available with the CCIL are not enough to provide adequate liquidity to meet a default by the member on whom the CCIL had highest exposure though the collateral available as margins along with the value of the counter-currency to be withheld in case of a default are adequate to cover the shortfall. Monthly stress-tests are performed, with a comprehensive reconsideration of models, parameters and scenarios. Though the CCIL can increase margin requirements under circumstances where stress-testing results indicate resources are not likely to be adequate to meet its obligations resulting from a default, a clear policy on actions to be taken in such event is not there.
Assessment	**Partly Observed**
Comments	On occasions, the largest exposure in the government securities and CBLO settlements exceed the liquid financial resources at the command of the CCP. Hence, there is a need for the CCP to have adequate financial resources sufficient to take care of its liquidity needs and avoid default of the largest exposures. Further, in case when stress-test indicates that

	resources are not adequate, actions to be taken like calling for additional resources, time and manner of collection, *etc.* require a clear and transparent policy to be put in place.
Recommendation 6	**Default Procedures:** A CCP's default procedures should be clearly stated, and they should ensure that the CCP can take timely action to contain losses and liquidity pressures and to continue meeting its obligations. Key aspects of the default procedures should be publicly available.
Description	Default procedures are clearly laid out in the CCIL's bye-laws, rules and regulations. The procedure for handling default is well-defined and transparent to its members. The intended actions in this regard are covered in the CCIL's bye-laws, rules and regulations. Though default procedure is in place, they are required to be supported by a policy. Further, it is observed that there is a lack of clarity on the eventuality of liquidating the US dollar assets or other securities, in case need arises.
Assessment	**Broadly Observed**
Comments	Though the default procedure is in place, it needs to be supported by a policy.
Recommendation 7	**Custody and Investment Risks:** A CCP should hold assets in a manner whereby risk of loss or of delay in its access to them is minimised. Assets invested by a CCP should be held in instruments with minimal credit, market and liquidity risks.
Description	**Government Securities** The margin contributions from members are collected in the form of cash and government securities. These are held in the account with the Reserve Bank. The LoC provided by the banks are also maintained separately in the Reserve Bank, having no custody and liquidity risks. **CBLO** The margin contributions from members are collected in the form of cash and government securities. These are held in the account with the Reserve Bank and with banks having very high credit standing. The LoC provided by the banks are also maintained separately in the Reserve Bank having no custody and liquidity risks. **Forex** US dollar funds are mostly in US Government T-Bills. A small portion of these US dollar funds are, however, kept as deposits with certain select banks. All these entities are expected to conform to Recommendation for SSS-12. ABN Amro Bank is the custodian for the US dollar T-Bills. Financial condition of ABN Amro is monitored as a settlement bank. US dollar funds are invested mostly in US Government T-Bills. A small portion

	of these funds is in the form of bank deposits with ABN Amro Bank or other banks having excellent credit standings. These deposits are, however, unsecured in nature. Investments are mostly in sovereign papers and bank deposits.
Assessment	**Observed**
Recommendation 8	**Operational Risk:** A CCP should identify sources of operational risk and minimise them through the development of appropriate systems, controls and procedures. Systems should be reliable and secure, and have adequate, scalable capacity. Business continuity plans should allow for timely recovery of operations and fulfillment of a CCP's obligations.
Description	The CCIL's operations are highly technology-intensive. It has over time identified various critical components of the processes and has put in place appropriate security policy and business continuity plan. In its quest to improve the standards on information security, the CCIL has acquired the ISO 27001 Enterprise-Wide Certification on Management of Information Security. The life cycle of business continuity plan is reviewed periodically in three stages: Business Impact Analysis, Strategy Selection and Detailed Plan, Testing, Revision and Modification. The recovery time during drill was less than the acceptable down-time as laid-down in the document for most of the applications.
Assessment	**Observed**
Recommendation 9	**Money Settlements:** A CCP should employ money settlement arrangements that eliminate or strictly limit its settlement bank risks, that is, its credit and liquidity risks from the use of banks to effect money settlements with its participants. Funds transfers to a CCP should be final when effected.
Description	**Government Securities** The settlement of government securities segment is in central bank money. **CBLO** The settlement of CBLO segment is in central bank money. Most of the settlement functions are in the books of the Reserve Bank except for settlements in the accounts of the co-operative banks and corporates

	which happen through private settlement banks. Funds settlement through settlement banks is final once the amounts are credited or debited to the accounts of the members settling through them. There are three settlement banks (HDFC Bank, UTI Bank and Citi Bank) in the CBLO segment with two more applications under processing. They are catering to corporates, mutual funds and some co-operative banks. **Forex** The settlement of Rupee leg is in the books of the Reserve Bank. Settlement of US dollar leg, however, happens through a settlement bank. In case of dollar leg of transactions which take place at New York, the finality of funds transfer is deemed to be achieved once the same is put in RTGS (Fedwire) by the settlement bank. Selected settlement banks enjoy very good credit standing. Internal processes are being developed to monitor their creditworthiness, access to liquidity and operational reliability, *etc.* on an ongoing basis. The policy for management of settlement bank risk has been approved by the Board. The detailed processes for monitoring exposures are not in place.
Assessment	**Broadly Observed**
Comments	Processes for monitoring of settlement bank risk are under implementation.
Recommendation 10	**Physical Deliveries:** A CCP should clearly state its obligations with respect to physical deliveries. The risks from these obligations should be identified and managed.
Description	All the settlements are in electronic book form.
Assessment	**Not Applicable**
Recommendation 11	**Risks in links between CCPs:** CCPs that establish links either cross-border or domestically to clear trades should evaluate the potential sources of risks that can arise, and ensure that the risks are managed prudently on an ongoing basis. There should be a framework for co-operation and co-ordination between the relevant regulators and overseers.
Description	There is no link between the CCIL and other CCPs.
Assessment	**Not Applicable**
Recommendation 12	**Efficiency:** While maintaining safe and secure operations, CCPs should be cost-effective in meeting the requirements of participants.
Description	Though there is no other CCP providing equivalent services for comparing the cost, CCIL operations are cost-effective and achieve risk-reduction with a minimal cost.
Assessment	**Broadly Observed**

Comments	There is no standard for assessing competitive cost and efficiency.
Recommendation 13	**Governance:** Governance arrangements for a CCP should be clear and transparent to fulfill public interest requirements and to support the objectives of owners and participants. In particular, they should promote the effectiveness of a CCP's risk management procedures.
Description	The CCIL has 17 Directors on its Board: SBI, Bank of Baroda, IDBI Ltd., ICICI Bank Ltd., HDFC Bank Ltd. and LIC, being promoter, have a right to nominate Directors on the Board. Independent directors on the Board of CCIL are drawn from various professional fields like law, finance, forex, IT, *etc.* The Board is helped in its oversight by various specialised Committees like Audit Committee, Risk Management Committee, Membership Approval Committee, *etc.*
Assessment	**Observed**
Recommendation 14	**Transparency:** A CCP should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using its services.
Description	CCIL has made available its procedures, rules, bye-laws, *etc.* to market participants through its website. To identify the risks and costs associated with counterparty guarantee activity the CCIL conducts stress-tests and determines the adequacy of various margins to control market risk.
Assessment	**Broadly Observed**
Comments	Stress-test methodology and the results of stress-tests are not disclosed to the members/public.
Recommendation 15	**Regulation and Oversight:** A CCP should be subject to transparent and effective regulation and oversight. In both a domestic and an international context, central banks and securities regulators should co-operate with each other and with other relevant authorities.
Description	CCIL is subject to regulation and oversight by the Reserve Bank by mutual agreement. With the enactment of the Payment and Settlement Systems Act, the regulation and oversight of CCIL by the Reserve Bank is on a firm basis.
Assessment	**Observed**

Annex V

Assessment of Observance of CPSS-IOSCO Recommendations for Securities Settlement Systems – Equities Market

Recommendation 1	**Legal Framework:** Securities settlement systems should have a well-founded clear and transparent legal basis in the relevant jurisdictions.
Description	The laws, regulations, rules, procedures and contractual provisions[8], governing securities settlement arrangements are public and readily accessible to system participants. The trades done on the exchanges are netted at the broker/custodian level for settlement in case of normal stocks and in case of trade-to-trade stocks, the trades are settled on gross basis. There is no netting of settlement obligations across the Clearing Corporations. The exchanges and CCPs[9] rules, bye-laws and regulations provide for settlement obligations of trading/clearing members on net/gross basis. The settlements made are final. As per the settlement system at the CCP, the securities pay-out is released only after receipt of the funds pay-in from the concerned trading/clearing member and custodian. The legal basis flows from regulatory framework including rules, regulations and bye-laws laid-down by the exchange and the CCP. There are well-laid-down laws and guidelines governing the payment and settlement processes of the CCP. Hence, generally, the courts uphold the legal basis of such activities/arrangements.

[8] The main laws, rules and regulations are as follows:
i) The Securities Contracts (Regulation) Act, 1956
ii) The Securities Contracts (Regulation) Rules, 1957
iii) SEBI Act, 1992
iv) The Rules, Bye-laws and Regulations of NSE and BSE
v) The regulations, guidelines, *etc.* issued by SEBI under SEBI Act, 1992
vi) The Depositories Act, 1996
vii) Bye-Laws and Operating Instructions of the depositories.

[9] All exchanges, except NSE, use clearing houses to clear and settle trades. With the advent of the anonymous screen-based trading system, which does not allow participants to assess the counterparty risk of others, and in the interest of better risk management through novation and counterparty guarantee, the modern markets started using the services of a clearing corporation for C and S. While many exchanges modified the structural design of the clearing house to address the emerging concerns, NSE set up a wholly-owned subsidiary, 'National Securities Clearing Corporation Ltd.', NSCCL, to provide C and S services. Thus, both the models of C and S, namely Clearing House and Clearing Corporation, are in use today within the extant legal framework in the cash segments of exchanges. Derivatives segment also uses both the models of C and S – Clearing House and Clearing Corporation. The trading members and clearing members trade and settle, respectively, in the derivatives segments, as against the brokers in cash segments.

The Clearing House of BSE, *i.e.*, Bank of India Shareholding Ltd. (BOISL) is a company jointly promoted by BSE (49 per cent) and Bank of India (51 per cent). BOISL, *inter alia*, handles some of the settlement-related activities as per instructions and directions of BSE. Responsibility of the Clearing House is to handle such settlement activities including co-ordination with the market participants, *viz.,* Depositories, Clearing Banks, *etc.* However, the overall responsibility of settlement and risk management functions, *viz.,* collection of margins, collateral management, *etc.* pertaining to transactions done on BSE Online Trading (BOLT) system lies with BSE. In case of any default, it is BSE's responsibility to handle the default. For this, BSE has well-laid-down rules, regulations and bye-laws. BSE can liquidate the collateral and other securities of the defaulter lying with it and its Clearing House.

	The rules of the system and contracts between system participants are enforceable notwithstanding the insolvency of a participant as the same are independent of insolvency proceedings. (*Comments to Recommendation 1 may also be referred)* Customers' assets are adequately protected, particularly against the insolvency of custodians and intermediaries. The custodians are SEBI-registered entities. There are well-prescribed norms for registration of custodians. The protection flows from the rules, regulations and bye-laws laid-down by the exchanges and the CCP. As per the Depositories Act, 1996 the securities are held with the CSD in a dematerialised form. Clients, who hold securities with the CSD, do not directly interact with the CSD but through an entity named as the Depository Participant (DP). DPs are the registered market intermediaries and are regulated by SEBI. As per SEBI Regulations, DPs are required to maintain separate accounts in the name of each of the beneficial owners and the securities of each beneficial owner have to be segregated, and cannot be mixed up with the securities of other beneficial owners or with the participant's own securities. Moreover, CSD maintains records of every beneficial owner in its system in addition to the DPs maintaining such records in their respective systems. Further, Regulation 37 of SEBI (Depositories and Participants) Regulations, 1996 *inter alia* states that *'where records are kept electronically by the depository, it shall ensure that the integrity of the automatic data processing systems is maintained at all times* and *take all precautions necessary to ensure that the records are not lost, destroyed or tampered with* and *in the event of loss or destruction, ensure that sufficient back-up of records is available at all times at a different place.'* If any DP closes down its operations, then as per the Depositories' bye-laws, the clients are given an option to shift their accounts to some other DPs or get the securities rematerialised. Thus, customers' assets are adequately protected and it is not affected by the insolvency of the intermediaries. (*Comments to Recommendation 1 may also be referred*) The transfer of dematerialised securities is by book entry. The Depositories Act, 1996 SEBI (Depositories and Participants) Regulations, 1996, Bye-Laws and Business Rules of the CSD contain various provisions for facilitating dematerialisation and transfer of securities. The Act gives

	an option to the investor to hold and transfer securities in dematerialised form. SEBI Regulations provide for the regulatory requirements and procedure for dematerialisation and transfer of securities. The Bye-laws and Business Rules provide for the operating guidelines and procedures in this regard. Currently, there is no cross-border participation.
Assessment	**Observed**
Comments	Section 9(2)(k) of SCRA, 1956 empowers the recognised stock exchanges to make bye-laws with prior approval of SEBI in respect of the consequences of default or insolvency on part of a seller or buyer or intermediary, the consequences of breach of omission by a seller or a buyer and the responsibility of the members who are not parties to such contracts. The bye-laws of stock exchanges provide for default proceedings including provision of priorities of payment. Therefore, contract in securities default, priorities of payment, *etc.* should be governed by bye-laws of stock exchanges and should not be subjected to general insolvency laws. As per the bye-laws of the stock exchange, on a member being declared as defaulter, all the deposits, assets or collaterals of intermediary shall vest on recognised stock exchanges/CCP. The above view is also supported by the decision of Supreme Court in the case of Vinay Bubna, (1999) 6 SC Cases 215. The Supreme Court has held that the membership card is not his personal property and, thus, on default being committed by him and after he ceases to be a member, it cannot be sold and its proceeds cannot be distributed among his creditors. Same principle is applicable in respect of any deposit, collateral by defaulting member with stock exchanges or CCP in respect of any contracts executed in stock exchanges.
Recommendation 2	**Trade Confirmation:** Confirmation of trades between direct market participants should occur as soon as possible after trade execution but no later than trade date (T+0). Where confirmation of trades by indirect market participants (such as institutional investors) is required, it should occur as soon as possible after trade execution, preferably on T+0, but no later than T+1.
Description	The exchange, for which the CCP clears and settles transactions, has a screen-based online trading system. Hence, the trades between direct market participants are confirmed online at the time of trade. The use of electronic trading system obviates the need for direct market participants to confirm the terms of the trade. CSD (Depositories) systems require the clients to mention the settlement details, *viz.*, settlement member and broker code while giving transfer instructions of securities for settlement purpose. The CCP matches the settlement instructions against the obligation of its clearing members.

	The CSD transfers securities to the receiving members (brokers) accounts upon receipt of instructions from the CCP. For transferring the settlement obligation from a trading member to indirect market participants, the participants use an interface. The custodians are registered with SEBI and admitted by the CCP for settlement purposes. Members are allowed to identify deals as NCIT (Non-Custodial Institutional Trades) deals, NCIT warehouse deals or as CP (Custodial Participant) warehouse deals and are required to report the same in electronic form only. The procedure for reporting these deals to the exchange is as follows: ● Members who have executed NCIT deals, NCIT warehouse deals, CP warehouse deals are provided with three files – one each for NCIT, CP-warehouse and NCIT warehouse – at the end of each trading day. ● These files are generated for each member daily and are placed in the extranet server in the respective member's work area by 18.00 hrs. on the same day. ● Members are required to send in the return files to the extranet server by 9.30 hrs. on T + 1 day. ● In case of non-receipt/late receipt of return files in respect of all such deals, margins are applicable as per procedure. ● For NCIT and NCIT warehouse trades, the members are also required to state the name of the institutional client in the files sent to CCP. All the files have to be sent within the stipulated time period and any file received after the deadline is not processed by the exchange.
Assessment	**Observed**
Recommendation 3	**Settlement Cycle:** Rolling settlement should be adopted in all securities markets. Final settlement should occur no later than T+3. The benefits and costs of a settlement cycle shorter than T+3 should be evaluated.
Description	The trades are settled on a rolling basis of T+2 days settlement cycle. At NSE, the settlement failures are around 0.30 – 0.40 per cent of total trades and at BSE, value of undelivered securities in a settlement is less than

	0.5 per cent (approximate) of the total delivery value of the securities in the settlement. Such shortage of delivery is auctioned/closed-out (as the case may be) on subsequent day. The close-out price is computed as per the norms prescribed by SEBI and the cost of the same is borne by the party who fails to deliver. The close-out prices are higher than the prevailing market prices. The close-out proceeds are passed on to the corresponding receiving party. Besides this, delay in fulfillment of financial obligations, failure to settle on the settlement date by the member-brokers attract fines/penalties and other disciplinary actions. VaR and Extreme Loss Margin (ELM) margins are collected on an upfront basis and mark-to-market margins are collected at end of day to mitigate risks. The aforesaid is monitored and enforced by the exchanges.
Assessment	**Observed**
Recommendation 4	**Central Counterparties (CCPs):** The benefits and costs of a CCP should be evaluated. Where such a mechanism is introduced, the CCP should rigorously control the risks it assumes.
Description	The CCP mechanism has been introduced. The Clearing Corporation, NSCCL, in the case of the NSE and in the case of the BSE, the exchange, BSE itself acts as the central counterparty for net settlement obligations of the participants. Novation has been put in place. The trades done on the exchanges are netted at the broker/custodian level for settlement in case of normal stocks and in case of trade-to-trade stocks, the trades are settled on a gross basis. There is no netting of settlement obligations across the Clearing Corporations. The exchange bye-laws and regulations provide for settlement obligations of trading/clearing members on net/gross basis. The present system of netting arrangements is enforceable against the participant's insolvency. The protection flows from the rules, regulations and bye-laws laid-down by the CCP. CCP imposes financial and operational standards for participation. CCP manages its risk by way of various margin calls from its participants for their exposures which can be in the form of collaterals. A comprehensive Risk Management framework as prescribed by SEBI from time to time is followed by the CCP. Certain types of margins (except MTM) are adjusted online from the collateral deposits of the member-brokers. The CCP groups securities based on liquidity and margins are accordingly levied. The collateral securities are taken from the member-brokers based on their exposure requirements. Also, VaR and ELM are collected online on an upfront basis at the time of trade. Besides these, MTM margins and Special Margins are also collected at end of day. Such margins are released to the trading members only on completion of the pay-in.

	The exchanges have a statutory committee called Defaulter's Committee, which handles various aspects related to the defaults on the exchange The exchanges' bye-laws clearly state circumstances under which the participant is declared as defaulter and, accordingly, they declare the defaulter by direction/circular/notification by the relevant authority. Rules for handling of participant's defaults are clearly laid-down in rules, regulations and bye-laws of the exchanges. There have been past instances of default at the exchanges. The deposit provided by participants has been utilised to meet the defaults. The exchanges can liquidate the collateral and other securities of the defaulter lying with it. The bye-laws, rules and regulations of the exchange provide for prompt close-out or to manage the positions of a defaulting participant and to apply the defaulting participants' collateral or other resources. Besides this, there is a Guarantee Fund which can be utilised in case of default by the participants. The participants are required to contribute to the said fund. Guarantee Fund comprises the core corpus and accretions and contributions by the participants and its adequacy is evaluated by the exchange as per the stipulated guidelines. The procedure empowers the exchange to promptly draw the funds from the Guarantee Fund and other sources like overdraft from banks *etc.* The rules for utilisation and contribution of Guarantee Fund are specified in the bye-laws of the exchange. Stress-test of Guarantee Fund is done as per criteria prescribed by SEBI to ascertain adequacy of Guarantee Fund. CCP also maintains Settlement Fund(s)[10] in respect of different clearing segment(s). The norms, procedures, terms and conditions *inter alia* specifying the amount of deposit or contribution to be made by each clearing member to the relevant fund, the terms, manner and mode of deposit or contributions, conditions of repayment of deposit or withdrawal of contribution from the fund, charges for utilisation, penalties and disciplinary actions for non-performance thereof are also prescribed in the bye-laws. In the event a clearing member is declared a defaulter and the clearing member fails to meet the clearing and settlement obligations to the CCP arising out of clearing and settlement operations of such deals as provided in the bye-laws and regulations, the

[10] The corpus being the same as the Guarantee Fund being maintained by the exchange.

	Settlement Fund and other monies to the extent necessary to meet the obligation are utilised in the manner specified in the bye-laws of CCP. CCP has in place lines of credit with the banks. To sum up, the institution of a CCP, which provides full novation and guarantees settlement, has eliminated counterparty risk entirely. Over 99 per cent of trades in the dematerialised form and STP, mandatory for all institutional trades, have enabled Indian settlement system to function seamlessly, notwithstanding the size and spread. On a T+2 cycles, all scrips are electronically cleared fully through a CCP on a rolling settlement. The dynamic risk management system comprises capital adequacy norms, trading and exposure limits, index-based market-wide circuit breakers, margin (mark-to-market) requirements. The encashability of underlying of margins, comprising cash, bank guarantees and securities is evaluated periodically. The real-time monitoring of broker positions, margins and automatic disablement of terminals with VaR-based margining, built in line with best of the markets in the world, has reduced the operational risk.
Assessment	**Observed**
Recommendation 5	**Securities Lending:** Securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method for expediting the settlement of securities transactions. Barriers that inhibit the practice of lending securities for this purpose should be removed.
Description	The legal, accounting and tax systems broadly support securities lending. On the regulatory side, SEBI has vide circular dated December 20, 2007 decided to allow both retail and institutional investors to short sell in the equities market. However, it has not allowed naked short-selling and all investors would be required to mandatory honour their obligation of delivering the securities at the time of settlement. The necessary framework has been put in place, subsequent to issue of SEBI circular dated December 20, 2007. Securities Lending and Borrowing (SLB) was operationalised with effect from April 21, 2008. Pursuant to the feedback from market participants and proposals for revision of SLB received from NSE and BSE, the framwork was revised vide SEBI circular dated October 31, 2008. For implementing the SLB mechanism, changes in the legal, regulatory and tax systems have been facilitated jointly by government and regulators. To allow institutions to participate in SLB, respective regulators have made/are in the process of making enabling amendments, *viz.,* SEBI for MFs and FIIs, IRDA for insurance companies and the Reserve Bank for banks. For exemption of applicability of Capital Gains Tax and

	Securities Transaction Tax (STT) for SLB, the tax authorities have issued a public clarification[11]. A screen-based order matching system has been implemented for SLB, as per the framework specified in SEBI circular issued on December 20, 2007. The facility has been made available for those securities on which derivative products have been permitted by SEBI. The facility is open to all market participants. Markets already have T+2 settlements in cash segments with shortages being met through auction and close-out mechanism. SLB mechanism is expected to help meet with shortages and also to enable short selling in the securities market. The stock exchanges in compliance with the aforesaid SEBI circular has ensured that all appropriate Screen-based Order Matching System and settlement practices as well as surveillance and risk containment measures, *etc.* are made applicable and implemented in this regard. Further, Approved Intermediaries (AIs) have framed suitable risk management systems for delivery of securities to borrower and to guarantee return of securities to the lender. Lending and Borrowing is on an automated screen-based platform where the order matching is on price time priority. The borrowing is for a fixed tenure of thirty days with the first leg settlement on T+1 day and reverse leg settlement on T+31 days. Securities traded in the F and O segment are eligible for lending and borrowing under the scheme. 'The Exchanges ensure that the risk management framwork strikes a balance between ensuring commercial viability of SLB transaction and ensuring adequate and proper risk managment. Margins in SLB are taken in the form of cash and cash equivalents as specified in SEBI circular dated February 23, 2005'. All categories of investors, through authorised clearing members including banks and custodians, are eligible to participate in SLB scheme. In order

[11] The Central Board of Direct Taxes (CBDT) vide circular no. 2/2008 dated February 22, 2008 has issued the following clarifications on the taxation of lending and borrowing of securities:

i. The Lending and Borrowing of Securities under the new scheme notified by SEBI vide circular no. MRD/DoP/SE/Dep/Cir-14/2007 dated 20/12/2007 is in accordance with the overall framework of the Securities Lending Scheme of 1997. Accordingly, the provisions of Section 47(xv) of the Income Tax Act would be equally applicable in respect of the transactions under the new Scheme.

ii. Securities Transaction Tax (STT) is levied on purchase or sale of an equity share, unit and derivative, under such circumstances as specified in section 98 of the Finance (No.2) Act, 2004. The transactions in the nature of lending and borrowing under the new Scheme do not fall within the scope of section 98 to the Finance (No.2) Act, 2004.

Therefore, the transactions of lending and borrowing are not liable to securities transaction tax (STT) and capital gains taxes.

	to become eligible to participate in SLB scheme, clearing members have to register as Participants in SLB scheme. SLB is permitted in dematerialised form only. The transactions are settled on a T+1 day basis as per time lines specified by AI. The lender is required to deliver the securities by the scheduled time on T+1 day. Failure to deliver securities results in financial close-out. For a borrow transaction, the obligation is the lending fees. The lending price is the previous day's closing price in the capital market segment of the exchange. Position limits at the level of market, clearing member and client level have been specified.
Assessment	**Broadly Observed**
Comments	SEBI circular dated May 7, 1997 had specified the 'Securities Lending Scheme of 1997 (SLS, 1997)'. The Scheme of 1997 had laid-down the modalities for lending and borrowing of securities through an AI. A lender, under an agreement with the AI, could lend his securities to the AI with the guarantee that the AI would return the equivalent securities of the same class and type. A borrower could also borrow from the AI on the specified terms of the AI and would also return the equivalent securities of the same class and type. The AI was the complete interface between the borrower and the lender. However, short selling was allowed to only few class of investors. Based on the features of the scheme, Ministry of Finance, Department of Revenue, Central Board of Direct Taxes (CBDT) vide their circular No. 751 dated February 10, 1997 clarified that the transactions of lending of shares or any other securities under the SLS would not result in 'transfer' for the purpose of attracting the provision relating to the capital gains under the Income Tax Act. However, SLS, 1997 was found to be inoperative as there was no market for securities lending and borrowing in the true sense. The matter was reviewed by SEBI in 2003 and 2004. Pursuant to the recommendations of the Secondary Market Advisory Committee (SMAC) in 2003 and 2004, SEBI vide circulars dated March 19, 2004 and March 4, 2005 had provided the operational modalities for Clearing Corporation/House to borrow and lend securities for the limited purpose of handling settlement shortages. Accordingly, no entity other than Clearing Corporation/Clearing House had been registered as an AI that borrowed and lent securities under the scheme. NSCCL, the clearing corporation of NSE and BOISL, the clearing house of BSE have been registered as AIs for the purpose of borrowing and lending securities to handle settlement shortages. While the said scheme of lending and borrowing securities in the Indian securities market by the clearing corporation/house of the stock exchanges for handling settlement shortages addressed the need for lending and borrowing in a limited way, it was observed that there was no scope for investors to capitalise on the demand for their securities in the market

	and, thus, earn a return by lending such securities. Hence, widening of the scope of the existing securities lending and borrowing scheme into a full-fledged lending and borrowing scheme enabling participation of all classes of investors, including retail investors, was felt. Further, a full-fledged securities lending and borrowing scheme is a significant regulatory reform in any securities market to facilitate other market reforms like physical settlement in the derivatives markets. Besides, lending and borrowing of securities is necessary for covering short positions in the market. Without lending and borrowing, the policy on short sales cannot be implemented and physical settlement of stock derivatives cannot also take place. In the light of the aforesaid factors, the issue of reviewing the regulatory policy on securities lending and borrowing was taken up for deliberations by SEBI. Pursuant to the recommendations of the SMAC of SEBI and the decision of the SEBI Board, it was, therefore, decided to permit all classes of investors to short sell subject to the broad framework. In order to provide a mechanism for borrowing of securities to enable settlement of securities sold short, it was decided to put in place a full-fledged SLB scheme for all market participants in the Indian securities market under the overall framework of 'Securities Lending Scheme, 1997' of SEBI specified by SEBI vide circular No. SMD/POLICY/SL/CIR-09/97 dated May 7, 1997. As the scheme has recently been implemented, the current position has been assessed as 'Broadly Observed' as of now.
Recommendation 6	**Central Securities Depositories (CSD):** Securities should be immobilised or dematerialised and transferred by book entry in CSDs to the greatest extent possible
Description	The Depositories Act, 1996 introduced a multi-depository framework for dematerialised settlement in India. It is designed to provide a legal framework for the establishment of depositories to record ownership details in book entry form. It also gives an option to the investors to hold the securities either in dematerialised form or in physical form. The securities held in physical form can be dematerialised subsequently. Over 70 per cent of the securities are held in dematerialised form with the CSDs in India. Most of the securities traded on stock exchanges are settled in dematerialised form. Two depositories – National Securities Depository Ltd (NSDL) and Central Depository Services (India) Ltd (CDSL) have been set up for electronic

	holding and transfer of securities. Investors can access their services through the Depository Participants[12]. Securities are issued on dematerialised basis, wherein, by operation, there is no physical scrip in existence as neither the individual who owns the shares nor the depository keeps scrips. The depository maintains the electronic ledger of the securities under its control. Under Section 68 B of the Companies Act, inserted by the Companies (Amendment) Act, 2000 it is mandated that every initial public offer made by a listed company in excess of Rs 10 crore has to be issued in dematerialised form by complying with the requisite provisions of the Depositories Act, 1996. As per the Depositories Act, 1996 the CSD is the registered owner of securities and the investors are the beneficial owners. Every depository on receipt of intimation from a participant, registers the transfer of security in the name of the transferee. If a beneficial owner or a transferee of any security seeks to have custody of such security, the depository informs the issuer accordingly. On pay-out of a settlement, the dematerialised securities are transferred to the pool/principal account of the broker members or directly to the Beneficial Owner (BO) accounts of clients based on the instructions of the concerned member-brokers. However, the broker-members are required to transfer the securities from their pool/principal accounts to the BO accounts of their respective clients within 24 hours from the time of pay-out. There is no time lag between the transfer and registration of the dematerialised securities in the demat accounts. The investor becomes the beneficial owner of securities the moment he/she receives the securities in his/her beneficial owner account.
Assessment	**Observed**
Comments	The following chart gives an overall view of the linkages within the depository system in the Indian securities market : SYSTEM LINKAGE ISSUER OTHER DEPOSITORY Electronic Link Electronic Link DEPOSITORY CC/CH Safekeeping of securities Electronic Link Electronic Link Safekeeping of securities DP DP BROKER/CLEARING MEMBER INVESTOR INVESTOR BROKER/CLEARING MEMBER

[12] As on April 30, 2008, there were 656 Depository Participants.
Source: SEBI Bulletin for the month of May 2008

Recommendation 7	**Delivery versus Payment (DvP):** CSDs should eliminate principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment.
Description	The Clearing Corporation and the CSDs in India are different entities. CSDs do not handle fund settlement. The Clearing Corporation ensures DvP for its direct participants (clearing members). The CCP/exchange acts as central counterparty for all netted transactions and effects pay-out of securities on receipt of equivalent funds towards the same. In the existing settlement system, the securities' pay-out is released by the exchange/ CCP to the receiving broker/custodians only after receipt of the funds pay-in from the concerned broker/custodians. The settlement takes place on T+2 day. The CSD processes and completes transfer of securities to the receiving members (brokers) account only upon receipt of instructions from the CCP which ensures receipt of payment. The transfer of securities in the CSD system takes place only upon the instructions of the concerned delivering investor. Neither the CSD nor the Participant has any authority to transfer securities from the investors' accounts without the instructions of the investors. Further, in the bye-laws of CCP on the limitation of its liabilities, in this regard, it has been clearly laid-down that the liability of the Clearing Corporation resulting from the deemed contracts of clearing members with the Clearing Corporation and to losses in connection therefrom would be limited to the extent of contributions available to the Settlement Fund. The Clearing Corporation shall not be available for obligations of a non-clearing Member, obligations of a clearing member to a non-member, obligations of a Clearing member to another member of the Clearing Corporation towards deals to which the Clearing Corporation is not a counterparty or obligations to a constituent by a clearing member, and to losses in connection therefrom.
Assessment	**Observed**
Recommendation 8	**Timing of Settlement Finality:** Final settlement should occur no later than the end of the settlement day. Intra-day or real-time finality should be provided where necessary to reduce risks.
Description	The timing of settlement is clearly defined for transactions within the CSD as well as for transactions over a link to another CSD, *i.e.,* between

	NSDL and CDSL. Transfers by CSD are done at designated times during the day based on instructions from the CCP. Pay-in and pay-out are carried out by the CCP on T+2 day. All settlements carried out at designated time on T+2 day are final. There is no concept of provisional transfer of securities. The settlement takes place on T+2 day. For delivery of securities in a settlement, the instructions for pay-in of securities are to be given to the depositories by the concerned parties by 10.30 a.m. on the designated pay-in day and for funds obligations the participants (brokers/custodians) are required to keep the funds ready in their designated accounts with their respective Clearing Banks by 10.30 a.m. on the designated settlement day. The pay-in of securities takes place at 11.00 a.m on T+2 day. The pay-out of securities takes place on T+2 by 1.30 p.m. Upon pay-out, the securities move to the Clearing Members' (CM) Pool accounts and thereafter the CMs are required to transfer the securities to the clients' accounts within 24 hrs. There is also a facility of direct delivery of securities from the Clearing Corporation to the clients' accounts. The schedule of availability of the CSDs system for transfer of securities is clearly mentioned to its Participants. Margins are collected to cover risks and, hence, intra-day finality is not required. Transfers effected upon instructions by beneficial owners are done on a continuous basis. The transfer becomes final immediately upon receipt and execution of valid and matching instructions by the DP. All settlements once carried out are final and there can be no revocation of transfers at any stage.
Assessment	**Observed**
Recommendation 9	**CSD Risk Controls to Address Participants' Failure to Settle:** CSDs that extend intra-day credit to participants, including CSDs that operate net settlement systems, should institute risk controls that, at a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle. The most reliable set of controls is a combination of collateral requirements and limits.
Description	CSDs do not extend credit or operate settlement systems in India. The settlements are carried out by the CCP. For CCPs, a comprehensive risk management framework as prescribed by the regulator from time to time is followed. The primary focus of risk management by SEBI has been to address the market risks, operational risks and systemic risks. To this effect, SEBI has been continuously reviewing its policies and drafting risk management policies to mitigate these risks, thereby enhancing the level of investor protection and catalysing market development. A new risk management framework, moving to upfront collection of VaR margins

	(instead of margin collection on T+1 basis), made effective from May 30, 2005 is given in SEBI Circular dated February 23, 2005. In the revised framework, the liquid assets deposited by the broker with the exchange should be sufficient to cover upfront VaR margins, ELM, MTM losses and the prescribed base minimum capital (BMC). The MTM margin is payable before the start of the next day's trading. The margin is calculated based on gross open position of the member. The gross open position for this purpose is the gross of all net positions across all the clients of a member including his proprietary position. The exchanges monitor the position of the brokers' online on a real time basis and there is an automatic deactivation of terminal on any shortfall of margin. Accordingly, the collateral securities are taken from the member-brokers based on their exposure requirements. Also, VaR and ELM are collected online on an upfront basis at the time of trade. Besides these, MTM Margins and Special Margins are also collected at end of day. Such margins are released to the trading members only on completion of the pay-in. In addition, exchanges also have an online surveillance system to monitor the market activities. Overdrafts or debit balances in securities are not permitted. Probability of multiple failures is evaluated by CCPs and as such settlement can be completed in that event. CCPs test the adequacy of Guarantee Fund as per SEBI requirement, assuming default by the top 10 members, on a periodic basis. CCP can use the Guarantee Fund to complete settlement in case of any failures. In the event of funds shortage from the members, the pay-ins are completed by the CCP. As a part of risk management, CCP collects margins from all the members on an upfront basis. In case of members who have fund shortages, the pay-outs of securities due to them are also not released. The margins are based on VaR method and, therefore, are structured to meet the worst scenario loss that may arise after disposing the pay-out of securities that were withheld and appropriated towards the pay-in requirements. In the event of shortfall in pay-in of securities, the pay-out of funds to the member is withheld to the extent of the valuation of the securities that were not delivered. An auction is conducted for procuring the securities to facilitate pay-out to the members who have not received securities due to the pay-in shortage. The pay-out amount withheld is

	used towards paying for the securities thus procured. If the securities are not available for procurement, a financial close-out is effected and here again the amount withheld is used. Given the robust risk management system, the funds shortages are observed to be very insignificant and arise mainly due to the time involved in fund movements. These small and temporary shortages were observed to be always recovered subsequently from the members. The securities shortages are also observed to be very small and insignificant. CCP has collateral deposits of the member-brokers, the Guarantee Fund corpus, BMC deposits of the member-brokers, *etc.* available to cover defaults of the member-brokers. CCPs utilise such resources for the value in the event of a member-broker's default/insolvency. As per the prescribed penalty system for settlement failures of trading/ clearing member, the concerned broker-member is not permitted to trade, if the amount of settlement default is beyond SEBI prescribed amount. Such member-broker is permitted to trade further only after he fulfils his settlement obligation and pays the penalties, so levied. Also administrative mechanisms (capital cushions) have been put in place in order to encourage member to maintain adequate capital with the exchange at all times.
Assessment	**Observed**
Recommendation 10	**Cash Settlement Assets:** Assets used to settle the ultimate payment obligations arising from securities transactions should carry little or no credit or liquidity risk. If central bank money is not used, steps must be taken to protect CSD members from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.
Description	The settlement agents are multiple private/public sector banks. There is no settlement in foreign currency. CCP appoints banks as the designated clearing banks. There are laid-down entry norms for their enrollment. Members have an option of settling through any of the empanelled clearing banks. At present, a broker/custodian has to designate one clearing bank for settlement purpose. The concentration of exposures in the various banks is commensurate with the net worth of the banks. The designated settlement banks are subject to the prudential supervision by the government authorities. Clearing banks are required to maintain prescribed net worth and capital adequacy which are continuously monitored. It is observed that some of the banks were dis-empanelled by NSCCL for non-fulfillment of continued eligibility. The Reserve Bank also issued a moratorium on these banks subsequently. Proceeds of the securities settlement can be used on the same day by the recipients. As per the present guidelines, the brokers need to pass on the

	proceeds of the securities settlement to their clients within 24 hours from the settlement. The payment system used for inter-bank transfers among settlement banks observes CP-SIPS. The CCP maintains accounts with each of the designated clearing banks. Clearing members also maintain accounts with any one of these banks. These clearing banks transfer funds from the member's account to the CCP's account based on electronic instructions from the CCP. During pay-out, funds are transferred from CCP's account to the receiving members account with the respective banks. These transfers are within the banks and, hence, instantaneous. Transfer of funds between CCP's accounts with the multiple clearing banks are through RTGS.
Assessment	**Observed**
Recommendation 11	**Operational Reliability:** Sources of operational risk arising in the clearing and settlement process should be identified and minimised through the development of appropriate systems, controls and procedures. Systems should be reliable and secure, and have adequate, scalable capacity. Contingency plans and backup facilities should be established to allow for timely recovery of operations and completion of the settlement process.
Description	The system operator has a process for identifying and managing its operational risks. The exchanges and CCPs have well-maintained back-up systems which ensure recovery of transaction information. The systems are in place and are scaled-up/upgraded on a regular basis. The contingency plan and back-up facilities pertaining to trading, clearing and settlement and other vital processes are in place for timely recovery of data. The operational reliability issues are reviewed regularly by senior management, including review by persons not responsible for the relevant operations. Periodic external audits of the IT system are conducted. An independent internal audit reviews operational risk controls. Considering the importance of systems audit in a highly technology-driven securities market, SEBI vide circular dated July 23, 2008 had *inter alia* advised the exchanges to conduct audit of their systems by a reputed independent auditor on an annual basis. The systems audit should be comprehensive encompassing audit of systems and processes related to

	examination of Trading Systems, Clearing and Settlement Systems (Clearing Corporation/Clearing House), Risk Management, Databases, Disaster Recovery Sites, Business Continuity Planning, Security, Capacity Management and Information Security Audit. Further, the exchanges have been advised to place the Systems Audit Report and Compliance Status before the Governing Board of the exchange and the findings along with their comments need to be communicated to SEBI. There have been no failures of the CCP system. The CCP has capacity plans for key systems and they are tested periodically to determine if they can handle stress volumes.
Assessment	**Observed**
Recommendation 12	**Protection of Customers' Securities:** Entities holding securities in custody should employ accounting practices and safekeeping procedures that fully protect customers' securities. It is essential that customers' securities be protected against the claims of a custodian's creditors.
Description	Custodians holding customer securities are required to be registered with SEBI and follow the rules and regulations specified by SEBI for protecting customer securities. The broker-members can deposit collateral with the exchange in the form of cash, bank's fixed deposit receipts (FDR), bank guarantees and securities. Cash is transferred to the exchanges' account. In case of FDRs, the exchange has lien on the same. Bank guarantees are issued in favour of the exchange and securities are also pledged in favour of the exchange. Hence, the exchange has full control over the same. For ensuring safety of securities held by the depositories, the following arrangements are provided in the Depositories Act, SEBI Regulations and CSDs bye-laws: *Separate Accounts [Regulation 42]* *Separate accounts shall be opened by every participant in the name of each of the beneficial owners* and *the securities of each beneficial owner shall be segregated,* and *shall not be mixed up with the securities of other beneficial owners or with the participant's own securities.* *A participant shall register the transfer of securities to or from a beneficial owner's account only on receipt of instructions from the beneficial owner* and *thereafter confirm the same to the beneficial owner in a manner as specified by the depository in its bye-laws.* *Every entry in the beneficial owner's account shall be supported by electronic instructions or any other mode of instruction received from the beneficial owner in accordance with the agreement with the beneficial owner.*

	Insurance against risks [Regulation 36] *Every depository shall take adequate measures including insurance to protect the interests of the beneficial owners against risks likely to be incurred on account of its activities as a depository.* *Indemnification [Section 16 of Depositories Act]* *Without prejudice to the provisions of any other law for the time being in force, any loss caused to the beneficial owner due to the negligence of the depository or the participant, the depository shall indemnify such beneficial owner.* *Where the loss due to the negligence of the participant is indemnified by the depository, the depository shall have the right to recover the same from such participant.* In case of closure of operations by any participant, whether by reason of insolvency or by any other reason, the securities of the clients remain protected with the depository and the clients are provided an option to transfer their securities to an account opened with some other participant. Reconciliation by the exchanges/CCP of collateral deposits is done on a daily/monthly basis. Besides this, periodical internal and external audits are also conducted. Custodians are required to reconcile as per SEBI regulations for custodians. For depositories, following provisions exist in the SEBI (Depositories and Participants) Regulations, 1996 regarding the above: *Reconciliation [Regulation 47* and *55]* *Every participant shall reconcile his records with every depository in which it is a participant, on a daily basis.* *The issuer or its agent shall reconcile the records of dematerialised securities with all the securities issued by the issuer, on a daily basis provided that where the State or the Central Government is the issuer of Government securities, the depository shall, on a daily basis, reconcile the records of the dematerialised securities.* *Internal* and *external monitoring, review* and *evaluation of systems* and *controls [Regulation 34, 35* and *46]* *Every depository shall have adequate mechanisms for the purposes of reviewing, monitoring* and *evaluating the depository's controls, systems, procedures* and *safeguards.*

	Every depository shall cause an inspection of its controls, systems, procedures and *safeguards to be carried out annually* and *forward a copy of the report to the Board.* *Every participant shall have adequate mechanism for the purposes of reviewing, monitoring* and *evaluating the participant's internal accounting controls* and *systems.* Further, the participants' operations are subject to periodic inspection by the CSD and SEBI. SEBI also inspects the CSDs. Custodians are subject to regulation and supervision by SEBI. Exchanges and CCPs are also subject to supervisions by SEBI. Internal and external auditors as well as regulators also conduct regular audit inspection of the collateral deposits. For depositories, following provisions exist in SEBI Regulations with regard to the powers of SEBI to inspect the CSD and participants: *Board's right to inspect [Regulation 59]* *The Board may appoint one or more persons as inspecting officer to undertake inspection of the books of accounts, records, documents* and *infrastructure, systems* and *procedures, or to investigate the affairs of a depository, a participant, a beneficial owner, an issuer or its agent for any of the following purposes, namely:* *(i) to ensure that the books of account are being maintained by the depository, participant, issuer or its agent in the manner specified in these regulations;* *(ii) to look into the complaints received from the depositories, participants, issuers, issuers' agents, beneficial owners or any other person;* *(iii) to ascertain whether the provisions of the Act, the Depositories Act, the bye-laws, agreements* and *these regulations are being complied with by the depository, participant, beneficial owner, issuer or its agent;* *(iv) to ascertain whether the systems, procedures* and *safeguards being followed by a depository, participant, beneficial owner, issuer or its agent are adequate; and* *(v) to* suo moto *ensure that the affairs of a depository, participant, beneficial owner, issuer or its agent, are being conducted in a manner which are in the interest of the investors or the securities market.*
Assessment	**Observed**
Recommendation 13	**Governance:** Governance arrangements for CSDs and CCPs should be designed to fulfill public interest requirements and to promote the objectives of owners and users.
Description	There are two CSDs in India, namely, NSDL and CDSL. National Securities Depository Ltd (NSDL) is a depository promoted by NSE, IDBI, UTI, SBI

	and other FIs. NSDL commenced operation in November 1996. Central Depository Service (India) Ltd. (CDSL) is a depository promoted by BSE jointly with SBI, Bank of India, HDFC Bank and other FIs. CDSL commenced its operations on July 15, 1999. As regards CCPs, the NSCCL, a wholly-owned subsidiary of NSE, functions as CCP in case of NSE and in case of BSE, the Exchange itself serves as a CCP. NSCCL was incorporated in August 1995. It was the first clearing corporation to be established and also the first clearing corporation to introduce settlement guarantee. NSCCL commenced clearing operations in April 1996. It has since completed more than 1800 settlements (equities segment) without delays or disruptions. The Clearing House of BSE, *i.e.,* Bank of India Shareholding Ltd. (BOISL) is a company jointly promoted by BSE (49 per cent) and Bank of India (51 per cent). BOISL, *inter alia*, handles some of the settlement related activities as per instructions and directions of BSE. Responsibility of the Clearing House is to handle such settlement activities including co-ordination with the market participants, *viz*., depositories, clearing banks, *etc.* However, the overall responsibility of settlement and risk management functions *viz.,* collection of margins, collateral management, *etc.* pertaining to transactions done on BSE Online Trading (BOLT) system lies with the BSE. The exchanges and CCP have well-laid-down rules, bye-laws and regulations regarding their operations. Besides these, circulars and publications of the exchanges and CCP are publicly available through website and in printed form. The ownership and financial information is available with the statutory and regulatory authorities and is also publicly available. Periodical reports containing operational and financial information and major decisions are periodically sent to the members of the board, shareholders and regulatory authorities. The constitution of the board of the exchanges is in accordance with the Section 4B of SCRA, 1956 and SEBI prescribed norms[13]. The board of the exchanges has constituted committees comprising members having the

[13] The representation of trading members does not exceed 1/4th of the total strength and remaining directors are appointed in the manner as may be specified by SEBI from time to time, ii. Chief Executive, by whatever name called, is an *ex-officio* director, and iii. SEBI shall have the right to nominate as many directors on the Governing Board, as and when deemed fit, irrespective of the size of the Governing Board.

	requisite skill-sets, knowledge and experience. The Board is responsible for selecting, evaluating and if necessary, removing senior management. There are mechanisms to ensure that the Board contains suitable expertise and takes account of all relevant interests. The trading member Directors have the necessary skills of their core business; the Independent Directors have vast experience in the field of accountancy, law, management and information technology. The exchanges are maintaining the prescribed norms under the corporate governance and the deliberations and the policy decisions are taken in the interest of the investors. Further, the CSDs have laid-down bye-laws and business rules regarding their operations describing the duties and obligations. Circulars issued from time to time to the participants, issuers and registrars and transfer agents are made electronically available to the concerned parties and publicly on the website. The boards of the CSDs have constituted various Committees like Audit Committee, Disciplinary Action Committee, *etc.* comprising eminent persons with professional expertise. Arbitration mechanism has been put in place for dispute resolution between investors and participants which is in addition to the Investor Grievance Redressal Cells. CSDs conduct internal audit of its processes as per the requirements under SEBI Regulations and a report thereof is filed with SEBI every year. Moreover, statutory audit is carried out by external auditors annually. CSDs have obtained ISO 27001 certification for its information security management systems. CSDs are required to carry out an audit of their information systems.
Assessment	**Observed**
Recommendation 14	**Access:** CSDs and CCPs should have objective and publicly disclosed criteria for participation that permit fair and open access.
Description	Access rules/criteria objective are clearly disclosed to all potential applicants. The exchange and CCPs have well-laid-down norms pertaining to admission and exit of the market participants, *viz.,* broker-members, custodians and clearing members. Such norms and guidelines are publicly available. Non-fulfillment of membership criteria including net worth could lead to suspension of membership. Further, other developments including arrest of the promoters of the member corporates could lead to limiting access. These arrangements are publicly disclosed.
Assessment	**Observed**
Recommendation 15	**Efficiency:** While maintaining safe and secure operations, securities settlement systems should be cost-effective in meeting the requirements of users.
Description	With regard to securities' depositories, SEBI has taken measures to rationalise costs of account-opening charges, custody charges and

	transaction charges, through a committee which compared costs across jurisdictions.[14] There are no charges levied by the clearing corporation for carrying out basic settlement activities. The charge structure is reviewed regularly by the CSD taking into consideration the movement in the volume of transactions and costs of operations. Depositories have been passing the benefit of increase in their volumes to the users of the CSD system by reducing the fee. Since inception, depositories have reduced the charges a number of times keeping its policy of passing on the benefit to the users. SEBI conducts periodic system audit of depositories to review the operational reliability including capacity levels against projected demand, and action is recommended based on the audit findings. DP inspections are carried out by both SEBI and Depositories to, *inter alia*, evaluate operational reliability of the DP. Depositories periodically review their systems' capacity as the volume goes up and with the advent of the new technologies in the market. Once the level of volume reaches a particular pre-decided level, the capacity enhancement is planned and effected in a systematic manner. Depositories have a team of systems personnel which analyses the requirement of systems upgrade taking into account various factors and makes suitable recommendations to the management, which decides about the system upgrade.
Assessment	**Observed**
Comments	According to an Annual Report on global trading volumes released by trade group Futures Industry Association (FIA) in Washington, NSE registered a growth of 95.32 per cent in its F and O volume in 2007 to close to 380 million as against about 194 million in 2006. NSE's growth was the quickest among the ten largest derivative exchanges. Besides,

[14] SEBI vide Circular No. MRD/DoP/Dep/Cir-22/05 dated November 9, 2005 advised that with effect from January 9, 2006 no charges shall be levied by a depository on DP and consequently, by a DP on a Beneficiary Owner (BO) when a BO transfers all the securities lying in his account to another branch of the same DP or to another DP of the same depository or another depository, provided the BO Account/s at transferee DP and at transferor DP are one and the same, *i.e.*, identical in all respects. In case the BO Account at transferor DP is a joint account, the BO Account at transferee DP should also be a joint account in the same sequence of ownership. All other transfer of securities consequent to closure of account, not fulfilling the above-stated criteria, would be treated like any other transaction and charged as per the schedule of charges agreed upon between the BO and the DP.

	NSE has moved up six places to become the ninth largest derivative exchange in the world, according to FIA. According to the latest data compiled by World Federation of Exchanges: 1. NSE has become the world's second fastest-growing bourse in terms of number of listed companies, while BSE has consolidated its position as the biggest bourse. 2. NSE recorded a 16.6 per cent jump in the number of listings to 1,274 during the one-year period ended July 2007, while BSE has become home to a total of 4,853 companies. These facts reflect the confidence of users in the system (and possibly its cost-effectiveness).
Recommendation 16	**Communication Procedures and Standards:** Securities settlement systems should use or accommodate the relevant international communication procedures and standards in order to facilitate efficient settlement of cross-border transactions.
Description	With regard to depositories, international standards are used for generating securities codes (ISINs). CCPs use ISINs for communication with depositories and for settlement procedure. STP has been implemented for institutional transactions with effect from July 2004 using internationally accepted ISO 15022 messaging standards, to facilitate seamless execution and settlement of transactions. With regard to cross-border transactions, there are no transactions involving direct flow of funds/securities across borders through the settlement/depository system. Foreign investors invest in Indian securities after appointing local custodians, who hold shares in India on behalf of the foreign investors. Funds are brought in by the foreign investors, and maintained in rupee accounts locally. In transactions involving ADRs/GDRs, two-way fungibility is allowed, and the transactions take place through communication between the local and global custodian. However, the underlying shares continue to be held in India with the local custodian, while the depository receipts are issued/cancelled by the global custodian based on instructions by investors.
Assessment	**Observed**
Recommendation 17	**Transparency:** CSDs and CCPs should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using the CSD or CCP services.
Description	CSDs and CCPs notify their Business Partners and market participants about various operational, systemic requirements, rules regarding risk management and other relevant rules, regulations and procedures by way of circulars and other announcements/publications in electronic as well as in hard copy in English. Circulars are electronically sent to the

	Business Partners and Market Participants and all policy-related circulars are displayed on the website of CSDs. The rules, regulations and circulars are regularly updated by CCPs on their websites. The depositories, *viz.*, NSDL and CDSL have obtained ISO 27001 certification and follows the requirements and audits specified therein. Information on all key aspects related to CCP is publicly available.
Assessment	**Observed**
Recommendation 18	**Regulation and oversight:** Securities settlement systems should be subject to transparent and effective regulation and oversight. Central banks and securities regulators should co-operate with each other and with other relevant authorities.
Description	CCP falls within the purview of SEBI which regulates various intermediaries and SROs in the Capital Market.[15] CCPs' operations are governed by the provisions contained in Companies Act, SEBI Act, SCRA, Depositories Act, Income-tax Act, *etc.* and the rules, regulations, bye-laws, notifications, circulars and directives issued thereunder. The objectives and responsibilities as well as roles and major policies of SEBI with respect to securities settlement systems are clearly defined by way of various Acts/Regulations, circulars and disclosed to public in electronic as well as hard copies, in English. These are also displayed on the website of SEBI. Regulatory and oversight activities have a sound basis with a statute-based approach where specific tasks, responsibilities and powers are assigned to respective market participants. The exchange provides data with respect to clearing, settlement, participant default, *etc.* to SEBI on a monthly basis. No operations of the CCP are outsourced. The exchange of information between SEBI and other relevant authorities is done on a regular basis. SEBI is the securities regulator and relevant

[15] The Securities Laws (Amendment) Act, 2004 enacted on January 7, 2005 inserted a new section (Section 8A) in the SCRA to provide for clearing and settlement by a CCP. It provides that an exchange may, with the approval of SEBI, transfer the duties and functions of a clearing house to a recognised CCP for the purpose of the periodical settlement of contracts and differences thereunder, and the delivery of, and payment for, securities. It obliges SEBI to approve such transfer if it is in the public interest or in the interest of the trade. It further provides that only a company can be recognised as a CCP and its bye-laws need to be approved by SEBI. The various provisions in the SCRA such as grant and withdrawal of recognition, supercession of management, suspension of business, *etc.* as applicable to stock exchanges, *mutatis mutandis* in would apply to CCPs. Thus, the CCPs are subjected to the same regulatory framework as the stock exchanges are.

	authority for CCP. However, the central bank also has some supervisory jurisdiction in respect of certain policies that have a bearing on them. The responsibilities and main policies of the securities regulator and central bank are clearly defined and publicly disclosed to the maximum extent, in plain language enabling understanding by CCPs and participants. SEBI and the central bank have evolved a framework for co-operation.
Assessment	**Observed**
Recommendation 19	**Risk in Cross-border Links:** CSDs that establish links to settle cross-border trades should design and operate such links to reduce effectively the risks associated with cross-border settlements.
Description	**Not Applicable**
Assessment	**Not Applicable**
Comments	Cross-border trading in securities market in India is not allowed at present.[16] Therefore, the issues relating to settlement of cross-border trades (e.g., links with foreign CSDs) in terms of this recommendation are presently not applicable. In any case, domestic securities markets are being increasingly integrated into a global market. Securities markets, particularly those in emerging economies, are susceptible to the effects of cross-border activities, especially to higher short-term volatilities either after economic shocks or during periods of great uncertainty. If the cross-border transactions were to be permitted, the regulatory implications of the evolving globalisation of market structures and the impediments to cross-border transactions need to be identified. As and when cross-border trading is permitted, the recommendation would be taken up for implementation.

[16] Although foreign national persons are prohibited from investing in financial assets, such investments are permitted by FIIs with suitable restrictions.

Annex VI

Assessment of Observance of CPSS-IOSCO Recommendations for Central Counterparties – NSCCL and BOISL/BSE

Recommendation 1	**Legal Risk:** A CCP should have a well-founded, transparent and enforceable legal framework for each aspect of its activities in all relevant jurisdictions.
Description	The CCP is accountable for: i. monitoring and supervising clearing and settlement systems; ii. to prevent or mitigate problems associated with clearing and settlement; iii. post-trade activities such as risk management and clearing and settlement of trades executed on stock exchange; and iv. Supervision of clearing members and also for establishing link and enforcing contractual obligation with clearing banks, depositories, *etc.* NSCCL, a wholly-owned subsidiary of NSE, functions as the CCP in case of the NSE and in case of the BSE, the exchange itself serves as a CCP. NSCCL was incorporated in August 1995. It was the first CC to be established and also the first CC to introduce settlement guarantee. NSCCL commenced clearing operations in April 1996. It has since completed more than 1,800 settlements (equities segment) without delays or disruptions. The Clearing House of BSE, *i.e.,* Bank of India Shareholding Ltd. (BOISL) is a company, jointly promoted by BSE (49 per cent) and Bank of India (51 per cent). BOISL, *inter alia*, handles some of the settlement-related activities. The settlement-related activities of the Exchange are handled by BOISL as per instructions and directions of BSE. Responsibility of the Clearing House is to handle such settlement activities including co-ordination with the market participants, *viz.,* Depositories, clearing Banks, *etc.* however, the overall responsibility of settlement and risk management functions, *viz.,* collection of margins, collateral management *etc.* pertaining to transactions done on BSE Online Trading (BOLT) System lies with the BSE.

	The rules, bye-laws and regulations relating to the exchanges and CCPs[17] are clearly stated, internally coherent and approved by SEBI and the same are readily accessible to participants and public in printed form and on the website. The bye-laws are required to be published in the Official Gazette. The information pertaining to the bye-laws of BSE relating to clearing and settlement is also publicly available. Besides these, circulars and publications of the exchanges are publicly available through the website and in print form. The exchange/CCPs have well-laid-down norms pertaining to admission and exit of the market participants, *viz.,* clearing members and custodians. Such norms and guidelines are publicly available through website. CCPs have the legal basis for novation. The rules and bye-laws and regulations are framed in such a manner that it guarantees the settlement of trades done on the trading system of the exchange. If the participant fails to settle the trades within the prescribed period of settlement, the CCP immediately settles such trades. The CCPs have the netting system whereby the funds obligation of the participants are netted for the settlement and the securities' positions are either settled on a net basis or settled on a gross basis, based on the type of trade and the group of securities (certain securities are settled on net basis and certain securities are required to be settled on gross basis). The payments are guaranteed as per the provision for Guarantee Fund as provided under the rules, bye-laws and regulations of the exchange and CCP. The regulatory framework including bye-laws, rules and regulations provide for the type of collaterals. The relevant authority has the powers to prescribe requirement of margins including collection of margins. The CCP has first and paramount lien in collateral security like Membership Deposit, BMC and Additional Collateral, *etc.* for all sums due by the member-broker to the exchange. There are well-laid-down norms in respect of finality of transfer of funds and financial instruments. There are also well-laid-down rules, regulations, bye-laws and circulars of exchanges/CCPs as well as various laws governing transfer of funds/securities, risk management, default procedures and various other aspects of the trading and settlement system. CCP's rules, procedures and contracts are enforceable when the participant defaults or becomes insolvent/bankrupt. Laws in force in India supports that the actions taken under such rules and procedures may not later be stayed, avoided or reversed as rules, bye-laws and regulations are approved under SCRA, 1956 and have force of law.

[17] The NSCCL/BSE interposes itself as a central counterparty between the counterparties to trades and nets the positions so that a member has security-wise net obligation to receive or deliver a security and has to either pay or receive funds. 'CCP' has, therefore, been used in all the subsequent paras as the connotation for NSCCL and BSE.

	Section 9(2)(k) of SCRA, empowers the Recognised Stock Exchange (RSE) to make bye-laws with prior approval of SEBI in respect of the consequences of default or insolvency on part of a seller or buyer or intermediary, the consequences of breach of omission by seller or a buyer and the responsibility of the members who are not parties to such contracts. The bye-laws of stock exchange provides for default proceedings including provision of priorities of payment. Therefore, contract in securities default, priorities of payment, *etc.* should be governed by bye-laws of stock exchange and should not be subjected to general insolvency laws.(*More details are provided under Recommendation 6).* As per bye-laws of the stock exchange, on a member being declared as defaulter, all the deposits, assets or collaterals of intermediary shall vest on RSE/Clearing House/Corporation. The above view is also supported by the decision of Supreme Court in the case of Vinay Bubna, (1999) 6 SC Cases 215. The Supreme Court had held that the membership card is not his personal property and, thus, on default being committed by him and after he ceases to be a member, it cannot be sold and its proceeds cannot be distributed among its creditors. Same principle is applicable in respect of any deposit, collateral by defaulting member with the stock exchange or CCP in respect of any contracts executed in stock exchanges. There is no cross-border participation in the CCP.
Assessment	**Observed**
Comments	As a part of the Recommendations mentioned at Section 5.4 of the Report, it has been proposed to enhance the legality of netting and settlement finality by making an amendment in SCRA.
Recommendation 2	**Participataries Requirements:** A CCP should require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the CCP. A CCP should have procedures in place to monitor that participation requirements are met on an ongoing basis. A CCP's participation requirements should be objective, publicly disclosed, and permit fair and open access.
Description	The CCPs have well-established requirements for participants' financial resources and creditworthiness. The exchanges have well-laid-down financial criteria for member-brokers which are based on their net worth

	and other deposits, *viz.,* Base Minimum Capital, Additional Capital (collateral securities on the basis of exposure requirements) and contribution towards Guarantee Fund. Members are required to have requisite infrastructure and manpower/staff with required certification. Regular Inspection of the member-brokers are also carried out. CCP can, at any time from the date of admission to the Clearing Membership of the Clearing Corporation, withdraw the admission and expel a clearing member if he has at the time of his application for admission to membership or during the course of the inquiry made preceding his admission made any wilful misrepresentation; or suppressed any material information required of him as to his character and antecedents; or has directly or indirectly given false particulars or information or made a false declaration. CCPs, from time to time, prescribe conditions and requirements for continued admittance to Clearing Membership which may, *inter alia*, include maintenance deposit or contribution to Settlement Fund, minimum net worth and capital adequacy. The CCP monitors that participation requirements are met on an ongoing basis. Operational requirements from members include margins and membership requirements include deposits, financial net worth, *etc.* The deposits and margins are monitored on an online basis. Members are required to produce net worth confirmations periodically. There is a stringent mechanism to review the net worth of members and also take action if the net worth of the trading members falls below the required level. Besides these, the participation requirements pertaining to the trading exposures are monitored and blocked on an online basis from their collateral deposits and the member-brokers not having enough collateral are not permitted to trade by the system. Non-adherence to the criteria as stipulated in the rules and bye-laws of exchange and CCPs can lead to suspension of membership. The conditions and the procedure for suspension are laid out clearly in the said rules and bye-laws. As provided in the bye-laws, rules and regulations of the CCP if a member fails to pay his annual subscription, fees, deposit or contribution to Settlement Fund(s), fines, penalties, other charges or other monies which may be due by him to the CCP within prescribed time after notice in writing has been served upon him, he is suspended until he makes payment and if within a further period of time as specified from time to time, he fails to make such payment, he is declared a defaulter and then expelled. The participation requirements limit the access mainly on grounds of risk. The rules, bye-laws and regulation of CCPs state the procedure for orderly exit of the participants.
Assessment	**Observed**

Recommendation 3	**Measurement and Management of Credit Exposures:** A CCP should measure its credit exposures to its participants at least once a day. Through margin requirements, other risk control mechanisms or a combination of both, a CCP should limit its exposures to potential losses from defaults by its participants in normal market conditions so that the operations of the CCP would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control.
Description	A sound risk management system is integral to an efficient clearing and settlement system. Risk containment measures for members include capital adequacy requirements of members, monitoring of performance and track record, stringent margin requirements, position limits based on capital, online monitoring of positions and automatic disablement from trading when limits are breached, *etc.* The CCPs perform risk monitoring on an online real-time basis. A comprehensive Risk Management framework based on VaR model, as prescribed by SEBI as well as CCPs' own norms as applicable from time to time are followed by the exchanges and CCPs. The collateral securities are taken from the member-brokers based on their exposure requirements. VaR and Extreme Loss Margins (ELM) are collected online on an upfront basis by blocking the amount of collateral securities at the time of trade. VaR margins are computed six times in a day on the basis of intra-day volatility. Besides these, MTM margins and Special Margins are also collected at the end of the day. Such margins are released to the member-brokers after completion of the pay-in (funds payment and delivery of securities in a settlement) obligations. The exchanges have an online surveillance system. Exposure of the members is monitored on a real time basis through an online monitoring system. For instance, a system of alerts has been built in at NSCCL so that both the member and the NSCCL are alerted as per pre-set levels (reaching 70 per cent, 85 per cent, 90 per cent, 95 per cent and 100 per cent) as and when the members approach these limits. The system enables NSCCL to further check the micro-details of the members' positions, if required, and take pro-active action. NSCCL has developed a comprehensive risk containment mechanism for the F and O segment. The most critical component of risk containment mechanism for F and O segment is the margining system and online position monitoring. The actual position monitoring and margining is

	carried out online on an intra-day basis through Parallel Risk Management System (PRISM). PRISM uses SPAN (Standard Portfolio Analysis of Risk) system for the purpose of margining, which is a portfolio-based system. SPAN system is used for the purpose of computation of online margins, based on the parameters defined by SEBI. A separate Guarantee Fund for this segment has been created out of the base capital of the members. (*The comprehensive risk management framework followed by the CCPs is explained in more details in reply to Recommendation 4).*
Assessment	**Observed**
Recommendation 4	**Margin Requirements:** If a CCP relies on margin requirements to limit its credit exposures to participants, those requirements should be sufficient to cover potential exposures in normal market conditions. The models and parameters used in setting margin requirements should be risk-based and reviewed regularly.
Description	A comprehensive risk management framework as prescribed by the SEBI from time to time is followed by the exchanges and CCPs. The collateral securities are taken from the member-brokers for their exposure requirements. Margins required are to cover the maximum potential losses arising out of a participant's position over a one-day time horizon using the VaR concept. VaR and ELM are collected online on an upfront basis by blocking the amount of collateral securities at the time of trade. VaR margins are computed six times in a day on the basis of intra-day volatility. Besides these, MTM margins and Special Margins are also collected at the end of day. Such margins are released to the member-brokers after completion of the pay-in (funds payment and delivery of securities in a settlement) obligations. During the online monitoring, if the margins exceed the deposits, the trading facility of the member is withdrawn. Member-brokers can deposit collaterals in form of cash, cash equivalent (bank guarantees and fixed deposits of the banks as per prescribed norms) and non-cash equivalent (eligible equity shares of the companies traded on the exchange subject to haircut) with exchange towards margin requirements. Securities are evaluated on a daily basis and hair-cut is applied. SEBI has prescribed composition of cash equivalent and non-cash equivalent component of the collateral. The back-testing is carried out on a quarterly basis to ascertain the adequacy of the margins. The exchanges/CCP also have an online surveillance system. NSCCL has developed a comprehensive risk containment mechanism for the F and O segment. The salient features of risk containment mechanism on the F and O segment are:

	(i) NSCCL charges an upfront initial margin for all the open positions of a Clearing Member (CM). It specifies the initial margin requirements for each futures/options contract on a daily basis. It also follows VaR-based margining computed through SPAN. The CM, in turn, collects the initial margin from the TMs and their respective clients; (ii) The open positions of the members are marked to market, based on contract settlement price for each contract. The difference is settled in cash on a T+1 basis; (iii) NSCCL's online position monitoring system monitors a CM's open position on a real time basis. Limits are set for each CM based on his base capital. The online position monitoring system generates alerts whenever a CM reaches a position limit set up by NSCCL. NSCCL monitors the CMs for MTM value violation, while trading members (TMs) are monitored for contract-wise position limit violation; (iv) CMs are provided with a trading terminal for the purpose of monitoring the open positions of all the TMs clearing and settling through him. A CM may set exposure limits for the TM clearing and settling through him. NSCCL assists the CM to monitor the intra-day exposure limits set up by CM and whenever a TM exceed the limits it stops that particular TM from further trading; and (v) A member is alerted of his position to enable him to adjust his exposure or bring in additional capital. Position violation results in disablement of trading facility for all TMs of a CM in case of a violation by the CM. (vi) A separate Guarantee Fund for this segment has been created out of the base capital of the members. The most critical component of risk containment mechanism for F and O segment is the margining system and online position monitoring, carried out online through Parallel Risk Management System (PRISM). PRISM uses SPAN (Standard Portfolio Analysis of Risk) for the purpose of computation of online margins, based on the parameters defined by SEBI.
Assessment	**Observed**
Recommendation 5	**Financial Resources:** A CCP should maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions.

Description	In the event of funds shortage from the members, the pay-in is completed by CCP. As a part of risk management, CCP collects margins from all the members on an upfront basis. In case of members who have fund shortages, the pay-outs of securities due to them are also not released. The margins are based on VaR method and, therefore, are structured to meet the worst scenario loss that may arise after disposing the pay-out of securities that were withheld and appropriating towards the pay-in requirements. CCP has well-established procedures to stress-test its exposures in extreme but plausible market conditions. A stress-test considering settlement failures by all the top 10 members and a percentage of loss in liquidation of positions is computed and compared with Guarantee Fund for adequacy periodically, on the basis of the criteria stipulated by SEBI. There have been no instances of stress-testing results indicating resources not likely to be adequate to meet its obligations resulting from a default. The risk management framework is as stipulated by SEBI. The margins collected take into consideration the volatility of the securities and also a look-ahead period. In the event of shortfall in pay-in of securities, the pay-out of funds to the member is withheld to the extent of the valuation of the securities that were not delivered. An auction is conducted for procuring the securities to facilitate pay-out to the members who have not received securities due to the pay-in shortage. The pay-out amount withheld is used towards paying for the securities thus procured. If the securities are not available for procurement, a financial close-out is effected and here again the amount withheld is used. Given the robust risk management system, the funds shortages are observed to be very insignificant and arise mainly due to the time involved in fund movements. These small and temporary shortages were observed to be always recovered subsequently from the members. The securities shortages are also observed to be very small and insignificant. CCP has collateral deposits of the member-brokers, the Guarantee Fund corpus, Base Minimum Capital deposits of the member-brokers, *etc.* available to cover defaults of the member-brokers. CCPs utilise such resources for the value in the event of a member-broker's default/ insolvency. CCP calls in and realises the security deposits in any form, margin money, other amounts lying to the credit of and securities deposited by the defaulter and recover all moneys, securities and other assets due, payable or deliverable to the defaulter by any other clearing member in respect of any deal or dealing made subject to the bye-laws, rules and regulations of the CCP. Such assets vest *ipso facto* on declaration of any clearing member as a defaulter, in the CC for the benefit of and on account of the

	CCP, exchange, SEBI, other clearing members, constituents of the defaulter, approved banks and any other persons as approved by the relevant authority and other recognised stock exchanges/clearing corporation. Further, in the bye-laws of CCP on the limitation of its liabilities, in this regard, it has been clearly laid-down that '*the liability of the Clearing Corporation resulting from the deemed contracts of clearing members with the Clearing Corporation* and *to losses in connection therefrom would be limited to the extent of contributions available to the Settlement Fund. The Clearing Corporation shall not be available for obligations of a non-clearing Member, obligations of a clearing member to a non-member, obligations of a Clearing member to another member of the Clearing Corporation towards deals to which the Clearing Corporation is not a counterparty or obligations to a constituent by a clearing member,* and *to losses in connection therefrom'.* The assets of the Guarantee Fund are invested in bank deposits, units of debt schemes of mutual funds. These assets can be encashed at a very short notice. The CCP also has overdraft facilities with its major clearing banks. However, the CCP has taken a clean line of credit from the clearing bankers, which can be drawn upon sufficiently quickly to ensure that the CCP can meet its obligations when due. The CCP's rules prohibit them from being used to cover operating losses or losses from other CCP activities.
Assessment	**Observed**
Recommendation 6	**Default Procedures:** A CCP's default procedures should be clearly stated, and they should ensure that the CCP can take timely action to contain losses and liquidity pressures and to continue meeting its obligations. Key aspects of the default procedures should be publicly available.
Description	The CCP's bye-laws clearly state circumstances under which the participant is declared as defaulter and accordingly the CCP declares the defaulter by direction/circular/notification by the relevant authority. In case default occurs, bye-laws give authority to deal with the assets of defaulter available with the CCP. The bye-laws, rules and regulations of the CCPs provide for prompt close-out or to manage the positions of a defaulting participant and to apply the defaulting participants' collateral or other resources. The procedure empowers the CCPs to promptly draw

	the funds from the Guarantee Fund and other sources like overdraft from banks, *etc.* The exchanges also have a statutory committee called Defaulters' Committee, which handles various aspects related to the defaults on the exchange. The key aspects of the default procedures incorporated in the Rules, bye-laws, regulations and various circulars are publicly available through printed copies and on website. The liquidator of the securities may be subject to legal risk of being objected to by the court receiver. If the assets of the customer are clearly ascertainable then the same could be dealt separately and returned to the customers under the insolvency laws[18]. The bye-laws provide a high degree of assurance that the decisions to liquidate or transfer a position *etc.* in the event insolvency would not be stayed or reversed except by the due process of law. The rules of the system and contracts between system participants are enforceable, notwithstanding the insolvency of a participant as the same are independent of insolvency proceedings. (Case of Vinay Bubna Vs BSE 1999 6 SCC 215) The need for co-ordination is currently not applicable. The CCP's have internal plans for implementing their default procedures as provided in the rules, bye-laws and regulations. The relevant authority has got the powers to implement the same.
Assessment	**Observed**
Recommendation 7	**Custody and Investment Risks:** A CCP should hold assets in a manner whereby risk of loss or of delay in its access to them is minimised. Assets invested by a CCP should be held in instruments with minimal credit, market and liquidity risks.
Description	Operations and procedures in respect of custody of collaterals are mandated by the agreement entered between the custodian and CCP. At present, the exchanges accept collateral from member-brokers in form of cash, bank guarantees, bank deposits and eligible securities of companies. The documents of such bank guarantees and bank deposits are well-preserved under the custody of the CCP (BSE/NSCCL). Periodic reconciliation and audit of the collateral securities deposited by the member-brokers is done. CCPs' interest in such collateral can be enforced and the CCP has prompt access to such collateral in the event of a participant's default. The Depositories Act also provides for invoking of pledged securities. At NSE, cash surplus is invested only in debt schemes of mutual funds, bank fixed deposits, bonds of public sector undertakings as per the

[18] India does not have a separate insolvency law. The regulatory regime dealing with corporate insolvency is contained in the Companies Act and the SICA. The experiences has, however, proved that the system does not provide for speedy and effective rehabilitation and efficient exit. There is a need for a contemporaneous change in the Indian insolvency system for bringing it at par with the international standards. Insolvency laws and institutions are critical to achieve the benefits and avoid the pitfalls of integration of national financial systems with the international financial system.

	prudential norms approved by its Board of Directors. Direct investments are made in instruments having top notch rating. Further, as a risk containment measure, adequate diversification is ensured by defining overall limits to individual schemes of mutual funds as well as a single mutual fund. As per the Investment Policy of BSE, cash received or income earned by the fund is invested in bank term deposits, units of debt schemes of mutual funds, fixed income investments, *etc.* Investment Policy ensures that investments are made in banks whose net worth is above specified criteria. Further, exposure limit of these banks has also been defined. mutual funds are empanelled on the basis of the assets under management, thereby ensuring empanelment of larger mutual funds. Exposure limits are fixed for each mutual fund as a whole and for various individual schemes. Investments are made in time deposits and in debt schemes of mutual funds, which are generally very liquid. The CCP considers its overall exposure to an obligor in choosing investments. The prudential norms specify the extent in absolute/ percentage terms to which investments can be made. Overall exposure limits are fixed for each class of investments, institutions, schemes, *etc.*
Assessment	**Observed**
Recommendation 8	**Operational Risk:** A CCP should identify sources of operational risk and minimise them through the development of appropriate systems, controls and procedures. Systems should be reliable and secure, and have adequate, scalable capacity. Business continuity plans should allow for timely recovery of operations and fulfillment of a CCP's obligations.
Description	The CCPs have a process for actively identifying, analysing and addressing their operational risk. No operations of the CCPs are outsourced. The exchanges and CCPs have well-maintained back-up systems. The systems are reliable and secured, and they are scaled-up/upgraded on a regular basis. The contingency plan, back-up facilities and disaster recovery site pertaining to trading, clearing, settlement and other vital processes are in place. There are adequate management controls and sufficiently well-qualified personnel ensuring appropriate implementation of the procedures. Operational reliability issues are reviewed regularly by senior management, including review by persons not responsible for the relevant

	operations. There is an internal audit function which reviews operational risk controls. There have been no failures in the CCP system. CCP has capacity plans for key systems and they are tested periodically to determine handling of stress volumes.
Assessment	**Observed**
Recommendation 9	**Money Settlements:** A CCP should employ money settlement arrangements that eliminate or strictly limit its settlement bank risks, that is, its credit and liquidity risks from the use of banks to effect money settlements with its participants. Funds transfers to a CCP should be final when effected.
Description	The CCPs are directly responsible for day-to-day monitoring/supervision of clearing and settlement system and their operators subject to overall supervision of the exchange and SEBI. The clearing members, custodian, clearing banks are governed by bye-laws/contractual arrangement with CCPs. Section 8A and Section 9(2) of SCRA, 1956 provides for prior approval of SEBI in respect of bye-laws of clearing corporation or clearing house. The CCP uses the private settlement bank model. Multiple clearing banks are currently used. The CCP appoints banks as the 'Designated Clearing Banks'. There are laid-down entry norms for enrollment of 'Designated Clearing Banks'. CCPs have defined eligibility criteria like net worth, type of bank (*i.e.,* scheduled commercial bank), *etc.* for empanelment of banks as clearing banks and also criteria for continued empanelment which covers aspects of creditworthiness, access to liquidity and operational reliability. Besides this, clearing banks have to enter into an agreement with the CCP. It is observed that in respect of some of the banks which were dis-empanelled by NSCCL for non-fulfillment of continued eligibility, the Reserve Bank had issued a moratorium on these banks subsequently. Currently, cross-currency payment is not applicable. The designated settlement banks are subject to the prudential supervision by the government authorities. The CCP's have agreements with clearing banks, which *inter alia* cover the points pertaining to obligations of a clearing bank to the CCP in respect of transfer of funds to the CCP's when a late confirmation of the same has been given by the concerned clearing bank. No specific exercise to ascertain liquidity pressure in case of a concentrated settlement bank's failure is currently being done. Settlement banks act as a pass-through for settlement of funds. The CCP does not allot member accounts to these banks and members are free to choose one of these banks as clearing bank. Multiple clearing banks provide advantages of competitive forces, facilitate introduction of new products, *viz.,* working capital funding, anywhere banking facilities, the option to members to settle funds through a bank, which provides the maximum services suitable to the member.

	CCPs' legal agreements with its settlement banks provide that funds transfers to its accounts are final when effected. At present, a broker/ custodian has to designate one clearing bank for settlement purpose. The CCP maintains accounts with each of the designated clearing banks. Clearing members also maintain accounts with any one of these banks. These clearing banks transfer funds from the members account to the CCP's account based on electronic instructions from the CCP. During pay-out, funds are transferred from CCP's account to the receiving members account with the respective banks. These transfers are within the banks and, hence, instantaneous. Transfer of funds between CCP's accounts with the multiple clearing banks are through RTGS. The banks are required to provide the minimum stipulated service as a single window to all clearing members of CCP. The concentration of exposures in the various banks is commensurate with the net worth of the banks. The designated settlement banks are subject to prudential supervision by the Reserve Bank. The clearing banks use the clearing system of the central bank, *i.e.,* Reserve Bank.
Assessment	**Observed**
Recommendation 10	**Physical Deliveries:** A CCP should clearly state its obligations with respect to physical deliveries. The risks from these obligations should be identified and managed.
Description	Presently, there are no physical deliveries. However, there are rules in place which state the obligations of CCP with regard to physical deliveries. The settlement cycle in place acts as a DvP mechanism mitigating the principal risk. Payment to the participant in a settlement is released by the CCPs only after receipt of delivery of securities from such participant. CCP has identified the liquidity, storage and delivery risks. Demat deliveries addresses these risks. The CCP has well-laid-down procedures for handling physical deliveries and bad deliveries as per its rules, bye-laws and regulations and various circulars issued from time to time. The procedure adopted in case of pay-in shortages by members in dematerialised security pay-in is to procure the securities by an auction mechanism. Failure to procure securities in auction results in financial close-out based on a pre-declared formula designed at adequately compensating the member who has failed to receive shares on account

	of the shortage. The securities or funds, as the case may be, are transferred to the receiving members' depository/settlement account on the settlement day. In case of physical securities (paper-based) pay-in shortage, there is no auction mechanism and such shortages are financially closed-out. The same procedure would be applicable in case of an insolvent member failing to make securities pay-in.
Assessment	**Observed**
Recommendation 11	**Risks in links between CCPs:** CCPs that establish link either cross-border or domestically to clear trades should evaluate the potential sources of risks that can arise, and ensure that the risks are managed prudently on an on-going basis. There should be a framework for co-operation and co-ordination between the relevant regulators and overseers.
Description	There is no cross-border participation in the CCP.
Assessment	**Not Applicable**
Recommendation 12	**Efficiency:** While maintaining safe and secure operations, CCPs should be cost-effective in meeting the requirements of participants.
Description	The CCP does not levy any direct charges on participants. There is no formal procedure for measuring costs against that of other CCPs as there are no direct transaction charges levied by the CCP. Some of the major costs involved are: a) Opportunity costs of the funds required to be maintained with CCP by the participants and b) Recurring contributions to Guarantee Fund – one of the major components of the Guarantee Fund is the margin collected from the members. These are levied as stipulated by SEBI. CCP regularly review its service levels but the surveys are informal.
Assessment	**Observed**
Recommendation 13	**Governance:** Governance arrangements for a CCP should be clear and transparent to fulfill public interest requirements and to support the objectives of owners and participants. In particular, they should promote the effectiveness of a CCP's risk management procedures.
Description	The NSCCL, a wholly-owned subsidiary of NSE, functions as the CCP in case of the NSE and in case of the BSE, the exchange itself, serves as a CCP. NSCCL was incorporated in August 1995. It was the first clearing corporation to be established and also the first clearing corporation to introduce settlement guarantee. NSCCL commenced clearing operations in April 1996. It has since completed more than 1,800 settlements (equities segment) without delays or disruptions. The Clearing House of BSE, *i.e.,* Bank of India Shareholding Ltd. (BOISL) is a company jointly promoted by BSE (49 per cent) and Bank of India (51 per cent). BOISL, *inter alia*, handles some of the settlement related

	activities. BSE has well-laid-down corporate governance norms for its functioning. The Securities Laws (Amendment) Act, 2004 enacted on January 7, 2005 inserted a new section (Section 8A) in the SCRA to provide for clearing and settlement by a CCP. It provides that an exchange may, with the approval of SEBI, transfer the duties and functions of a clearing house to a recognised CCP for the purpose of the periodical settlement of contracts and differences thereunder, and the delivery of, and payment for, securities. It obliges SEBI to approve such transfer if it is in the public interest or in the interest of the trade. It further provides that only a company can be recognised as a CCP and its bye-laws need to be approved by SEBI. The various provisions in the SCRA such as grant and withdrawal of recognition, supercession of management, suspension of business, *etc.* as applicable to stock exchanges shall, *mutatis mutandis*, apply to CCPs. Thus, CCPs are subjected to the same regulatory framework as the stock exchanges are. The information pertaining to ownership, board and management structure of CCP is publicly available. The ownership and financial information is available with statutory and regulatory authorities. There is a clear separation in the reporting lines between risk management and other operations of the CCP. While there is no independent risk management committee, the risk group reports to the MD and CEO of the organisation. A comprehensive risk management framework as stipulated by SEBI is followed by CCPs. Besides this, CCP also has its own risk management norms and an online surveillance system for robust risk management. The Board has constituted committees comprising members having the requisite skill-sets, knowledge and experience in various fields related to capital market and business carried on by the CCP. The reporting lines between Management and the Board are clear and direct. The Board is responsible for selecting, evaluating and, if necessary, removing senior management. The constitution of the Board of the exchanges is in accordance with the SEBI prescribed norms[19]. The trading member-directors have the necessary skills of their core business; the independent directors have experience

[19] Refer to footnote 13.

	in the field of accountancy, law, management and information technology. The CCP is maintaining the prescribed norms under corporate governance and the deliberations and the policy decisions are taken in the interest of the investors. Objectives are well-laid-down. There is a professional organisational structure in place regarding the job and responsibilities at various levels. There is an effective MIS reporting system. Also, regular reports of various developments are sent to SEBI. The participants and public are informed of various development through the circulars/press releases and website updation.
Assessment	**Observed**
Recommendation 14	**Transparency:** A CCP should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using its services.
Description	All relevant information is available to the participants in rules, regulations and bye-laws of CCPs as well as the exchanges through their various circulars/press releases/publications and website updation. The information and other details are regularly reviewed for their accuracy and completeness.
Assessment	**Observed**
Recommendation 15	**Regulation and Oversight:** A CCP should be subject to transparent and effective regulation and oversight. In both a domestic and an international context, central banks and securities regulators should co-operate with each other and with other relevant authorities.
Description	CCP falls within the purview of SEBI which regulates various intermediaries and SROs in the capital market. SEBI is the securities regulator and relevant authority for CCP. However, the Reserve Bank also has some supervisory jurisdiction in respect of certain policies that have a bearing on them. SEBI and the Reserve Bank have evolved a framework for co-operation. CCP has clearly defined rules, regulations and bye-laws for its clearing members[20]. The objectives and responsibilities as well as roles and major policies of SEBI are clearly defined by way of various Acts/Regulations and disclosed to public in electronic as well as hard copies, in English. These are also displayed on the website of SEBI. Regulatory and oversight activities have a sound basis with a statute-based approach where specific tasks, responsibilities and powers are assigned to respective market participants. The exchange provides data

[20] Refer to footnote 15.

	with respect to clearing, settlement, participant default, *etc.* to SEBI on a monthly basis. No operations of the CCP are outsourced. SEBI has also laid-down directions which the clearing and settlement system must satisfy such as establishing linkages with depositories, arrangement for T+2 rolling settlement, EFT, establishment of Guarantee Fund, *etc.* SEBI conducts annual or routine inspection of CCPs which include inspection of settlement system, risk management, *etc.* The exchanges are also required to conduct system audit of clearing and settlement and risk management system and submit periodical report including compliance report to SEBI. There is a regulatory requirement that a minimum of 20 per cent of the active clearing members should be inspected every year to verify their level of compliance with various rules, bye-laws and regulations of the exchange and CCP.
Assessment	**Observed**

Annex VII

Discussion Paper

Regulatory Framework for Clearing Corporation

Recent Reforms

1. The Clearing and Settlement (C and S) system in India has seen several innovations during the last decade, though some of them are yet to permeate to the entire market. The innovations in the C and S include use of the state-of-the-art information technology in the C and S, compression of the settlement cycle, T+2 rolling settlement, securities lending and borrowing, professionalisation of trading members, fine-tuned risk management system, multilateral netting, emergence of clearing corporation (CC) to assume counterparty risk, real time gross settlement/ electronic fund transfer facility, limited straight through processing, 100 per cent electronic trading which obviates the need for trade confirmation, finality of settlement from the moment trade is executed, delivery versus payment, dematerialisation and electronic transfer of securities, almost 100 per cent settlement in demat form, *etc.* These have improved the efficiency of C and S in India considerably and Indian securities settlement system (SSS) substantially complies with the international standards such as International Securities Services Association (ISSA) Recommendations 2000, CPSS-IOSCO Recommendations 2001, and G30 Recommendations 2003.

Historical Perspective

2. The Securities Contract (Regulation) Act (SCRA), enacted in 1956, dealt with trading of securities and governance of exchanges. It considered C and S as an integral part of trading. The members of the exchanges, called brokers, acted as trading-cum-clearing members. They knew each other and traded and settled trades among themselves. The SCRA did not explicitly provide for C and S, which was left to be dealt with by the bye-laws of the exchanges. The bye-laws generally provided for clearing houses and the exchanges traditionally set up departmental clearing houses to facilitate settlement. All exchanges, except National Stock Exchange of India Ltd. (NSE), use clearing houses to clear and settle trades.

3. With the advent of the anonymous screen-based trading system, which does not allow participants to assess the counterparty risk of others, and in the interest of better risk management through novation and counterparty guarantee, the modern markets started using the services of a clearing corporation for C and S. Besides, unbundling of activities made economic sense with the exchanges and CCs specialising in trading and clearing, respectively. While many exchanges modified the structural design of the clearing house to address the emerging concerns, NSE set up a wholly-owned subsidiary to provide C and S services. It, however, continued to have trading-cum-clearing membership which allowed brokers to trade on exchange and settle the trades through CC. Its bye-laws suitably provided for use of CC for C and S of its trades. Thus, both the models of C and S, namely Clearing House and Clearing Corporation, are in use today within the extant legal framework in the cash segments of exchanges.

4. A regulatory requirement segregated the trading and clearing functions in the derivatives segment with introduction of derivatives trading in 2001. Though derivatives segment uses both the models of C and S – Clearing House and Clearing Corporation – the trading members and clearing members trade and settle respectively in the derivatives segments, as against the brokers in cash segments who provide integrated trading and clearing services.

5. The Securities Laws (Amendment) Act, 2004 enacted on 7th January, 2005 inserted a new section in the SCRA to provide for C and S by a CC. It provides that an exchange may, with the approval of SEBI, transfer the duties and functions of a clearing house to a recognised CC for the purpose of the periodical settlement of contracts and differences thereunder, and the delivery of, and payment for, securities. It obliges SEBI to approve such transfer if it is in the public interest or in the interest of the trade. It further provides that only a company can be recognised as a CC and its bye-laws need to be approved by SEBI. The various provisions in the SCRA such as grant and withdrawal of recognition, supercession of management, suspension of business, *etc.* as applicable to stock exchanges shall, *mutatis mutandis*, apply to CCs. Thus, the CCs are subjected to the same regulatory frameworks as the stock exchanges are.

6. The said amendment Act also mandated corporatisation and demutualisation of stock exchanges under a scheme of corporatisation and demutualisation approved by SEBI. All the schemes approved by SEBI provide that the trading members shall clear and settle trades till the C and S functions are transferred to a recognised CC.

7. These changes in law provide for segregation of broking into trading membership and clearing membership and an enabling framework for C and S of trades through a CC. However, the amended Act states that various provisions in the SCRA shall apply to CC as they apply to an exchange. These provisions empower the Central Government to frame rules in respect of the exchanges. By implication, the Central Government needs to frame rules in respect of the CCs, as these have been done for exchanges. Similarly, the CCs need to frame bye-laws as has been done by the exchanges to provide for operational details. The provisions in the Rules to be made by the Central Government under the SCRA and the bye-laws to be made by CCs and approved by SEBI would constitute the regulatory framework for CC. This paper proposes the principles to be followed in evolving the framework.

Principles for CC

8. It is proposed to follow the following principles for evolving the regulatory framework for the CC:

A. Competition: It may not be necessary that each stock exchange must have its own exclusive CC. Since it involves huge infrastructure, many exchanges may not be able to set up and operate an exclusive CC. It is, therefore, proposed that a stock exchange may use the services of a CC for all its segments or different CCs for different segments and a CC may cater to the requirements of a particular segment/all segments of one or more exchanges. The law should enable more than one Clearing Corporation to provide option to exchanges and bring in competition among CCs. The exchanges should be free to use the services of any Clearing Corporation and Clearing Corporations may similarly be free to provide their services to any exchange. Apart from the scale economy, such an arrangement will allow the CC to have an overall view of the gross exposure position of clearing members across the exchanges and will be much better geared to manage the

risk. However, given the nature of business (networking) and use of IT in the operations of CC, C and S operations may tend toward monopoly. Since such monopoly situation is desirable and unavoidable to some extent, the concerns arising from such situations need to be addressed through governance standards for these entities.

B. Conflict of Interest: It is necessary that the ownership and management of CC are so structured that it eliminates any kind of conflict of interests. The exchanges should have only trading members while the CCs have only clearing members. The role of clearing members of the CC and trading members of the exchanges clearing through the clearing members of the CC in the ownership and management of the CC needs to be restricted or regulated. However, the exchanges should continue to be responsible for market safety and integrity. They should continue to ensure safe and efficient clearing and settlement, but through a clearing corporation. In view of the importance of clearing and settlement to the exchanges, at least 51 per cent of equity stake of Clearing Corporations should be held by exchanges. The CC and the exchanges clearing through the CC should be governed by contractual relations. The role of the regulator may only be to ensure that the terms of contract are fair, transparent and non-discriminating.

C. Risk Management: A well-designed CC with appropriate risk management systems reduces the risk faced by participants and contributes to financial stability. Although a CC has potential to reduce risks to market participants significantly, it also concentrates risk and responsibility of risk management. It, therefore, needs to have adequate resources, systems and skilled people to manage the risks. Among others that may be prescribed by SEBI, Clearing Corporations shall have a net worth of at least Rs.100 crore.

Provisions in the Rules

9. Based on the above principles, the following provisions are proposed with respect to the regulatory framework for CCs:

A. Recognition of CCs

a. It would be unlawful for any CC to operate in the market unless recognised in accordance with the Rules.

b. Clearing Corporations should be recognised in the same manner as exchanges are recognised by SEBI.

c. The validity period of recognition should be determined by SEBI.

d. The recognition should be refused or withdrawn following a procedure similar to that in respect of an Exchange.

e. SEBI would not grant recognition to any company to operate as a CC unless it is satisfied that it has a minimum net worth of Rs. 100 crore.

f. Before granting or renewing recognition of a CC, SEBI shall satisfy itself that the CC is a fit and proper person; it has automatic data processing systems protected against unauthorised access, alteration, destruction, disclosure or dissemination of records or data; it has secured network for continuous electronic communication among the constituents (Exchanges, clearing members, Depositories and Clearing Banks); and it has .the infrastructure and operational design and other requirements in place to discharge efficiently the C and S functions.

g. The CC shall maintain a Settlement Guarantee Fund to provide a cushion for any residual risk in the settlement process.

h. Since CCs need to have dedicated resources to meet the exigencies of settlement, it would not ordinarily undertake any other activity which can have contagion effect on the adequacy of its resources. However, it may be allowed to take up other activities not related to securities settlement with prior approval of SEBI.

i. The clearing members and trading members of its constituent exchanges together shall not hold more than 49 per cent of equity capital of the CC.

j. SEBI will have the right to inspect the books and records, the operational standards and any other relevant matter including action in case of non-compliance and default, similar to that in respect of an exchange.

B. **Regulation of Clearing Members (CM)**

a. Exchanges should have only trading members and Clearing Corporations should have only clearing members.

b. It would be unlawful for any CM to operate in the market unless registered by SEBI in accordance with the Regulations.

c. Clearing members should be registered by SEBI in the same manner as clearing members in derivative segment are registered today.

d. The registration should be refused or cancelled following a procedure similar to that in respect clearing members in derivative segment of an exchange.

e. Only corporate entities shall be allowed to become clearing members. The existing non-corporate brokers of exchanges may be allowed to become clearing members initially subject to the condition that they would become corporate entities within one year of the commencement of operations of Clearing Corporation.

f. For registration of a CC, SEBI shall follow the similar criteria as is followed with respect to registration of clearing members in derivative segments.

g. Clearing Corporations should act as the first level regulator in respect of their clearing members and for regulating business of clearing and settlement. They should also be responsible for inspection, disciplinary action and dispute resolution.

h. SEBI will have the right to inspect the books and records, the operational standards and any other relevant matter, including action in case of non-compliance and default.

i. Suitable amendments need to be made in the SEBI Regulations for registration, regulation and supervision of trading members of Exchanges and clearing members of clearing corporations, simultaneously with the amendment of SCR Rules.

C. Bye-laws for CCs

The CC would frame the bye-laws to govern the business operations, which shall be approved by SEBI. The bye-laws of Clearing Corporations should include the subjects mentioned in section 9 of

the SCRA to the extent relevant, including the power of Clearing Corporation to levy and recover fees, fine and penalties. In particular, the bye-laws of CCs would have following elements:

a. the criteria for admitting exchanges to clear and settle the trades executed on them,

b. the types of transactions and the securities to be cleared through the CC and the manner of their settlement,

c. the eligibility criteria for admission, the code of conduct and rights and responsibilities of clearing members,

d. the standard of business operations and the manner of interface between exchanges, custodians, depositories, clearing banks and clearing members,

e. the pattern and use of default resources such as settlement guarantee funds,

f. maintenance of books of accounts and records, submission of Reports to SEBI, appointment of compliance officer, *etc.*

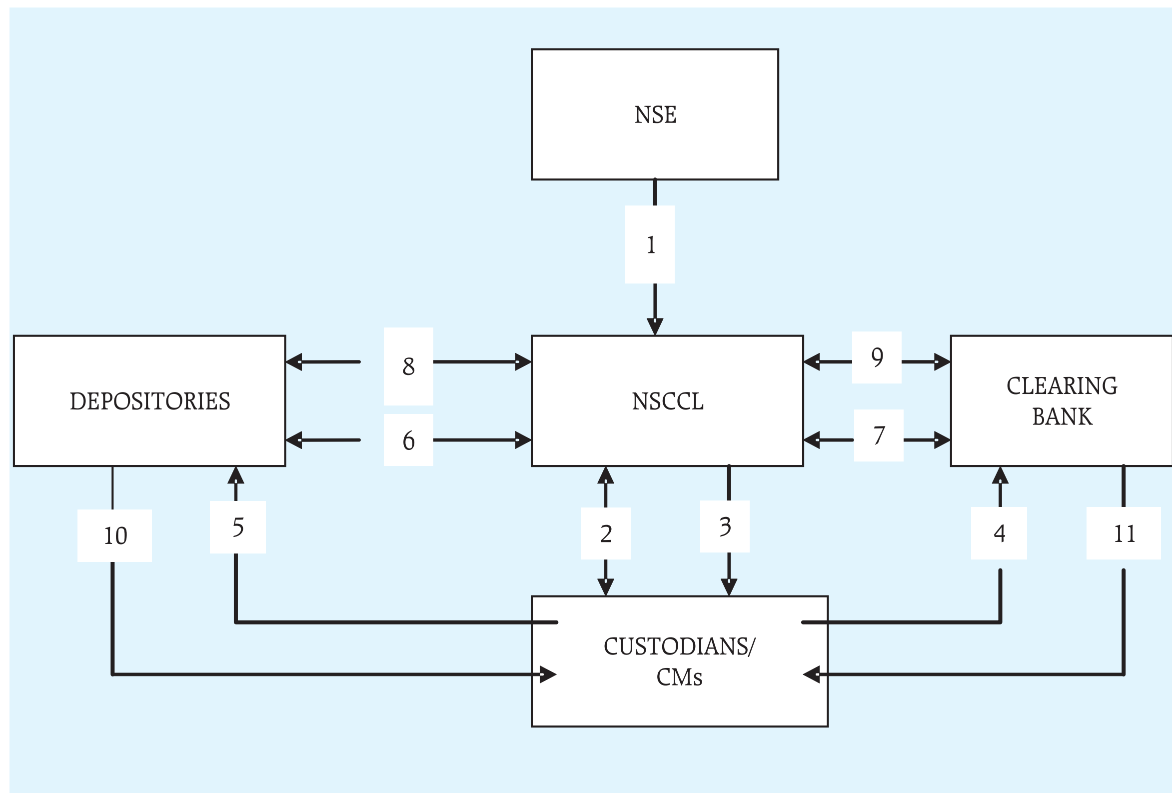
g. the risk management norms and the operational parameters for clearing members, procedures for ensuring finality of settlement like auction close-out and securities borrowing and lending mechanism,

h. procedure for arbitration and declaration of defaulters, *etc.*

Source: Ministry of Finance.

Annex VIII

Process Flow Chart Relating to Clearing and Settlement at NSCCL

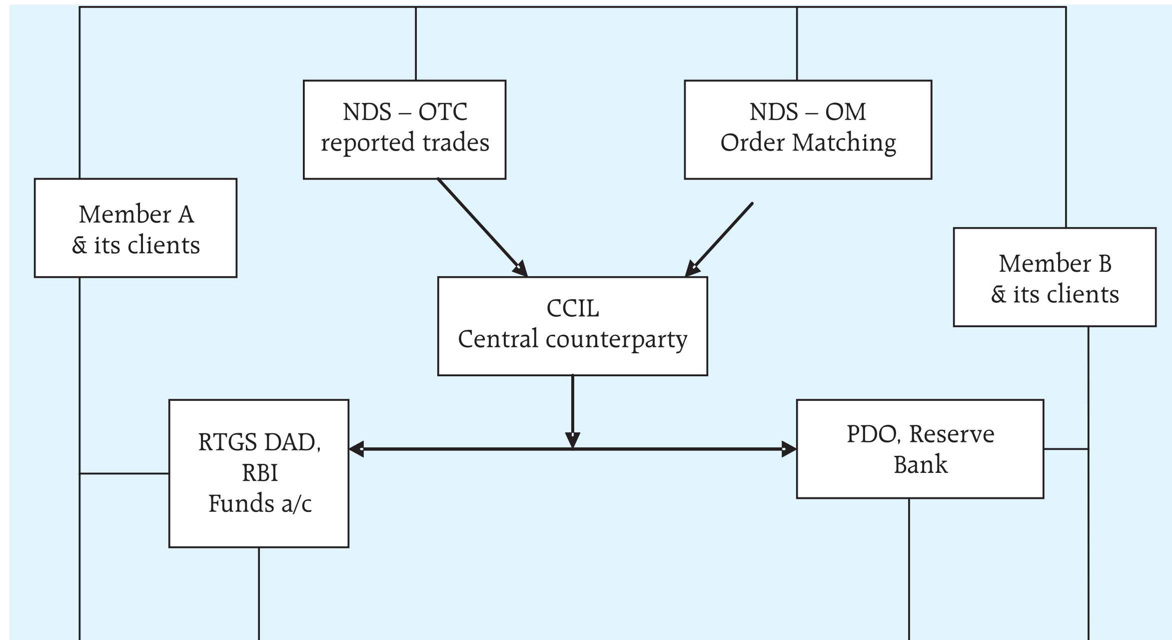


1. Trade details from exchange to NSCCL (real-time and end-of-day trade file).
2. NSCCL notifies the consummated trade details to clearing members/custodians who affirm back. Based on the affirmation, NSCCL applies multilateral netting and determines obligations.
3. Download of obligation and pay-in advice of funds/securities.
4. Instructions to clearing banks to make funds available by pay-in time.
5. Instructions to depositories to make securities available by pay-in time.
6. Pay-in of securities (NSCCL advises depository to debit pool account of custodians/CMs and credit its account and depository does it).
7. Pay-in of funds (NSCCL advises clearing banks to debit account of custodians/CMs and credit its account and clearing bank does it).

8. Pay-out of securities (NSCCL advises depository to credit pool account of custodians/CMs and debit its account and depository does it).
9. Pay-out of funds (NSCCL advises clearing banks to credit account of custodians/CMs and debit its account and clearing bank does it).
10. Depository informs custodians/CMs through DPs.
11. Clearing Banks inform custodians/CMs.

Annex IX

Process Flow Chart – Clearing and Settlement of Government Securities Transactions



1. The government securities transactions can be dealt either OTC or on Order –Matching (OM) platform on NDS (Negotiated Dealing System) of the Reserve Bank. All OTC transactions are reported in the NDS within 15 minutes of the conclusion of the transactions.
2. All these transactions flow electronically to CCIL for clearing as CCIL acts as central counterparty.
3. The net settlement obligations are worked out by CCIL and communicated to members.
4. Settlement file containing the details of net obligations of members on securities and funds is electronically sent to the Reserve Bank.
5. Securities' pay-ins are effected at PDO, Reserve Bank and funds pay-ins are posted at RTGS, Reserve Bank. On completion of pay-ins, pay-outs take place at DAD and PDO, respectively, ensuring DvP settlement. In case of any failure in pay-ins, settlement file is sent back to CCIL and CCIL re-works the pay-ins and pay-outs.
6. The members take settlement responsibility for their clients' transactions.
7. Some members are also using their settlement banks' fund account at RTGS, DAD for settlement in multi-modal settlement mode.
8. PDO acts as the depository to the government securities in the Reserve Bank.
9. DAD in the Reserve Bank maintains the current account of banks.

Annex X

Payment and Settlement Systems
A Peer Review of the Advisory Panel Report

By Greg Johnston

Introduction

It is clear from reading the Assessment Report that there has been some quite significant progress in the development of Indian financial market and payment system infrastructure since the first FSAP review was conducted in India in 2001. I believe that this latest self-assessment of systemically important systems by private and public sector officials is a very useful process, and one which will no doubt lead to further improvements in the risk management, efficiency and other features of these systems. The completed Assessment Report will also provide a very useful information reference point for participants in Indian financial markets and payments systems, as well as their international peers.

Because this note is yet to be considered by the Assessment Panel, and other stakeholders in systemically important systems, it is possible that I may have inadvertently included some factual errors in my comments. Please accept my apologies in advance, if this is the case. I would be happy to correct them once my comments have been reviewed.

Some points on the material covered in the draft Report, and its structure, are set out below.

General Comments

1. Structure of Report

To enhance the clarity of the Report, and ensure that detailed information relevant to each system's assessment is set out in as few places as possible, I would suggest a slightly amended structure for the Report as follows:

- Section 1: Purpose of the Report, summary of its structure and a short description of the information contained in it.
- Section 2: A short explanation of the standards against which Indian systems are being assessed and a brief history of previous assessments of systemically important systems in India.
- Section 3: A high-level overview of the current structure of Indian payments and financial market infrastructure, and the role, or roles, played by each system (see point 2 below for some additional comments on this issue). This section would also highlight the operational links between various systemically important systems, and summarise the broad responsibilities and powers of relevant regulators.
- Section 4: A summary of the assessment results for each system against the relevant international standard. This would point out the strengths of the current arrangements, as well as areas where further work is required to fully comply with standards. Further operational challenges, or areas for future policy development, could also be mentioned. However, factual information describing system functions and operations should either be in section 3 (for high-level information) or in the detailed assessments of the systems in the annexes.
- Section 5: The various appendices setting out the detailed assessment of each

system against the relevant standards. To add sufficient detail to back up fully the assessments made of each system against the relevant standards, it is probably necessary to assess each system individually rather than do a combined assessment for groups of systems.

To implement the above structure, a key change would be to bring forward the general information about the operational aspects of various systems in section 4 of the Report. For example, in sections 4.1 and 4.3, the summary information relating to the High Value Cheque Clearing System and the Clearing Corporation of India Ltd could be brought forward to section 3. Similarly, in section 4.3, the description of the securities and funds settlement arrangements for equities markets could be moved to section 3.

It would also be useful to briefly describe in section 3 some of the important operational connections/dependencies between the various systems in India. For example, it seems that the RTGS System is used to settle interbank obligations arising in the High Value Cheque Clearing System, as well as some other deferred net payments systems and cash obligations arising between the Clearing Corporation of India Limited and its members. The payment systems that are used to transfer funds between market participants and central counterparties participating in equities and other securities related settlements could also be mentioned in section 3.

In section 3.2.1 '(ii) Equities Market', it would be helpful to add a brief description of the National Stock Exchange's (NSE's) clearing and settlement operations, as data for this exchange is subsequently quoted in a table in this section and in the more detailed assessment annexes.

Stance of the Panel: The Report has been recast as per the format suggested by the peer reviewer.

2. Clarification of System Responsibilities

A somewhat sharper distinction between the functions of the various systemically important systems identified in the Report would aid the subsequent analysis of each system's compliance with relevant standards. It would also help readers with less specialist knowledge of payments and financial market infrastructure to quickly understand the roles the various systems undertake. This could be done early in the Report by updating some of the drafting in Section 3.

Stance of the Panel: The functions of the SIPS has been explained in more detail in Section 3 of the Report.

I have summarised in Table 1 below my understanding of the functions of the legal entities or systems providing high-value electronic payments services, central counterparty clearing and securities settlement services to various financial markets. In some cases, a particular system or legal entity performs more than one function. This is not unusual, but it is important to be clear about the role being assessed, so that the right standard is applied to it. For completeness, I have also included trading systems in Table 1, as they are mentioned on occasion in the Report, as well as depositories, as they are quite important for securities settlement arrangements.

The definitions of the various functions identified on the left hand side of Table 1 are as follows:

- ***Trading System***: an electronic system which enables its members to establish a binding contract for the sale/purchase of an asset (*e.g.*, securities or foreign exchange) or a right, obligation or option (*e.g.*, in relation to a derivatives contract). Where an electronic trading system does not exist, over-the-counter (OTC) trading is the standard alternative.
- ***Central Counterparty Clearing***: A central counterparty interposes itself between the original trade counterparties and becomes the buyer to the seller and the seller to the buyer. The usual result of this is that the central counterparty provides an associated settlement guarantee to each original counterparty and, therefore, takes on credit and market risks ahead of settlement. It also nets obligations between itself and its members and provides associated risk management services. Some operators of central counterparty systems also provide settlement services (see definition below). However, this is a quite separate function from that of a central counterparty. For risk control reasons, a majority of central counterparties serving securities markets are separate legal entities from the provider of settlement arrangements.[21]
- ***Payments System***: provides the necessary legal, operational and other requirements for its members to send and receive non-cash payments. These payments may be either settled on a real-time gross settlement (RTGS) basis or a deferred net basis.
- ***Securities Settlement***: a system or set of arrangements which provides the legal, operational other requirements for market participants, including central counterparties, to transfer ownership of securities using a book entry process (*i.e.*, to complete the contractual obligations established in a trading system or an over-the-counter market). The asset used to pay for securities is usually commercial bank or central bank money. The provision of settlement services can include providing the necessary facilities to enable trade counterparties to match trades. A securities settlement system, particularly for debt securities markets, may also provide depository services (see below).
- ***Depository***: an institution which allows the ownership of securities to be transferred by book entry (*i.e.*, without the need to move security certificates). This requires that securities are either held in dematerialised form or immobilised. The providers of this service can also provide registry-related functions such as managing maturity and interest payments on behalf of security issuers.

3. Systemically Important Payments Systems

The RTGS System in India is clearly a systemically important payments system. Based on Table 1 in the Assessment Report, the RTGS System settles nearly 50 per cent of the value of non-cash payments. It is also used as a means of settling obligations in other clearing systems (including obligations generated by financial market transactions).

Following the introduction of the RTGS System in 2004, it could be argued that the High Value Cheque Clearing System (HVCCS) is no longer a systemically important payment

[21] It is not uncommon for the separate companies providing central counterparty and securities settlement services to be owned by the same parent company.

Table 1: Summary of Systemically Important Payments Systems, Central Counterparties and Securities Settlement Arrangements in India

	High Value Payments	Foreign Exchange	Government Securities	CBLOs	Equities	
Trading System	N/A	OTC	NDS and NDS Order Matching	Trading system (operated by CCIL)	NSE	BSE
Central Counterparty Clearing	No central counterparty	CCIL	CCIL	CCIL	NSCCL	BSE/BOISL
Payments System	RTGS System	RTGS System and New York based settlement bank	RTGS System	RTGS System	RTGS System and other payments systems?	RTGS System and other payments systems?
Securities Settlement	N/A	N/A	PDO		NSCCL	BOISL
Depository	N/A	N/A	PDO	CCIL*	NSDL and CDSL	

* Securities held in the Gilt Accounts of CCIL.
OTC: Over-the-counter trading (*i.e.*, no electronic trading system).
N/A: Not Applicable (*i.e.*, for high-value payments or foreign exchange trading and settlement).

system. Based on data set out in Table 1 of the Report, it clears around 11.5 per cent of the value of non-cash payments and the HVCCS does not seem to be used to settle obligations arising out of other payments or securities settlement systems. Moreover, it is very difficult for even the best designed paper-based payment system to comply fully with the Core Principles (*e.g.*, because it is difficult to impose binding settlement obligation limits on clearing members in real time and, as a result, it is very difficult to control the settlement risk associated with payments exchanged across these systems and guarantee finality of payment).

Nevertheless, high-value cheques are exchanged across the HVCCS and the value of cheque payments could conceivably increase quite significantly in some circumstances. An assessment of the HVCCS's compliance with the Core Principles is therefore a useful way of considering whether unmanaged or inappropriate risks remain in this payment system. A longer-term policy question is whether the HVCCS should be phased out as usage of RTGS payments becomes more widespread.

In summary, only the RTGS System and, if desired, the HVCCS need to be assessed in

detail against the Core Principles for Systemically Important Payments Systems. Generally, references to central counterparties or settlement system arrangements only need to be made to the extent that it is material for making the case that the RTGS System (or HVCCS) complies with a particular Core Principle.

Stance of the Panel: The Panel has accepted the peer reviewer's suggestion and only RTGS system and High Value Clearing System have been identified as SIPS.

4. Assessment of Other Systemically Important Systems

The Clearing Corporation of India Limited (CCIL), the National Securities Clearing Corporation Ltd (NSCCL) and the Bombay Stock Exchange (BSE) all seem to act as central counterparty clearing systems. While it is true that these systems are systemically important, they do not look to meet the general definition of a systemically important payments system. Rather, as central counterparties, they are users of payments system services in order to meet their cash-related settlement obligations and to call in margin payments and other funds as part of their risk management activities. It would, therefore, be better to place the detailed assessments of the quality of these systems' various legal, risk management, governance and other arrangements against the relevant standard set out in Recommendations for Central Counterparties.

Equally, the assessment of various securities settlement arrangements in India should be assessed against the CPSS/IOSCO Recommendations for securities settlement systems. For equities, the settlement arrangements look to be a combination of the actions of central counterparties (*e.g.,* NSCCL), the depositories (NSDL and CDSL) and banks (for sending/receiving equity-related cash payments). For Government of India securities, the settlement arrangements look to be a combination of the functions of Public Debt Office (PDO) and the RTGS system.

Stance of the Panel: The Panel has accepted the peer reviewer's suggestion and CCIL, NSCCL and BSE are assessed only against the CPSS-IOSCO standards for CCPs.

5. Legislation Underpinning Settlement Finality and Netting

It is clear from the Assessment Report that legislation supporting the legal certainty of settlement finality in systemically important payments systems, and netting in financial markets, is in the process of being implemented. This is a very important step and critical to being able to make a strong and unqualified case that the RTGS System, central counterparties and net securities settlements comply with key international standards (*e.g.,* Core Principles 1 and IV for the RTGS System, and Recommendation 1 of the central counterparty standards for the CCIL). I strongly support the implementation of such legislation.

I understand that the Payment Systems and Netting Act is expected to be notified in the coming months. In addition to providing legal certainty for RTGS payments and netting, it will also set out the Reserve Bank of India's oversight responsibilities and powers in the payments system. Given the importance of these changes, it may be worth considering delaying the final release of the Assessment Report so that they can be incorporated fully in the assessment of Indian systems' compliance with international standards.

Stance of the Panel: The Payment and Settlement Systems Act has since been notified and the Report has been amended suitably.

6. Central Counterparties and Elimination of Credit Risk

Central counterparties can provide significant benefits to a market. Aside from enabling anonymous trading, they can generate

liquidity savings arising from netting and introduce sophisticated risk management procedures (*e.g.*, stress-testing, counterparty credit limits, margins, and settlement guarantee funds). However, while they standardise, and hopefully significantly reduce counterparty credit risk in a market, central counterparties do not entirely eliminate credit risk for their members[22]. This needs to be recognised in any assessment of the benefits and costs of central counterparties (*e.g.*, in the description section of Recommendation 4 – **Annex IV**). If this recognition is lacking, the discipline imposed on a central counterparty by its members routinely assessing their credit risk may be lost.

The release of a Report summarising stress-test results to a central counterparty's members may help them to assess the extent of their exposure to a central counterparty. However, the need to maintain the confidentiality of members' trading positions would need to be considered as part of this process. The underlying assumptions of a central counterparty's stress-testing methodology should also be released to its members (as recommended in section 5.2 of the Report), along with its general risk management policies and procedures.

The central counterparty's risk management policy could also be released publicly. However, the benefits of releasing detailed stress-testing results to the public are less clear and, in times of market turbulence, this might be counterproductive.

Stance of the Panel: The Panel has accepted the peer reviewer's suggestion and a recommendation to this effect has been added in the Report.

7. Other comments

Some other comments on the assessments and recommendations included in the Report are set out below:

- In the recommendations flowing from the assessment of the CCIL (covered in section 5.1), it is not completely clear whether the CCIL's potential inability to settle its obligations as they fall due if its largest member fails arises because of insufficient settlement guarantee fund and other assets, a potential lack of liquidity for some of its assets, or both. Arranging an additional line of credit may be of assistance if liquidity is the problem. However, if there are insufficient assets in the settlement guarantee fund, and other sources of funds, an additional line of credit may not be enough in itself to enable the CCIL to settle all of its obligations. For example, the line of credit may be withdrawn by the bank offering it if there is doubt as to the CCIL's solvency.

Stance of the Panel: The inability to settle in this case refers to the liquidity risk arising due to the shortage of line of credit facility.

- In section 5.1 of the Report, dealing with completion of daily settlements, there is a comment that settlement risk in high

[22] An exception to this general rule would arise in circumstances where some form of government or central bank guarantee was given to the central counterparty. However, such guarantees are not considered to be appropriate because of the 'moral hazard' issues which would arise.

value deferred net settlement systems is addressed though a mechanism of partial unwind. It is not clear whether this comment applies to all deferred net systems covered in the Report, or just the HVCCS or CCIL.

Stance of the Panel: Partial unwind is applicable only in the case of High Value clearing and the recommendation has been amended suitably.

- I support the recommendation that the CCIL should be able to impose a cap on the aggregate exposure it takes against its members, as well as member credit limits for each transaction category novated to it.
- To ensure participants are able to settle their Government securities trades in the event that novation through CCIL is not possible, the introduction of a model 1 DvP settlement option for secondary market trades and repos in Government securities could be considered by the Reserve Bank. If CCIL is not a party to a Government security trade (*e.g.,* because novation to it would breach a member credit limit it has imposed), it is not essential that CCIL be involved in the settlement of the trade.

Stance of the Panel: The Panel agrees with the comments of the peer reviewer.

- The clearing and settlement of foreign exchange (FX) trades through a central counterparty is not something that is routinely observed in other countries. In most instances, these transactions are settled directly between trade counterparties, and their correspondent banks, using high-value payments systems that comply with the Core Principles. The size of the FX market in developed economies is usually significantly larger than debt securities and equities markets. Aside from the size of FX transactions, settling participants can also be exposed to foreign exchange settlement risk. These characteristics can generate significant challenges for a central counterparty's risk management arrangements, which would need to be carefully assessed.

Stance of the Panel: The Panel agrees with the comments of the peer reviewer.

- The recommendation in section 5.1 to review and perhaps increase the value of committed lines of credit available to the CCIL in the event of a member failure seems to be a worthwhile step. However, the liquidity of a central counterparty's resources is a separate issue to whether the overall size of these resources is sufficient given the risks it is taking on. It is therefore important that CCIL stress-test the adequacy of the total value of resources available to it (*e.g.,* margins, other contributions by members, its own capital and perhaps loss sharing), and establish a clear and transparent framework within which these resources can be increased in the event that stress-test outcomes indicate that existing resources are inadequate.
- On page 10 of the Report (section 3.1.1), it is noted that the five systemically important payments systems (SIPS) identified in the Report are being operated and managed by the Reserve Bank. However, information on CCIL's website indicates that it is owned by banks, financial institutions and primary dealers. If so, this comment in the Report may need to be amended to make clear that CCIL is privately owned and operated.

Stance of the Panel: The Panel has accepted the peer reviewer's comments and the Report has been amended suitably (para 3.6.1).

Specific Comments on Compliance with Various Standards

The following sections set out some more specific comments on the detailed assessments

of the various payments, central counterparty and securities settlement systems' compliance with the applicable international standards. Given the scope of the assessments and systems covered, I have not covered all of the issues that could be relevant to a particular assessment.

Core Principles for Systemically Important Payments Systems

Core Principle I

As noted above, it is very important that there be no legal uncertainties associated with the finality of completed payments in systemically important payments systems. However, it is also important that SIPSs' regulations specifically identify the point at which a payment is considered to be final, and therefore receives the benefit of this legislative certainty. It might be helpful to refer to the specific regulation(s) for the RTGS System and the HVCCS that identify this point of finality in the commentary on Core Principle I.

The Report notes that the Reserve Bank provides liquidity to RTGS System participants via collateralised lending. It would be helpful to briefly explain in this section the types of collateral which are eligible and the legal underpinnings of these transactions under Core Principle I. For example, does India's insolvency legislation, and the rules of the relevant securities settlement system or depositories, support the Reserve Bank's right to collateral provided by an insolvent RTGS system participant? It would also be relevant to note whether the security charge over the collateral is updated in real time by the relevant depository.

For the HVCCS, the legal certainty of participants' multilateral net settlement positions is also very important. This, along with final same-day settlement, gives surviving banks confidence that settled multilateral net obligations against a failed bank will not be reviewed, and potentially unwound, by a court after they have given their account-holders access to cheque deposits. It is not clear from the description and comments relating to Core Principle I whether the Payment and Settlement Systems Act will also ensure the legal certainty of multilateral netting in the HVCCS, or other payments systems which settle on a deferred net basis. Some additional detail in this section of the document might be useful.

Stance of the Panel: The RTGS (Membership) Regulations 2004 and RTGS(Membership) Business Operating Guidelines, 2004, identifies the finality of payments. In case of High Value clearing, finality of payments will be defined by the Payment and Settlemnet Systems Act, 2007. The liquidity facility is explained in Section 3. The Payment and Settlement Systems Act provides for finality of settlement of Multilateral net settlement systems.

Core Principle II

The description in this section could be extended to provide some additional information on:

- The roles and responsibilities of various participants in the RTGS System and the HVCCS. This could include the Reserve Bank's abilities as the RTGS system operator (*e.g.*, for extending operating hours during a contingency, issuing directions to RTGS System members, changing rules under notice to participants), along with participants'

responsibilities in relation to meeting operational, contingency and other requirements (*e.g.,* ensuring that their settlement accounts at the Reserve Bank do not go into overdraft).

- The rules which apply to collateralised lending in the RTGS system, and whether this lending can be extended overnight if required;
- The rules and arrangements which apply to HVCCS settlement (*e.g.,* multilateral net or file-based gross settlement, when settlement occurs, and through what system clearing banks' obligations are settled).
- Any important links between the smooth operation of the RTGS System and other systems (*e.g.,* securities settlement/ depository systems that are used to keep track of the securities that RTGS System participants have pledged as collateral), and how these are dealt with in the regulations.

Stance of the Panel: As the details on the roles and responsibilities of various participants in the RTGS and HVCCS are given in detail in The RTGS (Membership) Regulations 2004 and RTGS (Membership) Business Operating Guidelines, 2004 and the Uniform Regulations and Rules for Bankers' Clearing House (URRBCH), respectively, these are not included in the Report. The links between RTGS Systems and other systems is included in Section 3 of the Report .

Core Principle III

The lack of legal certainty about the finality of completed payments is a consideration in relation to the RTGS System's effectiveness in enabling its participants to control their credit risk. The potential for some RTGS System payments to be unwound may need to be recognised if legislation supporting finality is not effective at the time the final Assessment Report is released. A short summary of the way in which the RTGS System, and its rules, ensure that members of the RTGS System cannot complete a payment without sufficient settlement funds would be useful in the detailed assessment of this Core Principle.

Some additional detail on the following matters would be helpful to make the case that the RTGS System allows its members to understand and control their liquidity risks:

- the way in which RTGS System participants can obtain intra-day, and if needed, overnight liquidity from the central bank;
- the way in which RTGS System members are able to manage their payment queues (*e.g.,* can they promote some payments to a 'priority' status while deferring others); and
- if applicable, any incentives build into the system for members to process their payments on a timely basis (*e.g.,* by the use of variable transaction fees depending on when a payment is completed, or throughput guidelines for RTGS System members)

Some additional detail on any assessment criteria based on creditworthiness or prudential regulation could also be included in the description section for this Core Principle.

The last paragraph in section 4.5 of the Report mentions that the HVCCS settles on a same-day basis. If this system is assessed against the Core Principles, it would be worth mentioning this again in the detailed assessment for Core Principle III, along with the specific time, or times, at which this settlement usually takes place. It would also be useful if the description in this section briefly mentioned the rules and arrangements which would apply in the event that one of the clearing banks in the HVCCS failed to settle.

Stance of the Panel: The Panel accepts the suggestions and these are incorporated in the assessment of RTGS.

Core Principle IV

See my comments above in relation to legislation underpinning settlement finality and netting.

In relation to the HVCCS, it is clear from section 4.1 of the Report that cheques are exchanged between 12 noon and 12.30 pm, with unpaid returns being processed from 3 pm to 3.30 pm. It would be helpful to note when the inter-bank obligations arising from these exchanges are settled, and whether the rules of the HVCCS clearly define the point at which high value cheques are not able to be returned by either drawee or beneficiary banks. The Report also notes that same-day withdrawals are allowed at branches with extended working hours or ATMs. If settlement for these high value cheque exchanges does not occur on the same day across the books of the Reserve Bank, the beneficiaries' banks could be exposed to settlement risk (ie because they have given 'good value' to their customers without receiving settlement funds from the drawee bank). Core Principle (CP) IV notes that SIPS should have prompt settlement on the day of value. If next day settlement occurs, this would mean that the HVCCS does not comply with CP IV on a strict assessment.

Stance of the Panel: It is clarified that the clearing and settlement of HVCCS is held on the same day. The settlement is not moved to the next day.

Core Principle V

In the comments section, it might be better to cover matters relevant to CCIL's ability to ensure settlement in the event of its largest participant failing under Recommendation 5 of the central counterparty standards (Annex III in the Report).

In relation to high-value cheque clearing, the long term policy objective should be to use the RTGS System for all payments that require within-day finality.

A brief reference here to the point at which payments are said to be final in systemically important payments systems' regulations might be useful in the discussion of this Core Principle.

Stance of the Panel: The Panel accepts the suggestion of the peer reviewer. The Panel notes that it is the policy of the central bank to progressively move all High Value clearing to RTGS/NEFT systems.

Core Principle VI

I note that, in some cities, obligations arising from HVCCS payments are settled across the books of banks in which the Government of India holds a majority shareholding. While these banks retain a government-based credit rating, the settlement asset used is acceptable. Nevertheless, a more standard arrangement internationally is for obligations between high-value payments system participants to be settled in central bank money. If same-day clearing of high value cheques is to continue in the long run, the Reserve Bank might wish to consider moving these remaining cities to central bank-based settlement arrangements using the RTGS System.

Stance of the Panel: The assessment of High Value clearing covers this suggestion.

Core Principle VII

Some additional detail on the RTGS System's existing and planned back-up arrangements would be useful in this section. For example, does the current 'on-city' back-up

site fully replicate core hardware and software, does this back-up site use different power sources from the primary site, is there real-time mirroring of transaction and other RTGS System data to a back-up source? Some information on the degree to which formalised contingency plans are in place and tested could also be added in the assessment of compliance with this Core Principle.

Stance of the Panel: This suggestion has been incorporated in the assessment of RTGS.

Core Principles IX and ***X***

Some additional details on the membership requirements for the RTGS System could be added in the description of Core Principle IX. For example, do members need to be prudentially supervised, or locally incorporated, or meet minimum operational requirements (*e.g.,* in ensuring that there is no or limited 'down time' in their ability to send/receive RTGS payments during the day).

It would also be useful if additional details could be set out on the way in which the RTGS System is governed, the way in which it disseminates decisions to RTGS System participants, and the way in which system participants are involved in discussing operational and other issues.

Stance of the Panel: The additional details on the membership of RTGS are explained in the RTGS (Membership) Regulations 2004 and RTGS (Membership) Business Operating Guidelines, 2004. Hence, these are not reproduced in this Report.

Responsibility A

The commentary for this responsibility indicates that the Reserve Bank has published a document outlining its role in the payments system and its policy objectives; the Report also notes that the RTGS Regulations and Rules are published on the Reserve Bank's website. It is possible that the Reserve Bank may have complied fully with this responsibility even if it does not, as yet, have an explicit legislative responsibility for payments system oversight.

Stance of the Panel: The comments of the peer reviewer have been accepted by the Panel.

Recommendations for Securities Settlement Systems

Recommendation 1 – Legal Basis

The description in Annex II of the Report dealing with the NDS may need to note that there is uncertainty at present with respect to some aspects of the settlement process for Government securities:

- the settlement finality of cash settlements processed through the RTGS System is somewhat uncertain until the Payment Systems and Netting Act is notified;
- the certainty of netting of Government securities' trades to the CCIL also requires legislative support (this, in turn, may adversely affect the central counterparty's ability to control its credit risk during a time of financial stress/volatility); and
- It is not clear from the discussion what additional uncertainties might be removed by the notification of the Government Securities Act.

The implications of these uncertainties may mean a reassessment of the 'observed' assessment for this recommendation if the above legislation is not effective before the final Report is published.

Stance of the Panel: The Payment and Settlement Systems Act and the Government Securities Act have since been notified.

Recommendation 2 – Trade Confirmation

For equities settlements, a reference to when indirect participants confirm trade obligations with a trading member would add additional weight to the 'observed' assessment for this recommendation.

Stance of the Panel: The suggestion has been accepted and the detailed assessment of equities settlement has been amended (Annex V).

Recommendation 3 – Settlement Lag

In **Annex IV**, dealing with equities settlements, there is a reference to shortening the settlement cycle to T+1 or introducing same-day settlement. Generally speaking, shorter settlement cycles reduce the duration of counterparty credit risk. However, one potential disadvantage of a very short settlement cycle for equities markets is the potential to increase the number of settlement failures. This is particularly the case where international custodians are participating in a market, or may do so in the future. If the existing settlement cycle is to be significantly shortened, consultation may be required with market participants to make sure this risk is controlled.

Stance of the Panel: The Panel has noted the suggestion made by the peer reviewer.

Recommendation 7 – Delivery Versus Payment

Delivery versus payment is achieved when final transfer of ownership of securities occurs if, and only if, final payment occurs (and *vice versa*). If this condition is not in place, participants in the settlement process are exposed to 'principal risk'.

In the case of equities settlements it seems that, as a first step, cash and securities are paid into a bank account or securities account held by the relevant central counterparty. Once all of the inward transfers are made, the central counterparty then sends cash and securities to the direct participants that are owed these assets. In **Annex IV**, the assessment description for Recommendation 8 notes that transfers of equity securities in depositories are considered to be final at the time they are made. Cash transfers sent to a central counterparty would have the same status if sent via the RTGS System.

From these settlement arrangements, it is clear that market participants no longer have a direct exposure to each other. However, from the settlement steps set out in the Report, it is less clear what would happen if doubt arises as to the central counterparty's solvency part way through the settlement process. At one level, members would have the protection of the central counterparty's risk management arrangements (*e.g.,* settlement guarantee and margin funds). However, if these protections failed, there is still a distinct question as to whether DvP is in place.

For DvP to be in place, the settlement rules and operational procedures that apply in a market should ensure that market participants cannot irrevocably transfer title to securities to a central counterparty without receiving a final transfer of the funds they are owed (and *vice versa*).

For Government securities, it would be helpful if a more detailed outline of the steps involved with transferring funds and securities could be given. Once again, the key point to make against recommendation 7 is how these steps, and the associated regulations in the CCIL, the NDS and the RTGS system ensure market participants are not exposed to principal risk.

Recommendation 12 – Protection of Customers' Securities

In Annex II, it is noted that the Government Securities Act will, when notified, ensure that ownership of dematerialised

securities held with custodians will rest with the beneficial owners in the event of the custodian's insolvency. However, it is less clear what the current legal position is with respect to these securities. If there is some doubt that ownership of these securities would rest with the beneficial owners at the time the Report is finalised, the assessment of this recommendation for Government securities may need to be reconsidered.

Stance of the Panel: As the Government Securities Act has been notified, a reconsideration of the assessment is not considered necessary by the Panel.

Recommendations for Central Counterparties

Recommendation 1 – Legal Risk

The discussion in Annex 3 for CCIL notes that the notification of the Payment Systems and Netting Act will provide legal certainty for multilateral netting between CCIL and its members. However, earlier in the Report, it also notes that the Government Securities Bill will provide legal certainty for dematerialisation of securities. In the context of the CCIL's use of Government securities as collateral, it is not clear whether the current lack of certainty on dematerialisation also applies to the certainty with which it can access/use its Government security collateral, if required. This general issue is also relevant to the assessment in recommendation 3 and 5 of the central counterparty standards.

From the assessment of central counterparties in the equities settlement systems in **Annex V**, is seems that the legal certainty of multilateral net positions against a failed member is provided by the SCR Act rather than the Payment Systems and Netting Act. If so, it may be worth while explicitly stating this, given that the assessment of all systemically important systems will be published together.

Stance of the Panel: As the Government Securities Act has been notified, it covers the acceptance of government securities as collateral.

Recommendation 2 – Participation Requirements

In Annex III, it might be useful in sections dealing with membership requirements to include a few more specific details relating to CCIL's access policy. For instance, does the CCP apply any requirements in respect of its members' credit ratings, capital or other financial resources? Are participants subject to ongoing monitoring and, if so, what form does such monitoring take? Also, are there any requirements in respect of operational capacity? The CCP's policy in the event that one of its members falls below the required threshold for participation could also be included.

The NSCCL assessment provides more information – for instance, some information is provided on credit-worthiness criteria for access – but more detail could be provided in respect of the nature of review processes and the range of sanctions that can apply if a participant fails to meet the stated requirements.

Stance of the Panel: As details on the membership requirements are available in the bye-laws, rules and regulations of CCIL, this is not elaborated in the Report.

Recommendation 5 – Financial Resources

In the assessment of this recommendation, a high-level outline of the various financial resources available to the CCP (both in total asset value and liquidity terms) could be set out as evidence of its adequacy to deal with the insolvency of one of its members. The breakdown might usefully distinguish between margin and participant contributions, a CCP's own capital, lines of credit and insurance. It might also describe the order in which risk resources would be called in the event of a participant default.

Currently, the CCIL assessment gives a broad overview of the categories of financial resources available in respect of each cleared instrument, but the relative magnitudes of each asset class is less clear. It is implied that separate

risk resources are held for each product line, but this is not entirely clear.

Recommendation 7 – Central Counterparty Asset Investments

I note that NSCCL and BOISL are able to invest their settlement guarantee funds in units of debt scheme mutual funds and fixed interest securities. It would be helpful to make clear the minimum risk ratings required for these assets. Also, while the size of funds under management can be an issue determining the liquidity of an asset, it is not the only factor that a central counterparty can take into account in determining appropriate investment assets.

Recommendation 9 – Money Settlements

For equities settlements, it might be better to explicitly identify the payment system (or systems) used by approved clearing banks to transfer settlement moneys between clearing members' accounts. From the description, it seems that the RTGS System is used for this purpose. However, are other payments systems used?

In the case of CCIL, more detail would be useful on the settlement process for each of the cleared instruments. For instance, in G-Sec, do all of CCIL's members have accounts at the Reserve Bank, or do they settle via a network of settlement banks? And at what point does finality occur? For settlement of cleared foreign exchange trades, does the process deliver payment-versus-payment?

Stance of the Panel: The cash leg of equities settlement is done through RTGS, NEFT or HVCCS and this has been added in the Report.

Chapter VI

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Chapter VI

Assessment of Effective Insolvency and Creditor Rights Systems

1. Introduction

This Report seeks to assess the adherence to the existing standards and codes in respect of creditor rights and insolvency systems as framed by the World Bank and prepare an assessment Report.

The key standards for creditor rights and insolvency are yet to be issued by the World Bank, which is co-ordinating a broad-based effort to develop a set of principles and guidelines on insolvency regimes[1]. Even though it has prepared a revised draft of the 'Principles and Guidelines for Effective Insolvency and Creditor Rights Systems' in 2005, the draft is yet to be reviewed by its Board. Meanwhile, the United Nations Commission on International Trade Law (UNCITRAL) has prepared a 'Legislative Guide on Insolvency Law (2004)' to help foster and encourage the adoption of effective national corporate insolvency regimes. Thus, at present, no detailed and contemporary standards have been formulated by the World Bank for the insolvency regime. However, it had collated the international best practices regarding insolvency and creditor rights, and produced a document titled 'Principles and Guidelines for Effective Insolvency and Creditor Rights Systems' (2001) in connection with the programme to develop 'Reports on the Observance of Standards and Codes' (ROSC). This document was used for a series of experimental country assessments by the World Bank. The Principles of 2001 consist of 35 principles broadly dealing with the areas relating to legal framework for creditor rights (Principles 1 to 5), legal framework for insolvency (Principles 6 to 16), features pertaining to rehabilitation (Principles 17 to 24), informal corporate workouts and restructuring (Principles 25 and 26) and implementation of the insolvency system (institutional and regulatory framework) (Principles 27 to 35).

After deliberations, the Panel decided that the present assessment should be undertaken based on the Revised Principles issued by the World Bank in 2005. The Handbook on Financial Sector Assessment (FSAP Handbook) of the World Bank and International Monetary Fund (IMF) was also used as a reference.

2. Principles for Effective Insolvency and Creditor Rights Systems

The Principles and Guidelines for Effective Insolvency and Creditor Rights Systems, 2005 (Revised Principles) issued by the World Bank is an improvement on the Principles of 2001, based on the experience gained by country assessments conducted by the World

[1] As per the Financial Stability Forum website.

Bank relying on those principles. Inputs for the revised Principles came from a variety of sources including the UNCITRAL Legislative Guide on Insolvency Law, the Forum on Asian Insolvency Reform, Forum on Insolvency in Latin America and International Association of Insolvency Regulators.

The Revised Principles have been categorised into four parts – Part A dealing with Legal Framework for Creditor Rights (consisting of five principles), Part B dealing with Risk Management and Corporate Workouts (consisting of five principles), Part C dealing with Legal Framework for Insolvency (consisting of 15 principles) and Part D on the Institutional and Regulatory Frameworks (consisting of eight principles). Each principle is further sub-divided into many sub-principles. The term 'insolvency' as used in the Principles and the FSAP Handbook covers both the provisions relating to liquidation as well as restructuring.

An attempt has been made here to examine the existing legal framework in respect of each sub-principle while trying to identify the gaps, if any, and an assessment has been made, with recommendations to bridge those gaps. The assessment of compliance with the Revised Principles has been made in the light of the provisions of the Companies Act, 1956 the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) the Provincial Insolvency Act, 1920 and the Presidency Towns Insolvency Act, 1909, as may be applicable. The assessment contained in the table annexed deals with mainly corporate insolvencies (both liquidation as well as rehabilitation). Apart from this, this Report has also examined the aspects of liquidation and rehabilitation of banks in the light of the observations made in the FSAP Handbook.

3. Recommendations of Earlier Committees on Insolvency Laws

3.1 High-level Committee on Law Relating to Insolvency of Companies (Justice Eradi Committee)[2]

The High Level Committee on Law Relating to Insolvency of Companies was set up by the Central Government under the Chairmanship of Justice Eradi in 2000. This Committee not only considered the existing provisions of Part-VII of the Companies Act, 1956 but also other relevant laws that had a bearing on the subject, such as the, Recovery of Debts due to Banks and Financial Institutions Act, 1993, UNCITRAL Model Law on Cross-border Insolvency approved by the United Nations and the International Monetary Fund Report on 'Orderly and Effective Insolvency Procedures'.

The Eradi Committee recommended that the provisions of Part VII of the Companies Act, 1956, be amended to include the provisions for setting up of a National Tribunal which would have

(a) the jurisdiction and power presently exercised by Company Law Board under the Companies Act, 1956;

(b) the power to consider rehabilitation and revival of companies – a mandate

[2] The Committee had submitted its Report on July 31, 2000 recommending major amendments to the Companies Act and repeal of SICA.

presently entrusted to the Board for Industrial and Financial Reconstruction/ Appellate Authority for Industrial and Financial Reconstruction under SICA; and

(c) the jurisdiction and power relating to winding-up of companies presently vested with the High Courts.

It was recommended that the Tribunal should be vested with the power to transfer all proceedings from one private liquidator to another 'private liquidator' or to the 'Official Liquidator' (OL), as the circumstances of the case may require and also to direct, at its discretion, the sale of business of the company as a going concern or the sale of assets in a piecemeal manner. The Committee recommended suitable amendments to the Constitution for enabling the setting up of National Tribunals. The Committee further recommended the creation of a panel of professional insolvency practitioners (like chartered accountants, company secretaries, advocates, *etc.*) and their appointment in the liquidation proceedings, the omission of Chapter IV of the Companies Act dealing with 'winding-up subject to the supervision of the Court', the adoption of the UNCITRAL Model Law on Cross-border Insolvency, and the creation of a rehabilitation fund. The fund would provide for revival and rehabilitation and for preservation and protection of assets of companies under the supervision and control of the Government.

It also recommended that companies be required to contribute a specified portion of their turnover to the above Fund. Further, it suggested that the creditors could approach the Tribunal for winding-up of a company only if the company defaults in payment of undisputed debts exceeding Rs.1 lakh and in other cases of default, creditors' voluntary winding-up should be resorted. The liquidator would not seek the sanction of the court except for important matters such as confirmation of sale of assets and distribution of proceeds realised. There would be a two-point criteria for determining the maintainability of the reference for revival and rehabilitation of a company to the Tribunal, namely, that the company has suffered erosion of 50 per cent of its net worth or there is a debt default involving a sum of not less than Rs.1 lakh in respect of undisputed debts.

3.2 Advisory Group on Bankruptcy Laws (Mitra Group)[3]

An Advisory Group on Bankruptcy Laws was constituted (under the Chairmanship of Dr. N. L. Mitra) by the Standing Committee on International Financial Standards and Codes set up by the Reserve Bank with the objective of identifying and monitoring the developments in global standards and codes pertaining to various segments of the financial system. The Mitra Group examined the recommendations of the Eradi Committee whose major suggestion was for a separate comprehensive bankruptcy code. However, the Mitra Group was of the view that separate Tribunals were not required. It recommended a separate bankruptcy bench in each High Court, and that professionals like chartered accountants (CA), company secretaries (CS), law firms, *etc.* should be empanelled and appointed as trustees to deal with insolvency proceedings. The Group agreed that the international standards, including the UNCITRAL Model law on Cross-border Insolvency should be incorporated in Indian laws and recommended for time-bound bankruptcy proceedings and giving time-frames for each portion of the proceedings. The Group further recommended adherence to the priority of claims as presently laid down under the law.

3.3 Expert Committee on Company Law (Irani Committee)[4]

An Expert Committee on Company Law (under the Chairmanship of J. J. Irani) was

[3] The Advisory Group had submitted its Report on May 9, 2001.

[4] J.J. Irani Committee had submitted its Report on May 31, 2005.

constituted by the Central Government to advise on the 'new company law'. While examining provisions of the new company law, the Irani Committee also examined the provisions regarding winding-up and rehabilitation of companies. It stated that the law should impose a prohibition on the unauthorised disposition of the debtors' assets and also a suspension of actions by creditors to enforce their rights or remedies against the debtors' assets for a limited prescribed period to preserve and protect assets besides maximising its value, so as to facilitate unobstructed conduct of insolvency process by the Tribunal without having to deal with complexities of multiple creditor actions in Debt Recovery Tribunals (DRTs). It further observed that on an average, a time-frame of two years should be feasible for the liquidation process to be completed, and that a period of one year should be adequate for rehabilitation process from commencement of the process till the sanction of a plan. There should also be a definite time-limit within which proceedings may commence from the date of filing of the application for rehabilitation.

The Committee recommended that the general insolvency process should apply to all enterprises or corporate entities including small and medium enterprises except banks, financial institutions and insurance companies, which could have their own special insolvency regimes, as these are systemically important for the stability of the financial sector. As regards stay of connected proceedings, the Committee was of the view that such prohibitions should not be automatic and should be on Tribunal's order on a specific application with approval of majority creditors in value and that the Tribunal should have adequate power to lift or modify the prohibition in case the circumstances so warrant. The Committee recommended that the insolvency process be administered by a qualified administrator (empanelled professionals) appointed by the Tribunal in consultation with the secured creditors with board authority to administer the estate in the interest of all stakeholders. It further recommended the constitution of separate committees for secured and unsecured creditors, and favoured the appointment of independent experts as valuers for the valuation of the assets of a business under liquidation. Further, public interest and government claims should not get precedence over private rights in the insolvency process. The Committee noted that, consequent to the Companies (Second Amendment) Act, 2002 a provision had been made for the levy of a rehabilitation cess, to be charged on the basis of turnover. The Committee was of the view that this resulted in efficient firms being penalised to the benefit of inefficient ones. The Committee, therefore, recommended the repeal of this provision. It proposed the creation of a Fund to which companies may contribute, on their own option, and use the funds (in the proportion of each company's contribution) when that particular company was in need of rehabilitation. The Committee also recommended the adoption of the Model Law on Cross-border Insolvency.

4. The Companies (Second Amendment) Act, 2002

The Central Government accepted majority of the recommendations of the Eradi Committee and, consequently, the Parliament passed the Companies (Second Amendment)

Act, 2002 amending the provisions of the Companies Act, 1956. The following were the major changes:

- The constitution of a National Company Law Tribunal (NCLT) to exercise and discharge such powers as are available to the High Court/Board for Industrial and Financial Reconstruction (BIFR)/Company Law Board. National Company Law Appellate Tribunal (NCLAT) is also proposed to be constituted as an appellate tribunal over NCLT. NCLT/NCLAT will comprise of experts/professionals. Any person aggrieved by any decision of the NCLAT may file an appeal in the Supreme Court.
- Part VIA (Sections 424A to 424L) has been introduced in the Companies Act to deal with revival and rehabilitation of sick industrial companies, which, once brought into effect, will replace the provisions under SICA in this regard. NCLT has been empowered to consider the rehabilitation and revival of a sick industrial company on a reference being made to it by the Board of Directors of such companies. NCLT will replace the BIFR functioning under SICA. NCLT to have flexibility to consider revival/ liquidation of a company.
- Introduction of provisions for levy by way of cess and formation of rehabilitation and revival fund, application of such fund, penalty for non-payment of cess and refund in certain cases.
- Provision for appointment of the liquidator from a panel of professionals like CA, CS, *etc.* Even a body corporate consisting of such professionals as may be approved by the Central Government may be considered for appointment as the liquidator. NCLT should give due regard to the views or opinion of the secured creditors and workmen while appointing the liquidator.
- NCLT to have powers to remove the OL on sufficient cause being shown and to proceed against the OL for professional misconduct.
- Section 457 (2A) empowers the liquidator to appoint security guard to protect the property of the company, appoint valuer/ chartered surveyor or CA to assess the value of the company's assets and give advertisement inviting bids for sale of the assets.

A Division Bench of the Madras High Court[5], however, found certain provisions of the Companies (Second Amendment) Act, 2002 relating to constitution of the Tribunals to be defective and in breach of the basic constitutional scheme of separation of powers and independence of judicial function and held those provisions to be unconstitutional. An appeal against the said decision is pending before the Supreme Court of India, since 2004.

5. Insolvency Law Framework for Banks

5.1 Views of Committees

Mitra Group and Irani Committee recognised that the insolvency process as applicable to the general corporate sector should not be made applicable to banks, financial institutions and insurance companies as the insolvency of banks and other financial institutions affect the domain of the monetary system and management and has implications for stability of the financial system.

5.2 General Issues in Bank Insolvency Proceedings and the Indian Legal Framework

5.2.1 General Issues in Bank Insolvency Proceedings

The World Bank-IMF Principles also recognise the need for giving a separate

[5] Thiru R. Gandhi, President, Madras Bar Association v. UOI [2004] 120 Comp Cas 510 (Mad).

dispensation to financial institutions and insurance companies[6]. The FSAP Handbook mainly refers to two types of insolvency regimes, *viz.*, (i) bank insolvency regime[7] and (ii) the general corporate insolvency regime[8]. In Appendix G to the FSAP Handbook, the 'General Issues in Bank Insolvency Proceedings[9]' on banking insolvency has been discussed. It says that there is no dominant model for bank insolvency and that a country's choice will depend on a variety of institutional, legal and practical factors, including the quality and effectiveness of the country's existing corporate insolvency legislation, the ability of insolvency courts to reach decisions in the short time-frame available for bank restructuring, the skills and integrity of the judiciary in comparison with the banking authorities, and the quality of supporting professions such as accountants and lawyers[10].

General Issues in Bank Insolvency Proceedings states that a special bank insolvency regime (in particular, an administrative one) can be designed to ensure speed and consistency between the supervisory and insolvency-related functions[11].

The FSAP Handbook suggests that the legal mandates and functions of each of the official agencies and authorities involved in the resolution of insolvent banks such as the central bank, the supervisory agency, the deposit insurance agency, and the Ministry of Finance should be clearly delineated in a manner that avoids gaps or overlaps[12]. The independence of the supervisory authority[13] (regulator) has been emphasised.

According to the General Issues in Bank Insolvency Proceedings[14], the regulator would be in a better position to initiate bank insolvency proceedings because of the systemic implications of a bank's insolvency and for prohibiting the initiation of proceedings by frivolous/malicious creditors against solvent banks. Even in cases where proceedings are initiated by a party other than the supervisory authority, it has been recommended that the supervisory authority should have a say in the proceedings, including a right to participate in all the proceedings. The supervisory authority (or any person proposed by it) could also be eligible for appointment as the official administrator and/or the liquidator. The

[6] See Principle 9 (A).

[7] This system of insolvency regime deals with the insolvency of banks alone. Two types of bank insolvency regimes have been discussed in Appendix G to the Handbook – (i) special regime (Could be either administratively implemented by the bank supervisor or initiated by the bank supervisor but under the jurisdiction of Courts) and (ii) the general law adapted for bank insolvency (generally implemented by the Courts).

[8] This system of insolvency regime deals with the insolvency of companies and institutions other than banks, where the insolvency proceedings are invariably conducted in the Courts.

[9] http://web.worldbank.org/wbsite/external/wbi/wbiprograms/fslp/0,,contentMDK:20656885~pagePK:64156158~piPK:64152884~theSitePK:461005,00.html

[10] See paragraph G.3.1 of Appendix G to the Handbook.

[11] See paragraph G.3.2 of Appendix G to the Handbook.

[12] Annex 5.A to Chapter 5 of the FSAP Handbook.

[13] Referred to as 'banking authorities' in the guidelines.

[14] See paragraph G.3.3 of Appendix G to the Handbook.

supervisory authority would have full access to the insolvent bank's records and be entitled to submit restructuring proposals, raise objections on proposals submitted by other parties and participate in all hearings and meetings of shareholders and creditors. It is also to be ensured (both in the administrative system as well as the Court-implemented system) that the bank supervisor's margin of discretion should be respected and Court/tribunal should not be allowed to substitute its own policy decisions for those of the supervisor. Therefore, the review mechanism would be confined to the legality of the actions of the supervisor and would not go into the merit of the decision.

Laws should grant legal protection for bank supervisors and their staff members to fulfil their responsibilities. However, such protection, would have to be coupled with the provisions concerning accountability to prevent any abuse of power. The law should require the banking supervisors to be transparent (without compromising the confidentiality, wherever it is required) while implementing the bank insolvency. When confidentiality precludes open decision-making or disclosure of information, the executive branch of government would have to be given comprehensive information.

The FSAP Handbook states that the provisions relating to the liquidation of a bank's estate should ensure an immediate and effective protection of assets, including an automatic moratorium or suspension of all collection activity against the bank to prevent a race between creditors for the seizure of assets and to ensure the orderly realisation of assets and equitable distribution of proceeds. It is also of vital importance that the rules provide sufficient flexibility to enable the liquidator to achieve the realisation of assets in the most cost-effective way and that they ensure that proceeds are distributed to the various classes of creditors (including depositors) in a fair and transparent manner, which does not violate their relative priority. Some of the key principles to govern the legal and regulatory framework for bank liquidation are as follows:

- Bank shareholders must be held responsible for the losses of the bank. When a bank is found to be insolvent, the supervisory agency must be in a position to write down shareholder equity and to eliminate shareholder rights.
- The supervisory agency should be given the responsibility to establish the list of qualified liquidators.
- The supervisory authority must have the right to appoint a bank liquidator to replace the shareholders. The bank liquidator must have the authority to sell all or part of the bank's assets including branches.
- The law must determine the priorities for distributing resources from asset sales among creditors.[15]

There should be a sound legal basis for the exchange of information and co-ordination among all the public bodies involved and the law should not impede the sharing of information. The supervisory authority should have an obligation to keep other bodies informed. Where the insolvent bank operates in more than one national jurisdiction, the provisions should enable the supervisor to share information with their foreign counterparts. The mode of such co-operation could also be through arrangements between national authorities. There should be a duty on the part of the foreign counterpart receiving information to keep it confidential in accordance with the national legislations of the countries concerned.

5.2.2 Legal Framework for Bank Insolvency in India

In India, the law relating to regulation and supervision of banks, including their insolvency,

[15] Appendix G – FSAP Handbook

is contained in the Banking Regulation Act, 1949 (hereinafter referred to as 'BR Act'). In terms of Section 5 (b) of the BR Act, 'banking' has been defined as 'accepting, for the purpose of lending or otherwise, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise'. The term 'banking company' is defined in Section 5(c) of the BR Act as 'a company which transacts the business of banking in India', and for the purpose of the BR Act, the term 'company' includes a foreign company also. Therefore, any company which is doing the business of banking in India would be a bank. Apart from the 'banking companies' there are entities which are created by or under statutes, that do the business of banking, namely, State Bank of India (SBI), its subsidiary banks, nationalised banks and regional rural banks (RRBs), which have been empowered under their respective statutes[16], to carry on and transact the business of banking as defined in clause (b) of Section 5 of BR Act. In terms of section 56(c) of the BR Act, 'co-operative bank' means a State Co-operative Bank, a Central Co-operative Bank or a Primary Co-operative Bank and the provisions of that Act apply accordingly, enabling these banks to carry on the business of banking.

The stated object of the Act is the protection of depositors. The Indian legal framework for bank insolvency relating to liquidation contemplates a special regime of insolvency initiated by the Reserve Bank (either on its own or as directed by the Central Government), but under the jurisdiction of the High Court. Further, under the BR Act, no banking company can be voluntarily wound-up by the High Court unless the Reserve Bank certifies in writing that the company is unable to pay in full all its debts to its creditors as they accrue. A special regime for bank insolvency has been provided for in the BR Act, wherein a separate chapter has been provided for the speedy disposal of winding-up proceedings against banks. The grounds under which the Reserve Bank can file a winding-up petition against a bank has also been provided.

Further, the Reserve Bank has the power to suggest the person who is to be appointed as the liquidator for a banking company in liquidation (such a person could be from the Reserve Bank itself, SBI or any other bank notified by the Central Government on its behalf or any individual). The powers and duties of each authority including the Reserve Bank, the High Court, the Central Government, the Deposit Insurance and Credit Guarantee Corporation (DICGC) and the liquidator have been provided for in the legislations[17]. The Reserve Bank has been conferred the power to inspect the books of accounts of the bank under insolvency on being so directed by the Central Government or by the High Court. Further, the Reserve Bank is entitled to call for returns/ information from the liquidator. It has also been empowered to tender advice in the winding-up proceedings. The preferential payments to be

[16] Section 33 of the State Bank of India Act, 1955; Section 37 of the State Bank of India (Subsidiary Banks) Act, 1959; Sections 3(5) of the Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970 and 1980; Section 18(1) of the Regional Rural Banks Act, 1976.

[17] Banking Regulation Act, 1949 and Deposit Insurance & Credit Guarantee Corporation Act, 1961.

made out of the assets of the insolvent bank have also been specified in the law.

The BR Act provides for the passing of a moratorium order by the High Court, on an application by the banking company which is temporarily unable to meet its obligations, staying the commencement or continuance of all actions and proceedings against the company upto a maximum period of six months. However, the Reserve Bank can in such cases, make an application for winding-up of that banking company on the ground that its affairs are being conducted in a manner detrimental to the interests of depositors. The law has also provided for provisions for the public examination of directors and auditors who have caused loss to the banking company and provisions for assessing damages against delinquent directors, officers, liquidator, *etc.* of the insolvent banking company. As regards the legal provisions granting protection to the Reserve Bank and its staff, there are express provisions in the BR Act[18] and the RBI Act[19] granting protection to the Reserve Bank and its officers in respect of anything which is in good faith done or intended to be done under that Act.

As regards the insolvency regime in respect of the reconstruction of the banking company, the Indian legal framework (the BR Act) has provided for a special regime to be administratively implemented by the Reserve Bank/Central Government. The provisions of the BR Act provide for imposition of an order of moratorium in respect of a bank before its reconstruction/compulsory amalgamation by the Central Government on the application of the Reserve Bank, where there is good reason to do so.

The law provides for voluntary amalgamation at the instance of the banks[20] and compulsory amalgamation at the instance of the Reserve Bank[21]. Though voluntary amalgamations may be resorted to by banks for various reasons, one such reason could be avoiding the risk of insolvency. The Reserve Bank has been empowered to sanction such voluntary amalgamations. The compulsory amalgamation of a bank with another bank is based on a scheme prepared by the Reserve Bank and sanctioned by the Central Government. It is observed that after the imposition of moratorium on a failed banking company, generally, a scheme for amalgamation of such failed banking company with another banking institution is preferred rather than a scheme for reconstruction of the failed banking company. One of the reasons for this situation may be the inability of the existing promoters to infuse capital or to arrange for capital infusion from outside in accordance with the relevant guidelines of the Reserve Bank regarding ownership and 'fit and proper' criteria. Another reason could be the speed at which the amalgamation process is effected to pave way for a removal of the moratorium enabling depositors to access their accounts in the normal course[22]. Moreover, such provisions empowering the regulator to initiate compulsory amalgamation measures in case of failed banks enable the retaining of public confidence in the systems and avoid systemic risks. In view of the above position, even winding-up proceedings are rarely resorted to by the Reserve Bank. The law provides for reduction of shareholder's interests and rights in the banking company by providing for it in the compulsory scheme of reconstruction/amalgamation. Of late, private sector banks are showing keen interest in taking

[18] Section 54.
[19] Section 58 A.
[20] Section 44A of the Banking Regulation Act, 1949.
[21] Section 45 of the Banking Regulation Act, 1949.
[22] In the recent cases of compulsory amalgamations, the period of moratorium has been reduced drastically.

over weak banks through the process of amalgamation on account of various business considerations.

Due to the complexity of the Indian banking sector, the legal framework applicable to insolvencies of banks which are statutory corporations, nationalised banks and those in the co-operative sector, each has a set of different legal principles applicable to it. These are distinct from the principles discussed hitherto. The Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980 provide that a corresponding new bank (nationalised bank) can be placed under liquidation only by an order of the Central Government and in such manner as the Central Government may direct (Section 18). Section 9 of that Act, specifically empowers the Central Government to make schemes for the reconstitution/amalgamation/transfer of undertaking of a nationalised bank. As regards co-operative banks, the provisions of the BR Act, 1949 regarding winding-up/amalgamation[23] are not applicable, except for the imposition of a moratorium by the Central Government on an application by the Reserve Bank. The provisions of the respective co-operative societies' acts would be applicable for the purposes of liquidation and reconstruction/amalgamation of the co-operative banks. For example, the Gujarat Co-operative Societies Act, 1961 empowers the Registrar of Co-operative Societies to *suo moto,* or on an application from the society (based on a resolution approved by three-fourths of the members), make an interim order directing the winding-up of the society. The Registrar has the power to confirm such an interim order after giving an opportunity for a hearing to the society. The Registrar is entitled to appoint any person as the liquidator. The liquidator has *inter alia* the power to effect a compromise and institute an arrangement between the society and its creditors (Sections 108 and 110). However, in the case of an insured co-operative bank (insured with DICGC), winding-up can only be made with the previous sanction in writing of the Reserve Bank. Further, the Registrar has to make an order of winding-up if so required by the Reserve Bank (Section 115A). The Multi-State Co-operative Societies Act, 2002 deals with the winding-up of multi-state co-operative societies. The Central Registrar has the power to direct the winding-up of such co-operative societies (Section 86). The Central Registrar is required to make a winding-up order if so required by the Reserve Bank in respect of multi-state co-operative societies covered by the DICGC Act, 1961. In the case of State Bank of India[24] and its subsidiary banks[25], the said banks may be placed under liquidation only by orders of the Central Government and in the manner directed by it.

5.3 Assessment of Bank Insolvency Issues in India

The Indian legal framework for the insolvency of banking companies is in substantial compliance with the emerging international standards espoused by World

[23] Part III.

[24] Constituted by Section 3 of the State Bank of India Act, 1955.

[25] Governed by the State Bank of India (Subsidiary Banks) Act, 1959.

Bank-IMF. However, one major area in which there are no clear legal provisions in respect of bank, insolvency is the formal legal mechanism for sharing information with other regulatory bodies and overseas regulators, and the extent of co-operation between them. Further, the priority of the claims of the DICGC over other creditors also needs to be unambiguously clarified by the insertion of an appropriate provision in the DICGC Act, 1961 expressly providing that the claims of DICGC will have priority over those of other creditors (including those creditors mentioned in sections 531 and 529A of the Companies Act) during liquidation proceedings. The DICGC Act, 1961 extends only to the territory of India. Further, in terms of Section 2(g) of that Act, it would not be applicable to depositors of branches of Indian banks outside India. Under section 43A of the BR Act, which deals with preferential payments to depositors (including depositors not having insurance cover), the payment to be made by the liquidator in preference is not expressly restricted to depositors in India. Therefore, it is possible to take a view that depositors of branches of Indian banks outside India are also covered by that provision and consequently, such depositors may also be entitled to preferential payment. However, the treatment of assets of branches of Indian banks outside India during liquidation would, also be subject to the laws of the country in which they are situated. Further, the sum payable in preference under section 43 A to such an uninsured depositor is insignificant.

The failure of co-operative banks and the rescue measures in that sector continue to be areas of considerable concern mainly on account of issues like dual control of such co-operative banks by the Reserve Bank and State Governments. For example, in the case of a failure of a co-operative bank, unlike banking companies, the Reserve Bank's powers extend only to the stage of imposing a moratorium and insofar as the process of amalgamation thereafter is concerned, the powers are vested with the respective State Governments. The Co-operative Societies Acts of the respective States permit amalgamation of a co-operative bank only with another co-operative bank and not with any other entity. In actual practice, when co-operative banks are in financial difficulties, quite often they are placed under directions issued by the Reserve Bank imposing limitations on incurring liabilities and making payments including repayment of deposits. Although depositors are denied access to their deposits beyond a small limit during the pendency of such directions, which normally lasts for a few years, the insurance protection under the DICGC Act is also not available to them under such eventualities. Further, the co-operative societies Acts prevailing in certain States are not in conformity with the provisions of the DICGC Act for availing the deposit insurance cover. In the case of RRBs, amalgamation is permissible only with another regional rural bank in terms of Section 23A of RRB Act, 1976. Though in the Banking Regulation (Amendment) Act, 2005 that is pending before Parliament, it has been proposed that (i) only the co-operative societies that have been licensed by the Reserve Bank should be allowed to carry on the business of banking, (ii) the primary co-operative societies should be given a time-frame within which they have to either stop the business of banking or fulfill all the requirements specified by the Reserve Bank and obtain a license to carry on the business of banking and (iii) the Reserve Bank to be empowered to order a special audit of co-operative banks in public interest for a more effective supervision of co-operative banks.

There are no solvency issues in the case of public sector banks (including SBI and its subsidiaries) as the sovereign is the majority shareholder in these banks. The Central Government would take into account all factors

including the interests of depositors, banking policy, public interest, *etc.* even in the unlikely event of any order of winding-up being required to be passed. However, in the case of co-operative banks, there is a need for the involvement of the Reserve Bank in all the liquidation proceedings, since there is dual control over them[26].

The process of recapitalisation of public sector banks/RRBs in India has been a matter of debate. Recapitalisation was started in 1993-94 to enable nationalised banks to meet the prescribed capital to risk assets ratio (CRAR) and the gap created by the application of prudential accounting norms. Over the years, the total capital contributed by the Government amounts to around Rs. 21,400 crore or 1.8 per cent of GDP on a cumulative basis up to 2002-03, taking into account the capital returned by banks. Literature[27] provides comparative information on fiscal costs of restructuring of the banking system in other countries. The fiscal costs may broadly be defined in terms of gross cost to the public sector (outlays of Government and central bank on liquidity support; purchase of impaired assets; deposit payments; and recapitalisation through purchase of equity or sub-ordinated debt) and net cost to the public sector (gross outlays are netted against resources generated from the sale of acquired assets and equity stakes, and repayment of debt by recapitalised entities). These costs have been estimated to be substantially large. According to an estimate from 40 episodes of banking crises across countries, governments spent on an average 12.8 per cent of national GDP to clean up their financial systems (Honohan and Klingebiel, 2000 and 2003). The percentage was even higher (14.3 per cent) in developing countries, and in some cases entailed much larger outlays. For instance, the governments spent as much as 40–55 per cent of GDP in the crises in Argentina and Chile in the early 1980s. Hoelscher and Quintyn (2003) provide an estimate of comparable fiscal costs across countries of various banking crises during 1981-2003. The costs have varied sharply, which ranged from small amounts (close to zero) in Russia and the United States to more than 50 per cent in Indonesia. The fiscal cost of banking crisis in select countries is given in Table 1.

It is a well-accepted principle that the subject matter should always determine the jurisdiction. This is to avoid any kind of regulatory overlap. In this regard, the Monopolies and Restrictive Trade Practices Act,1969 (MRTP Act) [Section 4(2)] had specifically excluded the applicability of that Act to banks in relation to matters in respect of which specific provisions exist in the RBI Act, BR Act, State Bank of India Act, 1955 (SBI Act) or State Bank of India (Subsidiary Banks) Act, 1959 (SBI (Subsidiary) Banks Act). The Competition (Amendment) Act, 2007 which has recently amended various provisions of the Competition Act, 2002 raises certain issues of serious

[26] By Reserve Bank and Registrar of Co-operative Societies.

[27] **References:** (i) Honohan, P. and Klingebiel, D. (2000): *Controlling Fiscal Costs of Banking Crises; World Bank Policy Research Working Paper No. 2441.* (ii) Honohan, P. and Klingebiel, D. (2003): *The Fiscal Cost Implication of an Accommodating Approach to Banking Crises; Journal of Banking and Finance.* (iii) Hoelscher, D.S. and Quintyn, M. (2003): *Managing Systemic Banking Crises; Occasional Paper; IMF.*

Table 1: Select Banking Crises and Fiscal Cost		
Country	**Year of Crisis**	**Fiscal cost (% of GDP)**
Argentina (I)	1980	55.1
Argentina (II)	1995	0.5
Australia	1989	1.9
Brazil	1994	13.2
Bulgaria	1996	13.0
Chile	1981	41.2
France	1994	0.7
Indonesia (I)	1992	3.8
Indonesia (II)	1997	50.0
Malaysia (I)	1985	4.7
Malaysia (II)	1997	16.4
Thailand (I)	1983	2.0
Thailand (II)	1997	32.8
Philippines (I)	1983	13.2
Philippines (II)	1998	0.5

Source: Honohan, P. and Klingebiel, D. (2003).

concern. Though Section 21A of the Competition Act provides for the Commission to make references to a statutory authority when the issue before it relates to an Act whose implementation is entrusted to that statutory authority, it is observed that the opinion of the statutory authority in such a case has not been given any binding effect on the Commission and the final decision has been left to the Commission. Going by the aforesaid principle, in respect of matters relating to banks, whose exclusive jurisdiction has been given to the Reserve Bank, it should have been left to the Reserve Bank to take the final decision in such matters and the opinion of the Commission could have been made an input for the Reserve Bank for decision-making. The provisions of the Competition Act, as amended, are likely to raise issues of regulatory overlap/conflict in future and pose a serious problem to the financial sector. Another area of concern for the financial sector is regarding the powers of the Commission to regulate mergers and acquisitions. With the growing realisation among banks and financial institutions that consolidation is essential and necessary for their existence and growth, and the fact that amalgamation is being used as an alternative to liquidation and reconstruction, the provisions of Competition Act are likely to become hurdles in the path of recovery of distressed banks. Under the provisions of Competition Act, every person or enterprise proposing to enter into a combination is required to give notice to the Commission before entering into a combination and wait for 210 days. Thus, the procedural requirements mandated under that Act as well as the wide powers conferred to the Commission even to nullify a combination, are likely to throw up issues of great concern to banks and financial institutions. Since voluntary amalgamation of banks under Section 44A of the BR Act, 1949 is at the instance of the banks concerned, it is apprehended that the aforesaid provisions may apply in such cases and consequently, it may become necessary for banks to give notice of proposal of voluntary amalgamation under Section 44A of the BR Act to the Commission and get the order of the Commission or wait for 210 days. The Reserve Bank may be able to consider giving sanction to the scheme of amalgamation only thereafter. This, apart from delaying the whole process, is also likely to raise regulatory conflicts. The position in the case of acquisition of business of other banks by SBI or its subsidiaries under Sections 35 and 38 respectively of SBI Act, 1955 and SBI (Subsidiary) Banks Act, 1959 is also not free from doubt. Since compulsory amalgamation under Section 45 of the BR Act is not at the instance of the banks and the scheme after being sanctioned by the Central Government is laid before both Houses of Parliament, a view can be taken that the aforesaid provisions of the Competition Act, regulating combinations, would not apply in such cases. The same view may also apply in case of amalgamations of nationalised banks under the schemes made by the Central Government in exercise of its powers under Section 9(2) of the Banking Companies

(Acquisition and Transfer of Undertakings) Acts, 1970 and 1980. However, considering the gravity of the matter and the repercussions it is necessary to have a serious look into the whole issue and if considered necessary, the Central Government may give exemption to banks under section 54 of the Competition Act.

In view of the complexity of laws involved, it may be appropriate to have a separate common and comprehensive insolvency code for banking institutions irrespective of the nature of entity involved, which is entirely different from the general insolvency code applicable to corporates, individuals, firms and societies. However, such a change would involve amendments to the Constitution[28] and other laws[29]. Further, while adopting the Model Law of Cross-border Insolvency, suitable clarificatory provisions should be inserted in the statute to the effect that the special insolvency regimes for banks and insurance companies would be outside its purview.

6. Insolvency of Insurance Companies and NBFCs

6.1 Insolvency of Insurance Companies

The provisions of the Companies Act, 1956 relating to winding-up are applicable to insurance companies, subject to the provisions of section 53 of the Insurance Act, 1938. Further, section 54 of the Insurance Act, 1938 prohibits the voluntary winding-up of a company except for effecting amalgamation or when it cannot continue its business by reason of its liabilities. Where the insurance business or any part of the insurance business of an insurance company (secondary company) has been transferred to another insurance company (principal company) under an arrangement, in pursuance of which the secondary company or its creditors have claims against the principal company, then if the principal company is being wound-up, it shall also commence (subject to certain conditions), the winding-up proceedings against the secondary company, unless otherwise ordered by the Court. Section 58 of the Insurance Act, 1938 enables part of the business of an insurance company to carry on, while the remaining part is wound-up. However, composite insurance companies are not permitted by Insurance Regulatory and Development Authority (IRDA).

Section 60 of the Insurance Act, 1938 imposes certain duties on the liquidator in the case of winding-up of an insurance company, when cash distribution of the assets is intended. It also confers certain privileges on the persons mentioned therein to give notice of disputing any value made by the liquidator. Besides the grounds mentioned under the Companies Act,1956 an insurance company may be wound-up by the Court on one or more of the grounds mentioned in section 53(2)(b) of the Insurance Act, 1938 on an application made by IRDA. Further, under section 53(2) of the Insurance

[28] Seventh Schedule, List I and List II.

[29] Laws such as the Co-operative Societies Acts of various States, the State Bank of India Act, 1955, the State Bank of India (Subsidiary Banks) Act, 1959, the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970, the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980, the Regional Rural Banks Act, 1976 and the Banking Regulation Act, 1949.

Act, 1938 other grounds have also been provided for winding-up an insurance company on an application made by the shareholders/policy-holders.

6.2 Insolvency of NBFCs

The provisions of the Companies Act, 1956 are applicable to the winding-up of Non-Banking Financial Companies (NBFCs). Further, in terms of section 45 MC of the RBI Act, the Reserve Bank is also empowered to file petitions for winding-up of NBFCs.

7. Summary of Assessment of Bankruptcy Laws based on World Bank Principles

7.1 General Issues

While the procedure for creating security interests for credit is almost similar throughout the country, irrespective of the nature and constitution of the creditor, the applicable law for enforcement of those security interests vary according to the type of creditor. The stamp duty payable on creation of the security interest varies from State to State. In some States, the rates of stamp duty are very high, increasing the cost of lending. In spite of the increase in the penetration of bank branches and developments in technology, a large portion of the rural population still relies on the informal credit providers for meeting their credit needs.

7.2 Creation and Enforcement of Security Interests

The contractual rights of creditors are recognised under Indian laws. The Transfer of Property Act, 1882, the Registration Act, 1908, the Sale of Goods Act, 1930, the Patents Act, 1970, the Trade Marks Act, 1999, the Designs Act, 2000, the Motor Vehicles Act, 1988 and the Companies Act, 1956, all enable the creation of a security interest in some form or the other. However, certain provisions of the law which give priority to sovereign claims over the claims of secured creditors have been causing concern to the secured creditors as regards their security interest. The Supreme Court has held that when a first charge is created by the operation of a law over any property, that charge will have precedence over all other charges including an existing mortgage. It is necessary that the law should be amended to the effect that the priority of charge for State dues should not operate in respect of prior mortgages created in favour of the secured creditors.

Even though the general laws of the land permit the creation of security interests over immovable properties, some State Governments have issued revenue orders restricting the sale, mortgage and subletting of lands belonging to specified categories like tribals and agriculturists. These orders have acted as disincentives to creditors for giving loans on the security of such lands. States should enact legislation similar to the Himachal Pradesh Agricultural Credit Operations and Miscellaneous Provisions (Banks) Act, 1972 to facilitate an adequate flow of credit for agricultural production and development through banks and other institutional credit agencies. States can also take steps to remove the restrictions on the creation of security interests in favour of banks and financial institutions, in respect of lands belonging to specified categories, by way of rescinding the revenue orders or by way of legislation, as the case may be. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests (SARFAESI) Act can be extended to cover the security interest in agricultural land beyond a specified holding (for example, 5 acres which would be exempt from the provisions of the SARFAESI Act). In the case of winding-up proceedings, even though the secured creditors are allowed to enforce their security interests outside the winding-up, on account of the *pari passu* charges in favour of the workmen, there is delay in appropriating the proceeds. The workmen's

dues in many cases are not calculated on time and the proceedings get prolonged affecting the interests of the secured creditors.

The system of registration of the security interest in respect of immovable property, motor vehicles, intellectual property and in respect of assets of companies provide adequate notice of creation of the security interest to the general public. However, there is no registry which keeps a record of the security interests created in respect of movable properties. There are specialised registries for registration of security interests in motor vehicles, vessels and intellectual properties (patent). There should be an express provision for registration of charges over Trademarks under the Trade Marks Act, 1999.

The Central Registry under the SARFAESI Act, which can take care of a major part of the transactions of banks and financial institutions, is yet to be set up. It should be set up without any further delay to create a central and reliable record of all security interests created by banks and financial institutions. The Registry should also be allowed to register all transactions creating security interests (both in movable as well as immovable property) by entities/ individuals in addition to those of banks/ financial institutions. For this purpose, it is necessary to bring a separate legislation in respect of the Central Registry. In course of time, the Registry (with adequate number of branches all over the country) should be the sole registry for registration of all security interests over properties and the registries under the various statutes should be wound-up with suitable amendments to the respective Acts dealing with the registration of security interests. Until then, the respective state registries can continue and the Central Registry, apart from its functions under the SARFAESI Act, can act as a central database with a statutory mandate to collect/ obtain information from various registries in the country. As the security interest in respect of immovable properties is being registered in the offices of the Sub-Registrar of Assurances where immoveable property is situated, it is difficult for creditors elsewhere to verify the record of the sub-registrars with regard to the title and the security interest. Computerised search features in land registries are available in some States. But a majority of the registries have not computerised their records. Therefore, there is an urgent need to computerise the records of Registrar of Assurances, provide online search facilities and link them to the Central Registry. Measures should be taken by all the State Governments in this regard. The details of all security interests should also be made online, after making online payments.

The SARFAESI Act recognises the contractual rights of secured creditors (banks and financial institutions) for the possession and sale of secured assets without intervention by the Courts. Further, special tribunals (DRTs) have been created under the provisions of the Recovery of Debts Due to the Banks and Financial Institutions Act, 1993 (DRT Act) for the purpose of recovery of loans and enforcement of securities by banks and financial institutions. The DRTs deal with secured and unsecured claims where the debt is Rs. 10 lakh and above. The Code of Civil Procedure, 1908 contains provisions for the recovery of loans by

filing suits in courts against debtors in all cases where separate exclusive jurisdiction like that of the DRTs has not been provided. The respective State Co-operative Societies' Acts provide for the enforcement of contractual rights of the co-operative societies on their debtors. The State Financial Corporations Act, 1951 empowers the state financial corporations to enforce their security interests without the intervention of courts. Apart from the above, creditors can enforce their contractual obligations by taking repossession of the securities in the case of hire-purchase contracts (provided there is a clause to that effect in the contract) in respect of movable properties. There is also a provision for referring the matters to the 'Lok Adalat', which is an informal dispute resolution forum under the Legal Services Authorities Act, 1987. Even though legal principles governing the enforcement mechanism are adequate and fair, there is delay in implementation. In the case of unsecured credit, the mechanism for recovery is comparatively less efficient, and in many cases proceedings have been pending for execution before the Recovery Officers under the DRT Act for lack of information about the properties of the debtors. Even though the number of new cases filed in the DRTs has come down because of the SARFAESI Act, the number of pending cases is still large. In order to minimise the delay, urgent steps should be taken to set up more DRTs and a separate bench should be formed for cases involving Rs. 1 crore and above to deal with large unpaid debts. Another issue is that of DRTs granting stay orders against sale of securities by banks/FIs under Section 13(4) of the SARFAESI Act. The fact is that the SARFAESI Act itself has been enacted to empower the banks to enforce their security interest and sell their security without the intervention of the courts, and with that objective, Section 34 of the SARFAESI Act even provides that civil courts shall not grant any injunction. Therefore, DRTs granting injunctions *ex parte* is a matter of serious concern. A suitable provision should be inserted in the SARFAESI Act to safeguard the interest of the lenders. Banks are facing abnormal delay in getting possession of properties when requests are made to District Magistrate under Section 14 of SARFAESI Act, on account of the burden of workload at the District Magistrate level. Therefore, there is a need to amend Section 14 of SARFAESI Act for providing an enabling provision for District Magistrate to delegate his powers under the SARFAESI Act to other Executive Magistrates in the District, so that the delay in taking possession/control of the secured asset may be obviated.

Generally, creditor-debtor agreements provide for the mode of enforcement of the security interest in movable properties. The recovery methods employed by the agents of many banks and financial institutions for repossession of the movable property (like vehicles, equipment, machinery, *etc.*) are not satisfactory. The Reserve Bank has issued guidelines reviewing the policy, practice and procedure involved in engagement of recovery agents by banks in April 2008. The guidelines require the performance of due diligence by banks before engaging recovery agents. The guidelines *inter alia* provide for the agents to undergo a certificate course on recovery, adherence to the Code formulated by the Banking Codes and Standards Board of India, use Lok Adalats for recovery of loans below Rs.10 lakh and a ban on the engagement of recovery agents in certain cases. The guidelines are expected to provide order and discipline in the process of enforcement of security interests in movable properties by banks. The laws for public notice for creation of security on moveable assets are inadequate and restricted to charges created on company's moveable assets and on motor vehicles. There is no provision for public notice for creation of security interest on moveable assets of other entities like partnership, proprietorship, *etc.*

There are instances where the directors have absconded after defrauding the creditors, including when winding-up petitions are initiated, making it difficult for the authorities/ creditors to trace their whereabouts. Some of these directors have also been successful in floating new companies. However, the Companies (Amendment) Act, 2006 has brought in provisions for Director Identification Numbers into the Companies Act, 1956 which would be helpful in tracing delinquent directors. This would also prohibit such directors (responsible for any violation/contravention) from floating/promoting new companies. The Companies Act has extensive provisions for dealing with delinquent directors in the course of winding-up proceedings or otherwise. There are adequate legal provisions as far as initiating proceedings against the directors and officers responsible for committing fraud. However, these provisions have not been invoked in many cases. Towards this end, more action is needed. The Indian Penal Code, 1860 (IPC) covers cases where property is removed/concealed or action is taken for preventing its distribution among the creditors. Further, in terms of Section 543 of the Companies Act, the Court/Tribunal has the power to assess damages against delinquent directors in respect of misapplication/retention/ liability or accountability for any money or property of the company or any malfeasance or breach of trust in relation to the company.

7.3 Credit Information

With the enactment of the Credit Information Companies Act (CIC), the law enables the setting up of credit information companies which collect credit information from credit institutions and distribute it to specified users. The restrictions imposed by several statutes on the disclosure of credit information by banks and financial institutions have become redundant to an extent on account of the provisions of the CIC Act. There are also provisions protecting the Reserve Bank, the Central Government, a credit information company, credit institutions and their officers, employees, agents and authorised persons from legal proceedings and prosecutions arising out of acts done in good faith in accordance with the provisions of the CIC Act. However, such a protection is not available in respect of unauthorised and fraudulent acts and acts in contravention of the provisions of CIC Act and customary usages/practices.

The CIC Act and the rules and regulations framed thereunder provide for the permissible use of personal data and the measures to be undertaken by the credit information companies and specified users to safeguard that information. Failure to comply with the requirements of the Act, rules or regulations attract penal provisions provided for under the Act. Further, the person to whom the loss is caused due to unauthorised/fraudulent use (including use in contravention of the statutory provisions or rules/regulations) can institute proceedings against the concerned credit information company, specified user and their officers, directors, employees *etc.* for recovery of damages on account of the loss caused to him by such disclosures. Therefore, there are several disincentives to prevent not maintaining the integrity of the database, including penal and other proceedings. The CIC Act will, thus, ensure

the collection of credit information in respect of a significant part of the population. There is no specific restriction on reporting of negative information beyond a certain period of time. It is felt that there are no compelling reasons of public policy to restrict reporting of negative information beyond a specified period of time (such as 5/7 years).

The CIC Act or the rules/regulations framed thereunder do not contain any provision which takes care of societal discrimination, such as discrimination based on race, gender, national origin, marital status, political affiliation, or union membership. Regulation 10 (c) of the Credit Information Companies Regulations, 2006 requires every specified user who is denying any credit or service to any borrower or client to *inter alia* furnish him with a copy of the credit information relied upon for such decision and also the name and address of the credit information company which had provided the credit information report. The Guidelines on Fair Practices Code for Lenders issued by the Reserve Bank specifically states that the lenders should convey in writing, the main reason/ reasons which, in the opinion of the bank after due consideration, have led to rejection of the loan applications. This has to be done within the stipulated time. The Code further stipulates that lenders must not discriminate on grounds of sex, caste and religion in the matter of lending. However, this does not preclude lenders from participating in credit-linked schemes framed for the weaker sections of the society. The banks/financial institutions have been advised to frame their own codes based on the above-mentioned guidelines. Non-adherence to the guidelines framed can be taken up with the Banking Ombudsmen under the Banking Ombudsman Scheme, 2006. Thus, there is ample provision to discourage loan rejections based on societal discrimination.

There are comprehensive provisions in the CIC Act, Rules and Regulations covering the principles on privacy. The major regulators in the financial sector like the Reserve Bank, IRDA and SEBI have been empowered to collect credit information from the credit information companies. In respect of disputes concerning the business of credit information companies, an alternate dispute resolution mechanism has been provided for under the CIC Act. Apart from this non-judicial remedy, judicial remedies to recover damages for losses caused *etc.* would also be available to the affected persons. The penalties prescribed under the Act are sufficiently stringent to ensure compliance.

7.4. Restructuring and Informal Workouts[30]

In the restructurings under SICA and Section 391 of the Companies Act, the schemes can provide flexibility with the sanction of the BIFR and the Courts. Ordinarily, the scope of interference by the regulators in the restructuring of a company is minimal except in the case of systemically important sectors like banking and insurance. On the other hand, One-Time Settlement Schemes are interim measures for short periods, generally to cover particular types of accounts. Tax laws in India do not expressly take care of debt re-scheduling or debt equity swaps for lenders. The provisions under the Income Tax Act do not cover situations where the transferor bank is a public sector bank or a RRB. The provisions do not cover any kind of amalgamations in which RRBs are involved, since RRBs are not covered under the definition of either 'banking company' or 'banking institution' as per 'Explanation' to Section 72AA of the Income Tax Act. Further, the benefit is also not available in case of acquisitions of a banking institution made by SBI and its subsidiaries. The benefit of the Income Tax Act, as stated above, should be made available to all

[30] Those workouts which are done privately by the parties (in accordance with the general law like law of contracts, transfer of property, *etc.*) and not in compliance with the procedure laid down under any specific law on rehabilitation/ restructuring/insolvency (like the SICA, Section 391 of Companies Act, *etc.*).

banks. The law enables and encourages the lending/recapitalisation of viable but financially distressed enterprises. In informal workouts, the terms and conditions subject to which the lending/recapitalisation is done is left to the discretion of the creditors/borrowers based on the agreement between them. However, there is a need to give priority by statute to the financial assistance given to rehabilitate a company in financial distress. Such priority of claim should be extended while disbursing assets in liquidation.

The Corporate Debt Restructuring (CDR) mechanism is a completely voluntary effort based on consensus. The Reserve Bank, by issuing guidelines, has facilitated informal workouts among creditors and between creditors and debtors. However, the CDR mechanism is for consortium/syndicate lending and covers outstanding exposure of Rs.20 crore and above. It has scope for mediation as well because the Group consists of members who may not be creditors. Once the prescribed majority of lenders (in value and number) decide on the restructuring plan, the same can be put into effect without any formalities (other than a creditor-debtor agreement). Measures under the SARFAESI Act would enable the creditors to further bring down the volume of non-performing assets in their books by assuming direct control over the business of the debtors and are expected to lead to many informal workouts between creditors and debtors.

7.5 Insolvency and Creditor Rights Systems

The existing legal framework covers insolvency proceedings against all persons, natural or legal, under different enactments. Insolvency laws are spread over many legislations depending upon the type of entity involved in the insolvency. The principles contained in those legislations are not uniform and in some cases it is left to the discretion of the authority deciding on the liquidation (For example, nationalised banks can be liquidated by the Central Government by an order and the manner of liquidation is left to the discretion of the Government). Therefore, in such cases it could be stated that the predictability and transparency cannot be taken for granted. However, there has not been any single instance of a nationalised bank getting placed under liquidation.

The Companies Act, 1956 covers provisions for compromises/arrangements, reconstructions/amalgamations and the winding-up of companies. The provisions of insolvency laws have been made applicable to companies in liquidation as regards debts provable and fraudulent preference in those proceedings. The Presidency Towns Insolvency Act, 1909 (which applies to the Metropolitan cities of Kolkata, Chennai and Mumbai) and the Provincial Insolvency Act, 1920 (which applies to other parts of the country) apply to insolvencies of all persons including individuals, association of individuals and partnership firms (other than companies and associations registered under any other enactment). Where insurance companies are concerned, the provisions of the Companies Act relating to winding-up are applicable subject to the provisions of section 53 of the Insurance Act, 1938. Further, section 54 of the Insurance Act, 1938 prohibits the voluntary winding-up of a company except for effecting an

amalgamation or when it cannot continue its business by reason of its liabilities. State Financial Corporations and other financial institutions are governed by their respective statutes.

SICA deals with the rehabilitation of sick industrial undertakings (pertaining to an industry mentioned in the schedule to that Act). In terms of the Act, the board of directors of a sick industrial undertaking can make a reference to the BIFR set up under the provisions of the Act for determination of measures to be taken against that undertaking. BIFR will then make an inquiry into the working of the company. BIFR has also been conferred with powers to direct any person (including a public financial institution, State-level institution and scheduled bank) to make a scheme for rehabilitation of a company and such a scheme can be sanctioned by it. The scheme can provide for reconstruction, amalgamation, sale of assets, any other preventive, ameliorative and remedial measures, *etc.* The scheme can also provide for rehabilitation by giving financial assistance.

In order to achieve a more transparent, predictable and sound insolvency system, there is a need to consolidate all the separate laws dealing with insolvencies into a single, uniform and comprehensive bankruptcy code with a common forum, irrespective of the entity involved in the insolvency. But given the complexity of the Indian legal system (with powers being divided between the Union and the States) and the variety of entities that exist, such a measure would require amendments to the Constitution and various other laws. However, special provisions may continue to be provided in respect of entities like banks, insurance companies, *etc.* on account of their systemic importance. A common code for all banking institutions irrespective of the nature of the entity may also be thought of. Such a change would call for amendments to the Constitution and various other statutes like the State Co-operative Acts, SBI Act, *etc.* The Reserve Bank (being the regulator and supervisor) should have the ultimate say in all insolvencies related to banks, irrespective of the nature of the entity (*i.e.*, company, statutory corporation, co-operative bank, *etc.*).

Winding-up petitions and cases referred to BIFR take very long for final disposal. A cross-country comparison on closing business in 'Doing Business Report' (2008) of the World Bank has analysed the main indicators for identifying the weaknesses in existing bankruptcy law and the main procedural and administrative bottlenecks in the bankruptcy process. These indicators, include, (i) average time to complete a procedure, (ii) cost of the bankruptcy proceedings, and (iii) the recovery rate, which calculates how many cents on the dollar, the claimants (creditors, tax authorities, and employees) recover from an insolvent firm. The data regarding the above indicators have been provided region-wise as well as country-wise in the study conducted by the World Bank. The average time taken for bankruptcy proceedings in India is 10 years. The cost of bankruptcy proceedings in India is stated to be 9 per cent of the estate and the recovery rate (for claimants) is found to be 11.6 cents to the dollar. The comparative figures show that India lags behind in terms of average time taken to complete the bankruptcy proceedings and recovery rate involved in those proceedings *vis-à-vis* Central Asian & Eastern European regional and East Asian & Pacific regional averages. However, the cost of proceedings in India is lower than the Central Asian & Eastern European average of 13.7 per cent of the estate and the East Asian & Pacific average of 23.2 per cent of the estate.

The Companies (Second Amendment) Act, 2002 enacted to bring about major changes in the insolvency regime, has not been operationalised because of litigation (which is pending in the Supreme Court) and the

consequent stay of the provisions. As the Companies (Second Amendment) Act, 2002 provides for the formation of a rehabilitation and revival fund, the appointment of professional liquidators and the setting up of NCLT with powers to deal with liquidation as well as rehabilitation/re-organisation of a company, its operationalisation needs to be expedited. A separate bench of NCLT should be set up to deal with case involving rehabilitation involving loan amounts of Rs.10 crore and above. Though there is a provision for constituting a Committee of Inspection (which includes creditors), for better creditor participation in insolvency proceedings, there is a need for an express provision for constitution of a creditors' committee, when the liquidator is not a creditor-nominated liquidator. Such committees should be empowered to take decisions along with the liquidator and to file a Report independently to the Court/Tribunal for improving liquidation proceedings. The Act should provide for a time-frame to conclude the liquidation proceedings.

The law provides for a general stay on suits and proceedings against the assets of the company. However, such a stay is not applicable to a secured creditor who enforces his security interest outside the winding-up proceedings. Until and unless the Court has passed an order in an insolvency petition, the company is free to deal with its properties and this tends to erode realisation, unless a Provisional Liquidator is appointed to mange the affairs. The law should provide for an automatic stay of further liabilities being created on the company's assets and the alienation of the company's assets camouflaged in the ordinary course of business on presentation of insolvency petition, provided the petitioner serves the company with due notice. As a safeguard against the abuse of such proceedings, the law should also provide for severe penalties against applicants for vexatious and *mala fide* petitions.

The law recognises the mutual set-off of obligations. However, it is silent on the closing-out of contracts and their netting. There is also no clarity regarding how multilateral netting is to be treated in liquidation proceedings. Parliament has passed the Payment and Settlement Systems Act, 2007 which *inter alia* provides for legal protection to netting including multilateral netting in insolvency proceedings. However, this protection is only available to contracts within a payment system. Certain rules and bye-laws of the stock exchanges also provide for close-out mechanism in respect of a member's obligation to a stock exchange during the insolvency. These rules and bye-laws have been held to be statutory and enforceable by Courts. However, the position regarding Over-the-Counter (OTC) transactions in derivatives *etc.* are not yet free from doubt. It would be worthwhile to have express provisions dealing with the treatment of set-off rights, netting and close-out contracts, personal contracts and labour contracts during re-organisation and winding-up. The law specifically provides that transactions (which are not in the ordinary course of business or done in good faith for valuable consideration) up to one year before the presentation of the winding-up petition can be treated as void by the liquidator. Apart from this, all other contracts are valid and enforceable

against the liquidator. The liquidator has been given limited power to disclaim unprofitable contracts.

There are elaborate provisions in respect of calling for claims and their adjudication in liquidation proceedings. In case of any dispute, the matter is placed before the Court for decision. However, in practice, disputes with respect to claims take very long to be resolved, and the claims of the other creditors are also held up because of such disputes. The implementation of provisions relating to the receipt of claims and their process needs to be improved to reduce the delay. It is hoped that the Companies (Second Amendment) Act, 2002 once made operational, would help solve this problem.

The mechanism of rehabilitation through SICA has been a failure. The new provisions introduced in the Companies Act vide the Companies (Second Amendment) Act, 2002 once brought into operation are expected to improve the rehabilitation mechanism. The proceedings under Section 391 of the Companies Act have been successfully resorted to by many companies for compromises/restructuring. The law should provide for the constitution of a Creditors' Committee and vest it with powers to improve the rehabilitation of an insolvent company. The law should provide for nominating unsecured creditors in the Creditors' Committee to ensure their participation and for safeguarding their interest. NCLT, once made operational, should be provided with adequate infrastructure for timely disposal of references.

The details of the plan of reorganisation or reconstruction or compromise under Section 391 of Companies Act can be worked out independently of the Court. The law gives the conditions under which the Company Court[31] can approve the plan. The scheme, after filing in the Court, may undergo modifications pursuant to the meetings of creditors during the pendency of court proceedings. The Courts generally approve amalgamation schemes of the banks without much delay as the scheme is already prepared or certified by the Reserve Bank. The courts do not normally substitute their judgment as against the judgment of the Reserve Bank. In the corporate sector, there is no statutory obligation cast on anybody to prepare the scheme of amalgamation or reconstruction or compromise except in the case of sick industrial company as defined in the SICA. The implementation of a plan is left to the company and the legal provisions do not require any reporting of implementation of the plan by the company periodically to the Court. It often happens that, after the sanction of a scheme, some companies do not implement it and in such cases the creditors/members of the company are again compelled to move the Company Court. There is a need for incorporating provisions which would compel the companies to report the implementation of its plan periodically to the Regional Director/ Department of Company Affairs (similar to the banks reporting to the Reserve Bank) till all the terms and conditions of the plan are substantially complied with. Thereafter, there should be a provision for the court to pass final orders to that effect.

Foreign judgments are recognised in India under the provisions of Code of Civil Procedure, 1908. Recognition of foreign claims depends on the terms of agreement and applicability of Indian law to the situation. There is no provision in the law enabling cross-border insolvency proceedings. It is necessary for the country to adopt the UNCITRAL Model Law on Cross-border Insolvency as suggested by various committees. While adopting the UNCITRAL Model Law, the conflict of existing laws should be considered. It is advisable to keep banking

[31] The designated bench of the High Court looking after company matters.

laws and insolvency procedures separate from the insolvency relating to ordinary companies. On adoption of the UNCITRAL Model Law, the interest of the regional depositors of banks may not get any protection over and above the global depositors as there would be pooling of assets of various countries belonging to the companies. This aspect needs to be kept in view.

7.6 Judicial and Administrative Systems

The independence of the Supreme Court and High Courts in India is ensured by the Constitutional provisions. The appointment of judges, their tenure, salary, removal, *etc.* are all enshrined in the Constitution itself, which cannot be altered by the executive to their detriment. The lower courts function under the administrative and judicial control of the High Courts and the Supreme Court. The judges of the higher Courts are generally considered to be highly impartial in exercise of their powers. However, the existing law does not provide for specialised insolvency Courts. At present, the High Courts take up insolvency matters in addition to their other jurisdictions, although in certain States there are special benches designated as 'Company Courts'. As regards insolvency proceedings of individuals, the jurisdiction is conferred on District Courts/High Courts (original jurisdiction) who take up such cases in addition to the routine civil cases. In view of the same, whether it is insolvency proceedings of corporate entities or individuals, the courts are not in a position to devote their entire attention to insolvency matters. In many High Courts, company matters are taken up only in one or two days during the week, resulting in delay. If the Companies (Second Amendment) Act, 2002 is operationalised without any substantial changes, by virtue of specialised tribunals being set up under the Companies Act, 1956 to deal with insolvency proceedings, schemes of arrangement, sick companies, *etc.* under 'one roof', a specialist approach could be achieved. It is felt that the delay could be reduced under the specialised tribunals.

The law provides for transparency and accountability of insolvency proceedings right from the initiation of proceedings to the passing of the order by the Court, both in case of an individual and a company. There are adequate provisions for the issue of notice of insolvency proceedings to parties concerned, access to the case files, pronouncement of judgment after hearing the matter and the publication/advertisement of the adjudicatory order/winding-up order, which would enable the affected persons to be aware of the happenings in the case. Internet has added to accessibility to the public, thereby bringing in more transparency in court proceedings. Making available online certified copies of court orders would help in improving the efficiency and utility of the system.

The law provides and encourages arbitration, conciliation, mediation and other means of out-of-court settlements. In case of pending cases also, the court has the discretion to refer the matter for settlement through mediation, arbitration, conciliation, *etc.* Lack of judicial time, lack of expertise and consequent lack of proper appreciation of issues pertaining to insolvency leads to delays. This can, to a large extent, be solved if the NCLT and the NCALT are set up by bringing into operation the

proposed amendments in the Companies Act. Further, referring the matters for mediation and conciliation to the Lok Adalats can also solve the problem. In case of contempt of court orders, the provisions of the Contempt of Courts Act, 1971 which provide for the procedures to file contempt of Court petition and the liabilities for the contempt of court, would be applicable.

The liquidators appointed for the winding-up of the companies are public servants. They can be tried for misconduct and they are accountable. So the chances of fraud and other illegalities during the course of winding-up are rare. Further, insolvency proceedings conducted by the liquidators are supervised by the Court. This enables the proceedings to be conducted in a fair, impartial and transparent manner. The Companies (Second Amendment) Act, 2002 when brought into force would enable the Tribunal to appoint professionals as insolvency representatives. There should be clear provisions for dealing with the misconduct and irregularities of such insolvency representatives also.

7.7 Conclusion

The assessment of the Indian insolvency and creditors' rights system shows that the provisions of the laws of the country are, generally, in compliance with the World Bank Principles. However, in terms of implementation of those laws at the ground level, there are shortcomings. To ascertain the status of the laws at the implementation stage, an attempt has been made by the Panel to conduct an empirical analysis with available data relating to recovery/insolvency regime in India.

8. Empirical Analysis of Data Relating to Recovery/Insolvency Regime

In order to ascertain the reasons for delays in the resolution of cases filed in DRTs and civil cases pending in High Courts, an attempt was made to collect data from four major banks. Only one bank was able to furnish the data along with the time taken for the resolution of the cases. Another bank gave qualitative data while the other two banks have expressed their inability to provide the data as they do not compile such data. A calculation of the mean and standard deviation based on the granular data provided by one bank was attempted. While it is recognised that the data analysis could suffer from small sample error, it was thought worthwhile to carry out this exercise even for one bank, to at least broadly estimate the delays.

The mean and standard deviation in respect of the cases pending in DRTs (based on the data-set furnished by one bank) are 8.2 years and 4.5 years, respectively. As per the information received from another bank, the DRTs take a period of 2 to 4 years to pass an order and after that six months to one year is taken to obtain the Recovery Certificate. The mean and standard deviation in respect of settlement of civil suits pending in courts are 4 years and 5 years, respectively. As per the information received from one of the banks, it takes, on an average, 2 to 3 years to obtain a decree, and after that, execution of the decree could take another 3 to 4 years. Based on the information on the pending BIFR cases, the mean and standard deviation in respect of cases pending in the BIFR are 8.25 years and 4.96 years, respectively. (For BIFR cases pending for more than 10 years, the average pendency has been assumed as 15 years for calculating the mean and standard deviation). The mean and the standard deviation in respect of settlement of winding-up cases (based on the data set furnished by one bank) are 11.25 years and 7.1 years, respectively.

As per the qualitative data furnished by one bank, winding-up cases take on an average 5-10 years for resolution. The data on companies under liquidation obtained from the Office of

Official Liquidator indicates that the average time taken for concluding liquidation proceedings is about ten years.

The cross-country comparison[32] of the insolvency process shows how India lags behind many countries on the three indicators of the insolvency process mentioned in that comparison. The data in respect of winding-up petitions filed by Reserve Bank against non-banking financial companies under Section 45 MC of the RBI Act indicates that such petitions have been pending for periods ranging between 5 to 10 years.

9. Detailed Assessment of Insolvency and Creditor Rights Systems

A gist of the legal framework in respect of each Principle and its assessment is provided in **Annex I**. Four grades, namely, 'Observed', 'Broadly Observed', 'Partly Observed' and 'Not Observed', have been used for assessing the Indian system based on the applicable principles. In cases where the legal framework and its implementation have been in total compliance with the principles, the grading has been mentioned as 'Observed'. The 'Broadly Observed' grading has been provided where there is substantial compliance with the principles in respect of the legal provisions and their implementation. In cases where there is only partial compliance with respect to the legal provisions and/or in their implementation, 'Partly Observed' grading has been given. Where there is no compliance of the principles, as regards the legal provisions and/or their implementation, the 'Not Observed' grading has been given. A summary of observance of the principles for creditor rights and insolvency systems is given in Table 2. A summary of recommendations of the Panel is given in Section 11.

10. The Companies Bill, 2008

Central Government has introduced the Companies Bill, 2008 (Bill No. 57 of 2008) in the Lok Sabha (Lower House of the Parliament) on October 23, 2008. The Bill seeks to replace the Companies Act, 1956 and has been introduced with the objective of enabling the corporate sector in India to operate in a regulatory environment of best international practices that fosters entrepreneurship, investment and growth. The Bill seeks to provide *inter alia* for (i) detailed declarations/ disclosures about the promoters/directors *etc.* at the time of incorporations itself, (ii) a revised framework for regulation of insolvency including rehabilitation, winding-up and liquidation of companies with the process to be completed in a time-bound manner, (iii) a comprehensive chapter for rehabilitation of sick companies (including by way of amalgamation with other companies), (iv) registration of valuers for the purpose of undertaking valuations as required in the proposed Act, (v) establishment of special courts for speedy trial of offenders under the proposed Act, and (vi) class action proceedings by creditors in cases where the management of the affairs of the company are conducted in a manner prejudicial to the interests of the company or creditors.

[32] See ***'Doing Business Report' (2008)*** of the World Bank on the time, cost involved and recovery rate in insolvency proceedings of comparable countries. Extract provided in Appendix Table 7.

Table 2: Summary of Observance of Principles for Effective Insolvency and Creditor Rights Systems

	Principle/Sub-Principle	Assessment
Part A.	**Legal Framework for Creditor Rights**	
A1	**Key Elements of Legal framework for Creditor Rights**	Partly Observed
A2	**Security (Immovable Property)**	Broadly Observed
A3	**Security (Movable Property)**	Broadly Observed
A4	**Registry Systems**	
A4.1	Land and Mortgage Registries	Broadly Observed
A4.2	Charge Registries	Broadly Observed
A4.3	Specialised Registries	Broadly Observed
A5	**Commercial Enforcement System**	
A5.1	Unsecured Debt	Broadly Observed
A5.2	Secured Debt	Broadly Observed
Part B.	**Risk Management and Corporate Workout**	
B1	**Credit Information Systems**	
B1.1	Legal Framework	Observed
B1.2	Operations	Observed
B1.3	Public Policy	Observed
B1.4	Privacy	Observed
B1.5	Enforcement/Supervision	Observed
B2	**Director and Officer Accountability**	Observed
B3	**Legislative Framework Enabling Workouts – Including Informal**	
B3.1	Require disclosure of or ensure access to timely, reliable and accurate financial information on the distressed enterprise	Observed
B3.2	Encourage lending to, investment in or recapitalisation of viable financially distressed enterprises	Broadly Observed
B3.3	Flexibly accommodate a broad range of restructuring activities, involving asset sales, discounted debt sales, debt write-offs, debt reschedulings, debt and enterprise restructurings, and exchange offerings (debt-to-debt and debt-to-equity exchanges)	Observed
B3.4	Provide favourable or neutral tax treatment with respect to losses or write-offs that are necessary to achieve a debt restructuring based on the real market value of the assets subject to the transaction	Broadly Observed
B3.5	Address regulatory impediments that may affect enterprise reorganisations	Observed
B3.6	Give creditors reliable recourse to enforcement as outlined in Section A and to liquidation and/or reorganisation proceedings as outlined in Section C of these Principles	Observed

	Principle/Sub-Principle	Assessment
B4	**Informal Workout Procedures**	
B4.1	An informal workout process may work better if it enables creditors and debtors to use informal techniques, such as voluntary negotiation or mediation or informal dispute resolution. While a reliable method for timely resolution of inter-creditor differences is important, the financial supervisor should play a facilitating role consistent with its regulatory duties as opposed to actively participating in the resolution of inter-creditor differences.	Observed
B4.2	Where the informal procedure relies on a formal reorganisation, the formal proceeding should be able to quickly process the informal, pre-negotiated agreement.	Observed
B4.3	In the context of a systemic crisis, or where levels of corporate insolvency have reached systemic levels, informal rules and procedures may need to be supplemented by interim framework enhancement measures to address the special needs and circumstances encountered with a view to encouraging restructuring. Such measures are typically of an interim nature designed to cover the crisis and resolution period, without undermining the conventional proceedings and systems.	Observed
B5	**Regulation of Workouts and Risk Management Practices**	
B5.1	A country's financial sector (possibly with the informal endorsement and assistance of the central bank, finance ministry or bankers' association) should promote the development of a code of conduct on a voluntary, consensual procedure for dealing with cases of corporate financial difficulty in which banks and other financial institutions have a significant exposure, especially in markets where corporate insolvency has reached systemic levels.	Observed
B5.2	In addition, good risk management practices should be encouraged by regulators of financial institutions and supported by norms that facilitate effective internal procedures and practices that support prompt and efficient recovery and resolution of non-performing loans and distressed assets.	Observed

	Principle/Sub-Principle	Assessment
Part C.	**Legal Framework for Insolvency**	
C1	**Key Objectives and Policies**	Broadly Observed
C2	**Due Process: Notification and Information**	
C2.1	Afford timely and proper notice to interested parties in a proceeding concerning matters that affect their rights. In insolvency proceedings there should be procedures for appellate review that support timely, efficient and impartial resolution of disputed matters. As a general rule, appeals do not stay insolvency proceedings, although the court may have power to do so in specific cases.	Observed
C2.2	Require the debtor to disclose relevant information pertaining to its business and financial affairs in sufficient detail to enable the court, creditors and affected parties to reasonably evaluate the prospects for reorganisation. It should also provide for independent comment on and analysis of that information. Provision should be made for the possible examination of directors, officers and other persons with knowledge of the debtor's financial position and business affairs, who may be compelled to give information to the court and insolvency representative and creditors' committee.	Observed
C2.3	Provide for the retention of professional experts to investigate, evaluate or develop information that is essential to key decision-making. Professional experts should act with integrity, impartiality and independence.	Broadly Observed
	Commencement	
C3	**Eligibility**	Partly Observed
C4	**Applicability and Accessibility**	
C4.1	Access to the system should be efficient and cost-effective. Both debtors and creditors should be entitled to apply for insolvency proceedings.	Partly Observed
C4.2	Commencement criteria and presumptions about insolvency should be clearly defined in the law. The preferred test to commence an insolvency proceeding should be the debtor's inability to pay debts as they mature, although insolvency may also exist where the debtor's liabilities exceed the value of its assets, provided that the value of assets and liabilities are measured on the basis of fair market values.	Observed
C4.3	Debtors should have easy access to the insolvency system upon showing proof of basic criteria (insolvency or financial difficulty).	Observed
C4.4	Where the application for commencement of a proceeding is made by a creditor, the debtor should be entitled to prompt notice of the application, an opportunity to defend against the	Partly Observed

	Principle/Sub-Principle	Assessment
	application, and a prompt decision by the court on the commencement of the case or the dismissal of the creditor's application.	
C5	**Provisional Measures and Effects of Commencement**	
C5.1	When an application has been filed, but before the court has rendered a decision, provisional relief or measures should be granted when necessary to protect the debtor's assets and the interests of stakeholders, subject to affording appropriate notice to affected parties.	Broadly Observed
C5.2	The commencement of insolvency proceedings should prohibit the unauthorised disposition of the debtor's assets and suspend actions by creditors to enforce their rights or remedies against the debtor or the debtor's assets. The injunctive relief (stay) should be as wide and all-encompassing as possible, extending to an interest in assets used, occupied or in the possession of the debtor.	Broadly Observed
C5.3	A stay of actions by secured creditors should be imposed in liquidation proceedings to enable higher recovery of assets by sale of the entire business or its productive units, and in reorganisation proceedings where the collateral is needed for the reorganisation. The stay should be of limited, specified duration, strike a proper balance between creditor protection and insolvency proceeding objectives, and provide for relief from the stay by application to the court based on clearly established grounds when the insolvency proceeding objectives or the protection of the secured creditor's interests in its collateral are not achieved. Exceptions to the general rule on a stay of enforcement actions should be limited and clearly defined.	Partly Observed
	Governance	
C6	**Management**	
C6.1	In liquidation proceedings, management should be replaced by an insolvency representative with authority to administer the estate in the interest of creditors. Control of the estate should be surrendered immediately to the insolvency representative. In creditor-initiated filings, where circumstances warrant, an interim administrator with limited functions should be	Observed

	Principle/Sub-Principle	Assessment
	appointed to monitor the business to ensure that creditor interests are protected.	
C6.2	There are typically three preferred approaches in reorganisation proceedings: (i) exclusive control of the proceeding is entrusted to an independent insolvency representative; or (ii) governance responsibilities remain invested in management; or (iii) supervision of management is undertaken by an impartial and independent insolvency representative or supervisor. Under the second and third approaches, complete administration power should be shifted to the insolvency representative if management proves incompetent, negligent or has engaged in fraud or other misbehavior.	Observed
C7	**Creditors and the Creditors' Committee**	
C7.1	The role, rights and governance of creditors in proceedings should be clearly defined. Creditor interests should be safeguarded by appropriate means that enable creditors to effectively monitor and participate in insolvency proceedings to ensure fairness and integrity, including by creation of a creditors' committee as a preferred mechanism, especially in cases involving numerous creditors.	Partly Observed
C7.2	Where a committee is established, its duties and functions, and the rules for the committee's membership, quorum and voting, and the conduct of meetings should be specified by the law. It should be consulted on non-routine matters in the case and have the ability to be heard on key decisions in the proceeding. The committee should have the right to request relevant and necessary information from the debtor. It should serve as a conduit for processing and distributing that information to other creditors and for organising creditors to decide on critical issues. In reorganisation proceedings, creditors should be entitled to participate in the selection of the insolvency representative.	Partly Observed
	Administration	
C8	**Collection, Preservation, Administration and Disposition of Assets**	
C8.1	The insolvency estate should include all the debtor's assets, including encumbered assets and assets obtained after the commencement of the case. Assets excluded from the insolvency estate should be strictly limited and clearly defined by the law.	Partly Observed
C8.2	After the commencement of the insolvency proceedings, the court or the insolvency representative should be allowed to take prompt measures to preserve and protect the insolvency estate and the debtor's business. The system for administering the insolvency estate should be flexible and transparent and enable	Broadly Observed

	Principle/Sub-Principle	Assessment
	disposal of assets efficiently and at the maximum values reasonably attainable. Where necessary, the system should allow assets to be sold free and clear of security interests, charges or other encumbrances, subject to preserving the priority of interests in the proceeds from the assets disposed.	
C8.3	The rights and interests of a third party owner of assets should be protected where its assets are used during the insolvency proceedings by the insolvency representative and/or the debtor in possession.	Observed
C9	**Stabilising and Sustaining Business Operations**	
C9.1	The business should be permitted to operate in the ordinary course. Transactions that are not part of the debtor's ordinary business activities should be subject to court review.	Observed
C9.2	Subject to appropriate safeguards, the business should have access to commercially sound forms of financing, including on terms that afford a repayment priority under exceptional circumstances, to enable the debtor to meet its ongoing business needs.	Broadly Observed
C10	**Treatment of Contractual Obligations**	
C10.1	To achieve the objectives of insolvency proceedings, the system should allow interference with the performance of contracts where both parties have not fully performed their obligations. Interference may imply continuation, rejection or assignment of contracts.	Observed
C10.2	To gain the benefit of contracts that have value, the insolvency representative should have the option of performing and assuming the obligations under those contracts. Contract provisions that provide for termination of a contract upon either an application for commencement, or the commencement of insolvency proceedings, should be unenforceable subject to special exceptions.	Partly Observed
C10.3	Where the contract constitutes a net burden to the estate, the insolvency representative should be entitled to reject or cancel the contract, subject to any consequences that may arise from rejection.	Observed

	Principle/Sub-Principle	Assessment
C10.4	Exceptions to the general rule of contract treatment in insolvency proceedings should be limited, clearly defined and allowed only for compelling commercial, public or social interests, such as in the following cases: (i) upholding general set-off rights, subject to rules on avoidance; (ii) upholding automatic termination, netting and close-out provisions contained in financial contracts; (iii) preventing continuation and assignment of contracts for irreplaceable and personal services where the law would not require acceptance of performance by another party; and (iv) establishing special rules for treating employment contracts and collective bargaining agreements.	Partly Observed
C11	**Avoidable Transactions**	
C11.1	After the commencement of an insolvency proceeding, transactions by the debtor that are not consistent with the debtor's ordinary course of business or engaged in as part of an approved administration should be avoided (cancelled), with narrow exceptions protecting parties who lacked notice.	Observed
C11.2	Certain transactions prior to the application for or the date of commencement of the insolvency proceeding should be avoidable (cancelable), including fraudulent and preferential transfers made when the enterprise was insolvent or that rendered the enterprise insolvent.	Observed
C11.3	The suspect period, during which payments are presumed to be preferential and may be set aside, should be reasonably short in respect to general creditors to avoid disrupting normal commercial and credit relations, but may be longer in the case of gifts or where the person receiving the transfer is closely related to the debtor or its owners**.**	Observed
C12	***Claims and Claims Resolution Procedures***	
C12.1	**Treatment of Stakeholder Rights and Priorities** The rights of creditors and priorities of claims established prior to insolvency proceeding under commercial or other applicable laws should be upheld in an insolvency proceeding to preserve the legitimate expectations of creditors and encourage greater predictability in commercial relationships. Deviations from this general rule should occur only where necessary to promote other compelling policies, such as the policy supporting reorganisation or to maximise the insolvency estate's value. Rules of priority should enable creditors to manage credit efficiently consistent with the following additional principles.	Observed

	Principle/Sub-Principle	Assessment
C12.2	The priority of secured creditors in their collateral should be upheld and, absent the secured creditor's consent, its interest in the collateral should not be subordinated to other priorities granted in the course of the insolvency proceeding. Distributions to secured creditors should be made as promptly as possible.	Broadly Observed
C12.3	Following distributions to secured creditors from their collateral and payment of claims related to costs and expenses of administration, proceeds available for distribution should be distributed *pari passu* to the remaining general unsecured creditors, unless there are compelling reasons to justify giving priority status to a particular class of claims. Public interests generally should not be given precedence over private rights. The number of priority classes should be kept to a minimum.	Partly Observed
C12.4	Workers are a vital part of an enterprise, and careful consideration should be given to balancing the rights of employees with those of other creditors.	Observed
C12.5	In liquidation, equity interests or the owners of the business are not entitled to a distribution of the proceeds of assets until the creditors have been fully repaid. The same rule should apply in reorganisation, although limited exceptions may be made under carefully stated circumstances that respect rules of fairness that entitle equity interests to retain a stake in the enterprise.	Observed
C13	**Claims Filing and Resolution**	Broadly Observed
C14	**Reorganisation Proceedings**	
C14.1	The system should promote quick and easy access to the proceeding, assure timely and efficient administration of the proceeding, afford sufficient protection for all those involved in the proceeding, provide a structure that encourages fair negotiation of a commercial plan, and provide for approval of the plan by an appropriate majority of creditors. Key features and principles of a modern reorganisation proceeding include the following:	Partly Observed
C14.2	*Plan Formulation and Consideration*: A flexible approach for developing a plan consistent with fundamental requirements designed to promote fairness and prevent commercial abuse.	Broadly Observed

	Principle/Sub-Principle	Assessment
C14.3	*Plan Voting and Approval:* For voting purposes, classes of creditors may be provided with voting rights weighted according to the amount of a creditor's claim. Claims and voting rights of insiders should be subject to special scrutiny and treated in a manner that will ensure fairness. Plan approval should be based on clear criteria aimed at achieving fairness among similar creditors, recognition of relative priorities and majority acceptance, while offering opposing creditors or classes a dividend equal to or greater than they would likely receive in a liquidation proceeding. Where court confirmation is required, the court should normally defer the decision of the creditors based on a majority vote. Failure to approve a plan within the stated time period, or any extended periods, is typically grounds for placing the debtor into a liquidation proceeding.	Broadly Observed
C14.4	*Plan Implementation and Amendment:* Effective implementation of the plan should be independently supervised. A plan should be capable of amendment (by vote of the creditors) if it is in the interests of the creditors. Where a debtor fails or is incapable of implementing the plan, there should be grounds for terminating the plan and liquidating the insolvency estate.	Broadly Observed
C14.5	*Discharge and Binding Effects*: The system should provide for plan effects to be binding with respect to forgiveness, cancellation or alteration of debts. The effect of approval of the plan by a majority vote should bind all creditors, including dissenting minorities.	Observed
C14.6	*Plan Revocation and Closure*: Where approval of the plan has been procured by fraud, the plan should be reconsidered or set aside. Upon consummation and completion of the plan, provision should be made to swiftly close the proceedings and enable the enterprise to carry on its business under normal conditions and governance.	Observed
C15	**International Considerations**	Broadly Observed
Part D.	**Institutional and Regulatory Frameworks**	
D1	**Role of Courts**	Broadly Observed
D2	**Judicial Selection, Qualification, Training and Performance**	Broadly Observed
D3	**Court Organisation**	Observed
D4	**Transparency and Accountability**	Observed
D5	**Judicial Decision-making and Enforcement of Orders**	Observed
D6	**Integrity of System – Court and Participants**	Observed
D7	**Role of Regulatory/Supervisory Bodies**	Broadly Observed
D8	**Competence and Integrity of Insolvency Representatives**	Observed

Chapter VI

Assessment of Effective Insolvency and Creditor Rights Systems

Principles/Sub-Principles	O	BO	PO	Total
A. Legal Framework for Creditor Rights				
A1 Key Elements of Legal Framework for Creditor Rights	–	–	1	1
A2 Security (Immovable Property)	–	1	–	1
A3 Security (Movable Property)	–	1	–	1
A4 Registry Systems	–	3	–	3
A5 Commercial Enforcement Systems	–	2	–	2
Total – A	**–**	**7**	**1**	**8**
B. Risk Management and Corporate Workout				
B1 Credit Information Systems	5	–	–	5
B2 Director and Officer Accountability	1	–	–	1
B3 Legislative Framework enabling Workouts	4	2	–	6
B4 Informal Workout Procedures	3	–	–	3
B5 Regulation of Workouts and Risk Management Practices	2	–	–	2
Total – B	**15**	**2**	**–**	**17**
C. Legal Framework for Insolvency				
C1 Key Objectives and Policies	–	1	–	1
C2 Due Process: Notification and Information	2	1	–	3
C3 Eligibility	–	–	1	1
C4 Applicablility and Accessibility	2	–	2	4
C5 Provisional Measures and Effects of Commencement	–	2	1	3
C6 Management	2	–	–	2
C7 Creditors and Creditors' Committee	–	–	2	2
C8 Collection, Preservation, Administration and Disposition of Assets	1	1	1	3
C9 Stabilising and Sustaining Business Operations	1	1	–	2
C10 Treatment of Contractual Obligations	2	–	2	4
C11 Avoidable Transactions	3	–	–	3
C12 Claims and Claims Resolution Procedures	3	1	1	5
C13 Claims Filing and Resolution	–	1	–	1
C14 Re-organisation Proceedings	2	3	1	6
C15 International Consideration	–	1	–	1
Total – C	**18**	**12**	**11**	**41**
D. Institutional and Regulatory Frameworks				
D1 Role of Courts	–	1	–	1
D2 Judicial Selection, Qualification, Training and Performance	–	1	–	1
D3 Court Organisation	1	–	–	1
D4 Transparency and Accountability	1	–	–	1
D5 Judicial Decision-making and Enforcement of Orders	1	–	–	1
D6 Integrity of System – Court and Participants	1	–	–	1
D7 Role of Regulatory of Supervisory Bodies	–	1	–	1
D8 Competence and Integrity of Insolvency Representatives	1	–	–	1
Total – D	**5**	**3**	**–**	**8**
Grand Total (A + B + C + D)	**38**	**24**	**12**	**74**

O – Observed; BO – Broadly Observed; PO – Partly Observed.

11. Summary of Recommendations

Part A. Legal Framework for Creditor Rights

- The law should provide that the priority of charge for State dues should not operate in respect of prior mortgages created in favour of the secured creditors.
- Since there is no comprehensive credit guarantee scheme in the market, it would be worthwhile to improve the scheme notified under the DICGC Act, 1961.
- Though Competition Act requires reference by the Competition Commission to relevant authorities with regulatory powers, the concerned authorities' opinion will not be binding. Hence, the present status of the Reserve Bank and other regulators on matters of insolvency of banks and financial institutions is likely to be severely diluted raising concerns about stability. Under the provisions of the Competition Act, every person or enterprise proposing to enter into a combination is required to give notice to the Commission before entering into a combination and wait for 210 days. This, apart from delaying the whole process, is likely to raise regulatory conflicts. This is applicable to all categories of banks including SBI, its associates and nationalised banks. Considering the gravity of the matter and the repercussions, it is necessary to have a serious look into the whole issue and if considered necessary, the Central Government should give exemption to banks under section 54 of Competition Act.

Security (Immovable Property)/(Movable Property)

- All States should take steps to remove restrictions on the creation of security interests in favour of banks and financial institutions in respect of lands belonging to specified categories by rescinding the revenue orders or by way of legislation, as the case may be.
- All States should enact legislation similar to the Himachal Pradesh Agricultural Credit Operations and Miscellaneous Provisions (Banks) Act, 1972 to facilitate an adequate flow of credit for agricultural production and development through banks and other institutional credit agencies.
- SARFAESI Act may be extended to cover the security interest in agricultural land beyond a specified holding (for example, five acres which would be exempt from the provisions of the SARFAESI Act).
- Stamp duties charged by the States should be nominal so that they do not hamper the transfer of immovable properties and interests therein. State Governments should look at property taxes as the main source of revenue, which they do not do at present.
- There should be a common legislation dealing with the creation and registration of security interests (collaterals) irrespective of the nature of the security and its location. However, such a move would require amendments to several legislations as well as the Constitution.
- There is a need to amend Section 14 of the SARFAESI Act for providing an enabling provision for district magistrates to delegate powers under the SARFAESI Act to other executive magistrates in the district, so that the delay in taking possession/control of the secured asset may be obviated.

Registry Systems

- The Central Registry envisaged under the provisions of the SARFAESI Act should be constituted to provide a good database on the creation of security interests/charges under the SARFAESI Act. This would also be an authentic source of public notice.
- The Central Registry should also be allowed to register all transactions creating the security interest (both in movable as well

as immovable property) by entities/individuals other than banks/financial institutions. For this purpose, it would be appropriate to bring in a separate legislation in respect of the Central Registry. In course of time, the Central Registry (with adequate number of branches all over the country) should become the sole registry for the registration of all security interests relating to all kinds of interests over properties. Registries under the various statutes should be wound-up with suitable amendments to the respective Acts dealing with registration of security interest.

- There is an urgent need to computerise the record of Registrar of Assurances, to link them to the Central Registrar and provide an online search facility. Measures should be taken by all the State Governments in this regard.
- The online search facility has to be provided to verify the existence of a security interest over a patent, trademark or design after making payments online.
- There should be express provision for the registration of charges over trademarks under the Trade Marks Act, 1999.

Jurisdiction of Recovery Tribunals

- The number of DRT benches should be increased and a separate bench should be formed to deal with cases of large unpaid debts involving Rs. one crore and above.
- DRTs granting *ex parte* stay orders against the sale of securities by banks/financial institutions under section 13(4) of the SARFAESI Act are a matter of serious concern. A suitable provision to safeguard the interest of the lenders needs to be inserted into the SARFAESI Act.

Part B. Risk Management and Corporate Workout

- There is a need to grant priority (by statute) to the claim of banks or financial institution in respect of the financial assistance given to rehabilitate a sick/weak company in financial distress. Such priority of claim should also extend while disbursing the assets in liquidation.
- NCLT, envisaged under the provisions of the Companies Act, should be made functional for significant improvement in the restructuring process.

Part C. Legal Framework for Insolvency

- In order to achieve a more transparent, predictable and sound insolvency system, ideally, there is a need to consolidate all the separate laws dealing with insolvencies into a single, uniform and comprehensive bankruptcy code with a common forum, irrespective of the entity involved in such insolvency. This would require amendments to the Constitution and various other laws.
- There is a need to provide for priority to the financial assistance given at the time of rehabilitation while disbursing the assets in liquidation, by inserting a special provision in the Companies Act. The law should provide for an extension of financial aid during the rescue process only to such an entity as would have suffered losses as a result of matters beyond its control and not to those entities that have

suffered losses due to maladministration and recklessness.

- It is advisable to keep insolvency procedures of entities with systemic risk like the banks/insurance companies separate from the insolvency relating to ordinary companies.
- The law should provide for time-frame to conclude liquidation proceedings.
- The UNCITRAL Model Law on Cross-border Insolvency with suitable modifications should be adopted.
- The Companies (Second Amendment) Act, 2002 provides for the formation of a rehabilitation and revival fund, the appointment of professionals as liquidators and the setting of NCLT with powers to deal with liquidation as well as rehabilitation/reorganisation of a company. So its operationalisation must be expedited.
- A separate bench of NCLT should be set up to deal with cases involving rehabilitation with loan amounts of Rs.10 crore and above.
- Companies often use the SICA to prevent creditors from proceeding against them. This is on account of statutory stay on initiation/continuance of suits or other legal proceeding once a reference is made to the BIFR. The Companies (Second Amendment) Act, 2002 should be brought into operation to remedy this situation.

Provisional Measures and Effects of Commencement

- The Companies (Second Amendment) Act, 2002 should be quickly brought into operation as it seeks to expressly empower the court/liquidator to take relevant measures to protect the properties of the company during the proceedings.
- The law should provide for an automatic stay on creation of further liabilities on or alienation of the company's assets, camouflaged as in the ordinary course of business, after the presentation of winding-up petition and service of its notice on the company. As a safeguard against abuse of such proceedings, the law should also provide for severe penalties against applicants for vexatious and mala fide petitions.
- Because of delay, the actual realisation of assets in liquidation is very low and there is a need to provide for an expeditious disposal mechanism for better valuation.

Creditors and the Creditors' Committee

- The law should provide for a creditors' committee at the initial stage of insolvency proceedings to consider the re-organisation of the company.
- There should be provision for an exclusive creditors' committee/assembly in insolvency laws, when the liquidator is not a creditor-nominated liquidator. Such committees should be empowered to participate in the decisions along with the liquidator and to file a report independently to the court/tribunal for improving liquidation proceedings.
- The law should provide for nominating unsecured creditors in the Creditors' Committee to ensure their participation, and for safeguarding their interest.

Administration

- The Companies (Second Amendment) Act, 2002 should be brought into operation quickly to empower the liquidator/court to protect the assets of the company and to even sell the undertaking as a going concern.

Treatment of Contractual Obligations

- There should be express provisions dealing with the treatment of set-off rights, netting and close-out contracts, personal contracts and labour contracts during re-organisation and winding-up.

- A limited extent of certainty has been introduced by way of the Payment and Settlement Systems Act, 2007 in respect of contracts in a payment system. However, the position regarding treatment of the OTC transactions in derivatives settled outside the 'payment systems' regulated under the Payment and Settlement Systems Act, 2007 especially the closing-out provisions in such contracts, is not yet clear. Appropriate provisions should be inserted in the Securities Contracts (Regulation) Act, 1956 to provide protection to the contracts entered on recognised stock exchanges because the provisions of the Payment and Settlement Systems Act, 2007 are not applicable to stock exchanges and clearing corporations of such stock exchanges regulated by SEBI and, therefore, the protection afforded to netting and close-out conducted on such stock exchanges.

Claims Resolution Procedures

- The implementation of the provisions relating to the receipt of claims and their process in liquidation needs to be improved to reduce delay.

Reorganisation Proceedings

- The Companies (Second Amendment) Act, 2002 should be operationalised to improve the rehabilitation mechanism available to sick industrial companies.
- The law should provide for setting time-limits for the approval of a rehabilitation plan. It would be necessary for the legal provisions to limit the number of plans that can be submitted for sanction before the court or provide for the automatic lapse of a scheme if the same is not approved within a specified period, say within three months or six months from the date of submission.
- In rehabilitation proceedings under SICA, there should be a provision for the appointment of a creditor-nominated representative/committee.
- There is a necessity for incorporating provisions that would compel companies to report the implementation of their plan periodically to the Regional Director/ Department of Corporate Affairs (similar to the banks reporting to the Reserve Bank) till all the terms and conditions of the plan are substantially complied with and the court passes final orders to that effect.

International Considerations

- It is necessary to adopt the UNCITRAL Model Law on Cross-border Insolvency as suggested by various committees.

Part D. Implementation: Institutional and Regulatory Frameworks

Judicial Decision-making and Enforcement of Orders

- Certified copies of court orders should be made available online to improve the efficiency and utility of the system.
- The lack of judicial time, lack of expertise and consequent lack of proper appreciation of issues pertaining to insolvency, is causing delay in deciding the court cases. This can, to a large extent, be solved if the NCLT and the NCLAT are set up.

Annex I

Detailed Assessment of Observance of Principles for Effective Insolvency and Creditor Rights Systems

<table>
<tr><th colspan="2">Part A. Legal Framework for Creditor Rights</th></tr>
<tr><td>A1</td><td>Key Elements

A modern credit-based economy should facilitate broad access to credit at affordable rates through the widest possible range of credit products (secured and unsecured) inspired by a complete, integrated and harmonised commercial law system designed to promote:
reliable and affordable means for protecting credit and minimising the risks of non-performance and default;
reliable procedures that enable credit providers and investors to more effectively assess, manage and resolve default risks and to promptly respond to a state of financial distress of an enterprise borrower;
affordable, transparent and reasonably predictable mechanisms to enforce unsecured and secured credit claims by means of individual action (e.g., enforcement and execution) or through collective action and proceedings (e.g. insolvency); and
a unified policy vision governing credit access, credit protection, credit risk management and recovery, and insolvency through laws and regulations that are compatible procedurally and substantively.</td></tr>
<tr><td>Legal Framework</td><td>India has a fairly large number of credit institutions to cater to the needs of the public. These institutions are providing various types of credit products to large portions of population. These institutions mainly include, banking companies, nationalised banks, the SBI and its subsidiary banks, RRBs, co-operative banks (both under State Co-operative Societies Acts as well as Multi-State Co-operative Societies Act, 2002), primary agricultural credit societies, land mortgage banks, co-operative credit societies, NBFCs, State Financial Corporations, housing finance companies and other public financial institutions. Apart from the above institutional creditors, informal credit providers, such as money-lenders and micro-finance institutions, are also active in many semi-urban and rural areas of the country.

While the procedure for creating security interests for credit is almost similar throughout the country, irrespective of the nature and constitution of the creditor, the applicable law for enforcement of those security interests vary according to the type of creditor. For e.g., co-operative banks have a separate recovery mechanism prescribed under the State Co-operative Societies Acts. Similarly, State Financial Corporations have been given certain non-judicial remedies in respect of the credit disbursed by them. Banks and financial institutions have</td></tr>
</table>

	been empowered to enforce their security interests in certain assets through non-judicial remedies under the SARFAESI Act. However, NBFCs have to resort to the ordinary court system for enforcing their security interests. The stamp duty payable on creation of security interest varies from State to State. In some States, rates of stamp duty are very high leading to increased cost of lending. The Companies Bill, 2008 seeks to enable the creditors to initiate class action proceedings against a company, if they are of the opinion that the management or control of the affairs of the company is being conducted in a manner prejudicial to the interest of the company or the creditors, so that the Tribunal may restrain them from acting in such manner. **Recognition to Contractual Rights of Creditors** The contractual rights of creditors are recognised under the laws in India. The Transfer of Property Act, 1882, the Registration Act, 1908, the Sale of Goods Act, 1930, the Patents Act, 1970, the Trade Marks Act, 1999, the Designs Act, 2000, the Motor Vehicles Act, 1988 and the Companies Act, 1956 all enable creation of security interests in some form or the other. The provisions of the above enactments read with the provisions of the Indian Contract Act, 1872, the Code of Civil Procedure, 1908, the Recovery of Debts due to Banks and Financial Institutions Act, 1993 (DRT Act) and the SARFAESI Act, 2002 enable enforcement of secured and unsecured claims, by recognising the contractual rights of the creditors (banks and financial institutions) and debtors. Certain provisions of law which gives priority to sovereign claims over the claims of secured creditors have been, however, causing concern to the secured creditors as regards their security interest. State has no priority for recovery of tax from the property of the person liable to pay tax over the secured debts, unless statutory charge has been created by the Act passed by the Central/State legislature. Certain legislations provide for such statutory charges. For example, Section 11AAAA of Rajasthan Sales Tax Act, 1954 provides as under: '11AAAA. Liability under this Act to be the first charge. – Notwithstanding anything to the contrary contained in any law for the time being in force, any amount of tax, penalty, interest and any other sum, if any, payable by a dealer or any other person under this Act, shall be the first charge on the property of the dealer, or such person.' (Similar provisions are available in the Sales Tax Acts of Karnataka and Kerala.)

	In the Central Acts, Section 11 of the Employees Provident Fund Act, 1952 provides for statutory first charge. In respect of Income Tax, Section 281 of the Income Tax provides that, during pendency of any proceedings under the Act or after completion thereof, if an assesse creates a charge on the property in favour of any other person, such charge shall be void against any claim in respect of any tax payable by the assesse. Therefore, the banks need to ascertain the position regarding pendency of any proceedings against the assesse under Income Tax Act before creating any security interest. In the State Bank of Bikaner and Jaipur Vs. National Iron and Steel Rolling Corporation and others (reported in (1995) 2 SCC 19; [1995] 82 Comp Cas 551 (SC)), the Supreme Court has held that when a first charge is created by operation of law over any property, that charge will have precedence over all other charges including an existing mortgage. A similar view has been expressed by the Supreme Court in the matter of Dena Bank Vs. Bikubai Prabhu Dass Parekh & Co. (reported in 2000 (5) SCC 694; AIR 2000 SC 3654), while examining the provisions of Karnataka Sales Tax Act, 1957 read with provisions of Chapter XVI of Karnataka Land Revenue Act, 1964. In the winding-up of a company, however, preferential payments as laid down under the provisions of the Companies Act, 1956 shall be applicable and accordingly the workmen's dues and debts due to secured creditors shall rank *pari passu*, giving priority over all other debts. *Secured Claims* The SARFAESI Act recognises contractual rights of secured creditors (banks and financial institutions) for possession and sale of secured assets in accordance with the procedure prescribed thereunder. Special tribunals (DRTs) have been created under the provisions of the DRT Act for the purpose of recovery of loans and for enforcement of securities charged with them (by banks and financial institutions). However, DRT deals with secured/unsecured claims where debt due is Rs.10 lakh and above. The Code of Civil Procedure, 1908 also contains provisions in respect of suits filed in Courts against debtors. The respective State Co-operative Societies Acts and the Multi-State Co-operative Societies Act, 2002 provide for enforcement of the contractual rights of the creditor co-operative societies on their debtors. The State Financial Corporations Act, 1951 empowers the State Financial Corporations to enforce their security interests without the intervention of courts. Apart from the above, the creditors can enforce their contractual obligations by taking repossession of the securities in the case of hire-purchase contracts (provided there is a clause to that effect in the contract) in respect of movable properties. The law provides for rehabilitation of industrial companies, that are sick under the provisions of SICA. The SICA provides for rehabilitation by giving financial assistance by way of loans, advances or guarantees or reliefs or concessions or sacrifices from the Central Government, State Government, any scheduled bank or any other bank, a public financial institution or State-level institution or any

	institution or authority referred to under a scheme made under that Act. The BIFR or the operating agency (a scheduled bank or financial institution) entrusted with the work of rehabilitation would monitor the implementation of the plan. The SICA is sought to be replaced by Chapter VIA inserted in the Companies Act, 1956 by Companies (Second Amendment) Act, 2002 (which is yet to be brought into operation). The Companies Act, 1956 provides for initiation of liquidation proceedings as well as filing of claims in those proceedings by creditors against companies. The liquidation proceedings are presently dealt with by the High Courts. The Companies (Second Amendment) Act, 2002 has amended the Companies Act, 1956, providing for constitution of a NCLT to *inter alia* deal with liquidation/ rehabilitation proceedings under the Companies Act, 1956. However, the said provisions are yet to be made operational due to the order passed by the Madras High Court in Thiru R. Gandhi President, Madras Bar Association Vs. UOI (reported in (2004) 52 SCL 79). At present, the matter is pending before the Supreme Court. In the case of public sector banks, the Reserve Bank, from time to time, comes up with One-Time Settlement Schemes for settlement of outstanding dues and guidelines for informal restructuring of debts for specified debtors (for amounts below Rs.10 crore). However, there has been no One-time Settlement Scheme for the last few years (last such scheme was issued on January 29, 2003). *Unsecured Claims* The DRTs under the DRT Act can be utilised by banks and financial institutions for enforcing their unsecured claims also. The State Co-operative Societies Acts and the Multi-State Co-operative Societies Act, 2002 also provide for enforcement of the contractual rights of the creditor co-operative societies in respect of unsecured claims on their debtors. Apart from the above, the Indian Contract Act, 1872 sanctifies the contractual rights of creditors in respect of unsecured claims also and enforcement of the same through courts of civil jurisdiction under the provisions of the Code of Civil Procedure, 1908. The One-Time Settlement Schemes were made applicable even in cases of unsecured claims. **Information on Debtors** The CIC (Regulation) Act, 2005 provides for registration of credit information companies, who act as repositories of information relating to the trade, credit and financial standing of the borrowers of credit institutions (all types of banks, financial institutions, NBFCs, State financial corporations, *etc.*) and provide credit scoring in respect of each borrower. It is obligatory on the credit institutions to

send information of its borrowers to the credit information company in which it is a member. This information would be available to the member credit institutions on payment of a prescribed fee.

Credit Guarantee

Credit Guarantee Trust for Small Industries (CGTSI)

With a view to resolving the problem of collaterals, and to induce banks to gradually move away from a completely risk-averse stance towards Small-scale Industries (SSIs), the Ministry of Small Scale Industry, Central Government and the Small Industries Development Bank of India (SIDBI) took the initiative of designing a guaranteeing mechanism for ensuring collateral-free loans to small entrepreneurs, SSIs and tiny units. Thus, Credit Guarantee Fund Scheme for small industries was formally launched in August 2000. The prime objective of CGTSI is to facilitate the flow of collateral-free credit to the SSI sector and encourage lenders to shift from collateral-based or security-oriented lending to project-based lending. CGTSI has been trying to achieve this objective by extending guarantees to the commercial banks/institutions, referred to as member lending institutions (MLIs), sanction credit to eligible borrowers based on the viability of the projects and seek guarantee cover from CGTSI against payment of one-time guarantee fee and annual service charges. CGTSI guarantees upto 75 per cent of the credit risk, subject to loan cap of Rs.25 lakh and guarantee cap of Rs.18.75 lakh per borrower.

Export Credit Guarantee Corporation of India Ltd. (ECGC)

ECGC was established in the year 1957 by the Central Government to strengthen the export promotion drive by covering the risk of exporting on credit. It provides a range of credit risk insurance covers to exporters against loss in export of goods and services and offers guarantees to banks and financial institutions to enable exporters to obtain better facilities from them. ECGC provides overseas investment insurance to Indian companies investing in joint ventures abroad in the form of equity or loan. ECGC provides *inter alia* Packing Credit Guarantee, Export Production Finance Guarantee, Post-Shipment Export Credit Guarantee and Export Finance Guarantee.

Deposit Insurance and Credit Guarantee Corporation Act, 1961 (DICGC Act)

In terms of Section 21A of the DICGC Act, DICGC has been empowered to frame schemes for providing credit guarantees to credit institutions by charging the notified fees from them. DICGC has notified some schemes such as the Small Loans Guarantee Scheme, 1971, Small Loans (SSI) Guarantee Scheme, 1981 and Small Loans (Co-operative Banks) Guarantee Scheme, 1984. The claim can be lodged *inter alia* only if the account is written-off in the books of the institution and the recovery received in a particular account is less than 25 per cent of the total debits in the account on the date of write-off of such accounts. Further, the DICGC guarantee would only cover the principal amount sanctioned and the liability of DICGC would be subject to the sharing pattern between the DICGC

	and the credit institution and the ceilings as prescribed by the DICGC from time-to-time for different types/segments of priority sector advances and also for the multiple claims. These conditions have operated as a disincentive to the credit institutions from tapping the credit guarantee facility provided by DICGC.
Assessment	**Partly Observed**
Comments	In spite of the increase in the penetration of bank branches and developments in technology, a large portion of the population still relies on the informal credit providers at high rates of interests for meeting their credit needs. This aspect has been revealed by the All-India Debt and Investment Survey (NSS Fifty-Ninth Round), 2002 which states that the share of money-lenders in the total dues of rural households increased from 17.5 per cent in 1991 to 29.6 per cent in 2002. A Government-appointed Committee on Financial Inclusion (2008) (Chairman: Dr. C. Rangarajan) in its Report has stated that, 45.9 million farmer households in the country out of a total of 89.3 million households (or 51 per cent) do not access credit, either from institutional or non-institutional sources. The Committee further observed that exclusion is most acute in the central, eastern and north-eastern regions, having a concentration of 64 per cent of all financially-excluded farmer households in the country. In terms of occupational groups, about 20 per cent of indebted marginal farmer households have access to formal sources of credit. The Committee has recommended a four-pronged strategy for building an inclusive financial sector including: (a) effecting improvements in the extant formal credit delivery mechanism; (b) suggested measures for improving credit absorption capacity, especially amongst marginal and sub-marginal farmers; (c) evolving new models for effective outreach; and (d) leveraging technology-based solutions. The Rangarajan Committee has *inter alia* made the following recommendations: ● the launching of a National Rural Financial Inclusion Plan (NRFIP) with a clear target to provide access to comprehensive financial services, including credit, to at least 50 per cent of financially-excluded households by 2012 through rural/semi-urban branches of commercial banks and RRBs. ● disaggregating the national targets State-wise with adequate focus on districts having a large percentage of population not accessing bank credit. ● setting targets for rural/semi-urban branches of commercial banks (including RRBs) to provide access to credit to at least 250 hitherto excluded rural households.

- Constitution of two funds: Financial Inclusion Promotion and Development Fund with NABARD, towards meeting the cost of developmental and promotional interventions and a Financial Inclusion Technology Fund, with NABARD, to meet the costs of technology adoption, each with an initial corpus of Rs.500 crore and a start-up funding of Rs.250 crore.
- Expansion of effective outreach by allowing banks to appoint ex-servicemen/ retired bank staff as their business facilitators. In addition, banks may also facilitate easy roll-out of the mobile banking model through simplification and rationalisation of bank-end processes and front-end procedures to make banking operations more customer-friendly.
- Leveraging technology to open up channels beyond branch network and create the required banking footprints to reach the unbanked, so as to extend banking services similar to those dispensed from branches.

The Committee has further observed that the share of credit to rural and semi-urban credit in total credit decreased from around 25 per cent to less than 20 per cent over the period 1996-2007. The growth of rural banking relative to GDP in rural and semi-urban areas has been modest.

Trends in Rural Banking

(Amount in Rs. crore; Ratios in per cent)

Indicator	Year	Rural and semi-urban	Urban and metropolitan
Share of deposits	1996	33.9	66.1
	2001	34.3	65.7
	2006	25.3	74.7
	2007	23.7	76.3
Share of credit	1996	24.5	75.5
	2001	21.6	78.4
	2006	18.3	81.7
	2007	17.7	82.3
Deposits/GDP	1996	12.1	23.6
	2001	15.5	29.7
	2006	14.8	43.8
	2007	14.9	48.1
Credit/GDP	1996	5.2	16.1
	2001	5.5	20.1
	2006	7.8	34.7
	2007	8.4	38.9
Memo:			
Deposits	1996	1,44,500	2,81,600
	2001	3,25,600	6,23,800
	2006	5,28,300	15,62,900
	2007	6,15,000	19,83,900
Credit	1996	62,300	1,92,400
	2001	1,16,200	4,22,300
	2006	2,77,500	12,36,300
	2007	3,44,600	16,05,000

	SSIs have traditionally faced difficulties in obtaining formal credit or equity from banks. The maturity periods of loans extended to SSIs are often limited to a short period and they are not provided access to credit at competitive interest rates. These factors have led to lack of adequate financing for SSIs. It is seen from the Rangarajan Committee Report that the share of credit to SSI has declined from around 15 per cent in 1998 to less than 7 per cent in 2007, although the share of SSI in GDP has remained at around 13 per cent. Therefore, the institutional credit providers have immense opportunities in tapping this market by providing credit at affordable rates and for making credit accessible to many more persons. There is a need to expedite delivery mechanism of institutional credit to the rural masses and the weaker sections in urban areas to ensure timely credit at affordable rates. Even though there is no unified policy vision document for the purpose of providing a broader credit access, credit protection, credit risk management and recovery and several individual policy measures have been initiated in these areas. The proposed legislation for the registration and regulation of micro-finance institutions, with provisions enabling them accept deposits and lend to weaker sections is an example. Efforts, in the nature of 'micro finance programs,' have also been undertaken to develop newer delivery approaches to reach out to the poor. The Central Government and the Reserve Bank have come out with several measures for furthering financial inclusion. The Union Budget, 2007-08 has proposed the establishment of two funds, namely, the Financial Inclusion Fund (for meeting the cost of developmental and promotional interventions) and the Financial Inclusion Technology Fund (to meet the costs of technology adoption) with a corpus of Rs.500 crore each. The Union Budget, 2008-09 has also proposed to allow individuals such as retired bank officers, ex-servicemen, *etc.* to be appointed as business facilitator or business correspondent or credit counsellor. The Self-Help Group (SHG)-Bank linkage programme, with the refinancing of NABARD in certain cases, has been introduced in the area of micro-finance. This linkage is for the purpose of organising the poor into small, cohesive groups and inculcating a habit of savings within the group. The SHG is linked to a bank and the saved and borrowed funds are rotated through lending within the group. The refinancing by NABARD is provided at a lower rate. For example, during 2006-07, interest rates on refinance under investment credit (including SHGs) in the north-eastern region, Sikkim and Andaman and Nicobar Islands were 6.5

	per cent (for borrowings upto Rs.50,000) and 7 per cent (for borrowings above Rs.50,000). In other parts of the country, for loans to SHGs, interest rate of 7 per cent was charged to all agencies irrespective of the quantum of per capita loan (6.5 per cent to StCBs/SCARDBs for per capita loans upto Rs.50,000). During 2006-07, 0.68 million SHGs were credit-linked by the banking system, taking the cumulative number of SHGs credit-linked to 2.9 million since its inception in 1992-93 with cumulative loan disbursement and refinance support aggregating Rs.18,000 crore and Rs.5,400 crore, respectively. In terms of shares in the cumulative loan disbursed, commercial banks had an overwhelming share of 63 per cent, followed by RRBs (28 per cent) and co-operative banks (9 per cent). Further, the Kisan Credit Card (KCC) scheme offered by commercial banks, RRBs and co-operative banks, for providing credit to the agricultural sector (including allied activities) is another policy initiative. Banks and RRBs have been permitted to introduce General Credit Card (GCC), on the lines of KCC, to their constituents in rural and semi-urban areas, based on the assessment of income and cash flow of the household similar to that prevailing under normal credit cards, without insistence on security, purpose or end-use of credit. The total credit facility under GCC for an individual has been capped at Rs.25,000 and the rate of interest to be charged has been left to banks, as considered appropriate and reasonable. Financial inclusion with the help of technology is also being thought of in the country. A Technical Group on Review of Legislations relating to money-lending, set up by the Reserve Bank and comprising members/co-optees from several State Governments, has recommended for amendments to the States' money lending laws to encourage linkage between formal and informal credit providers for improving the credit delivery, especially in the rural areas. Special laws, like the SARFAESI Act, and the DRT Act have been enacted for the purpose of quick and effective recovery of credit through securitisation, enforcement of security interests through non-judicial methods and setting up of specialised forums for recovery of debt. The CIC (Regulation) Act, 2005 provides for dissemination of credit information among creditors for better assessment of the credit-worthiness of the borrower. The Reserve Bank has come out with detailed guidelines in respect of risk management practices to be followed by banks and financial institutions. Even though there are Credit Guarantee Schemes notified under the DICGC Act, they have become less popular due to the conditions subject to which claims can be made by credit institutions. There is a need for a comprehensive look at the functions of DICGC with respect to its performance of the functions of a deposit insurer and credit guarantor. The Reserve Bank may consider appointing a committee for this purpose, including the requirement for setting up a separate independent body for credit guarantee functions. The banks have been permitted to utilise the services of non-governmental organisations (NGOs/SHGs), micro-finance institutions and other civil society organisations as intermediaries in providing financial and banking services through the use of business facilitator and business correspondent models.

<table>
<tr><td></td><td>Notwithstanding the success of SHG-Bank linkage program, the outreach remains limited in terms of the number of households served. Outstanding bank loan disbursements under the SHG-Bank linkage in March 2006 at Rs.14,000 crore was a shade over one per cent of the rural outstanding bank credit (source: Rangarajan Committee Report). There are also concerns regarding the uneven regional spread of such linkages. Therefore, though several policy measures have been initiated side by side to improve the credit access, there is much more to be done in this regard.

Certain laws creating first charge over the secured assets of borrowers have been a matter of concern for the secured creditors. Under the Income Tax Act, 1961 any security created during the pendency of proceedings/crystallisation of claims would be subservient to the claims of the Income Tax Department. The law should be amended to the effect that priority of charge for State dues should not operate in respect of prior mortgages created in favour of the secured creditors.

The Reserve Bank has come out with the regulatory framework for facilitating registration of mortgage guarantee companies for reducing the lending risk of banks/financial institutions in respect of housing finance.</td></tr>
<tr><td>A2</td><td>Security (Immovable Property)

One of the pillars of a modern credit economy is the ability to own and freely transfer ownership interests in land and land use rights, and to grant a security interest (such as a mortgage or charge) to credit providers with respect to such interests and rights as a means of gaining access to credit at more affordable prices. The typical hallmarks of a modern mortgage system include the following features :
● Clearly defined rules and procedures for granting, by agreement or operation of law, security interests (mortgages, charges, etc.) in all types of interests in immovable assets;
● Security interests related to any or all of a debtor's obligations to a creditor, present or future, and between all types of persons;
● Clear rules of ownership and priority governing competing claims or interests in the same assets, eliminating or reducing priorities over security interests as much as possible; and
● Methods of notice, including a system of registry, which will sufficiently publicise the existence of security interests to creditors, purchasers, and the public generally at the lowest possible cost.</td></tr>
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Legal Framework	The Transfer of Property Act, 1882 facilitates mortgage of immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, an existing or future debt or the performance of engagement, which may give rise to pecuniary liabilities. It also provides for creation of charge over an immovable property. The Act also provides for priorities of rights among the creditors based on the dates on which the rights are created. The mortgages can be foreclosed by the mortgagee (by filing a suit for foreclosure in respect of certain types of mortgages) in accordance with the provisions of the Act. In the case of banks and FIs, generally, registered mortgage and mortgage by deposit of title deeds are being taken. For these types of mortgages, suit for sale of the mortgaged properties are being filed. In case of mortgage of an immovable property, where through fraud, misrepresentation, or gross neglect of a prior mortgagee, another person is induced to advance money on the security of the mortgaged property, the prior mortgage shall be postponed to the subsequent mortgagee. Further, if an owner of two or more properties mortgages them to one person and then mortgages one or more of the properties to another person, the subsequent mortgagee is entitled to have the prior mortgagee debt satisfied out of the property or properties not mortgaged to him, but not so as to prejudice the rights of the prior mortgagee or any other person who has for consideration acquired interest in any of the properties. As regards secured debts, the same are transferable by way of assignment unless there is a provision to the contrary in the agreement. Using this provision, many banks and financial institutions are selling off their loan portfolios/book debts to other banks, financial institutions, NBFCs and recovery firms/companies either by out-and-out transfer or by factoring. The Companies Act, 1956 recognises creation of charge (including floating charge) over the properties of the company, including immovable property, movable property, inventory, receivables, proceeds, goodwill, patent, trademark and copyright and the said charges are required to be registered in the form and manner prescribed by/under the Companies Act. The Companies Act also recognises the priority of charges on the assets of the company and requires registration of such charges for the purposes of establishing priority and for public notice. The priority of dues of secured creditors over other claimants, including Government, is recognised under the Companies Act and other insolvency laws but difficulties are experienced at enforcement and distribution stage. Secured creditors have a right to remain outside winding-up proceedings and realise their securities, subject to a *pari passu* charge in favour of the workmen, if any. The secured creditor (after valuing his security) also has the option of surrendering his security and claiming preferential payment in accordance with the priority prescribed under the Companies Act. The priority of claims among secured creditors (depending on the type of charge, *viz.,* first charge or second charge) would be in accordance with the provisions of the Transfer of Property Act.

	The law recognises creation of security interests over immovable properties and covers present, future or contingent interests in such properties. The SARFAESI Act (see definition of 'financial asset') provides for enforcement of security interests created in respect of any beneficial interest in property, including interests which are existing, accruing, future, conditional or contingent. The SARFAESI Act does not apply to security interest created in agricultural land. Further, there is a statutory restriction/bar while enforcing the security interest created in certain agricultural land to the extent provided under section 60 of the Code of Civil Procedure, 1908. Foreign creditors can also take security (immovable property) with the approval of the Reserve Bank in accordance with the provisions of the Foreign Exchange Management Act, 2000 (the restriction being that while enforcing the security interest the property should be sold to an 'Indian Resident' and the proceeds can be repatriated). There are no restrictions on Indian creditors taking security (as collateral) in foreign countries. Paragraph 5 (2) of the Fifth Schedule to the Constitution of India empowers the Governor of a State to make regulations prohibiting or restricting the transfer of land by or among members of the Scheduled Tribes in a scheduled area. Further, certain State Governments have issued 'Revenue Orders' restricting sale, mortgage and subletting of lands belonging to specified categories, like tribals and agriculturists. However, the State of Himachal Pradesh has passed the Himachal Pradesh Agricultural Credit Operations and Miscellaneous Provisions (Banks) Act, 1972 to facilitate adequate flow of credit for agricultural production and development through banks and other institutional credit agencies. This legislation *inter alia* provides that it is lawful for an agriculturist, whose rights of alienation of land or of any interest therein are restricted on account of any law or custom or tradition, to alienate the land or his interest therein, including by creation of a charge or mortgage on such land or interest in favour of a bank for the purpose of obtaining financial assistance from that bank. There are similar legislations in some other States also. In terms of the Registration Act, 1908 the documents creating mortgages (other than mortgage by deposit of title deeds) and charges of the value of Rs.100 and upwards in immovable property are required to be compulsorily registered. The SARFAESI Act provides for setting up of a Central Registry for registering the security interests in financial assets (security interest created in favour of banks

	and financial institutions), within thirty days after the date of creation of security interest, other than those specifically exempted under section 31 of the said Act. However, the Central Registry has not yet been constituted by the Central Government. The SARFAESI Act enables a banking or financial institution (specified) to enforce security interest (mortgages over immovable properties and hypothecations) without the intervention of the Court.
Assessment	**Broadly Observed**
Comments	Even though the general laws of the land permit creation of security interests over immovable properties, certain State Governments have issued Revenue Orders restricting sale, mortgage and subletting of lands belonging to specified categories like tribals and agriculturists. These orders have acted as disincentives to creditors for giving loans on the security of such lands. States should enact legislations similar to the Himachal Pradesh Agricultural Credit Operations and Miscellaneous Provisions (Banks) Act, 1972 to facilitate adequate flow of credit for agricultural production and development through banks and other institutional credit agencies. States can also take steps to remove the restrictions on creation of security interests in favour of banks and financial institutions and in respect of lands belonging to specified categories, by way of rescinding the revenue orders or by way of legislation, as the case may be. The SARFAESI Act may be extended to cover security interest in agricultural land beyond a specified holding (*eg.,* 5 acres upto would be exempt from the provisions of the SARFAESI Act). In the case of winding-up proceedings, even though the secured creditors are allowed to enforce their security interests outside the winding-up, on account of the *pari passu* charges in favour of the workmen, there is delay in appropriating the proceeds. The workmen's dues in many cases are not calculated in time and the proceedings get prolonged affecting the interests of secured creditors. The Central Registry envisaged under the provisions of SARFAESI Act, once constituted, would afford a good source/database about the creation of security interests/charges under the SARFAESI Act and would also be an authentic source for public notice. Another area of concern is the high rates of stamp duty on instruments concerning transactions in immovable properties levied by many States. The stamp duties charged by the States should be nominal so that the same would not hamper the transfer of immovable properties and interests therein. State Governments should not look at property taxes as the main source of revenue. Presently, the legal provisions in respect of creation of security interest and its registration in respect of both immovable and movable properties are dispersed in various legislations. It may be worthwhile to have a common legislation dealing with creation and registration of security interests (collaterals) irrespective of the nature of the security and its location. However, such a move would require amendments to several legislations and the Constitution.

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<tr><td>A3</td><td>Security (Movable Property)

A modern credit economy should broadly support all manner of modern forms of lending and credit transactions and structures, with respect to utilising movable assets as a means of providing credit protection, to reduce the costs of credit. A mature secured transactions system enables parties to grant a security interest in movable property, with the primary features that include:

● Clearly defined rules and procedures to create, recognise, and enforce security interests over movable assets, arising by agreement or operation of law;

● Allowance of security interests in all types of movable assets, whether tangible or intangible (e.g. equipment, inventory, bank accounts, securities, accounts receivables, goods in transit, intellectual property, and their proceeds, offspring and mutations), including present, after-acquired or future assets (including goods to be manufactured or acquired); wherever located and on a global basis; based on both possessory and non-possessory interests;

● Security interests related to any or all of a debtor's obligations to a creditor, present or future, and between all types of persons;

● Methods of notice (including a system of registration) that will sufficiently publicise the existence of security interests to creditors, purchasers, and the public generally at the lowest possible cost; and

● Clear rules of priority governing competing claims or interest in the same assets, eliminating or reducing priorities over security interests as much as possible.</td></tr>
<tr><td>Legal Framework</td><td>Indian Contract Act, 1872 allows execution of loan agreement against security of movable property, such as pledge. Further, the Motor Vehicles Act, 1988 (for motor vehicles) and the SARFAESI Act give recognition to hypothecation of movable property (non-possessory pledge). The Companies Act, 1956 recognises creation of charge (including floating charge) over the properties of the company, including movable property, inventory, receivables, proceeds, goodwill, patent, trademark and copyright and the said charges are required to be registered in the form and manner prescribed by/under the Companies Act. However, pledge of movable property of a company is not required to be registered. The Companies Act recognises even the charges created on properties of the company situated outside India. The Patents Act, 1970 and the Designs Act, 2000 recognise charges</td></tr>
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	created on patents and designs. The Trade Marks Act, 1999 enables registration of assignment and transmission of registered Trademarks. However, there is no provision for registration of charges over Trademarks under the Trade Marks Act, 1999. The Patents Act, 1970 requires every mortgage of a patent to be reduced to writing and registered with the Controller and the mortgagee is required to apply to the Controller for registration of his title or interest therein. A similar provision is contained in the Designs Act, 2000 also as regards mortgage of a design. The priority of charges is in accordance with the registration. Possessory interests over tangible movable property have been recognised by the Indian Contract Act, 1872 and Sale of Goods Act, 1930. Clause 69 of the Companies Bill, 2008 seeks to provide for registration of charges created on all properties and assets of the company (situated in India and outside) along with a copy of the instruments creating such charge, within 30 days of creation of such a charge. This is unlike the present provisions which contain certain exceptions from registration as in the case of pledge of movable properties. Unsecured debts are treated as 'actionable claims' under the Transfer of Property Act, 1882 and the same is transferable from person to person. In terms of this Act, 'actionable claim' means a claim to any debt, other than a debt secured by mortgage of immoveable property or by hypothecation or pledge of moveable property, or to any beneficial interest in moveable property not in the possession, either actual or constructive, of the claimant, which the Civil Courts recognise as affording grounds for relief, whether such debt or beneficial interest be existent, accruing, conditional or contingent. The hypothecated security interest can be enforced under the provisions of SARFAESI Act.
Assessment	**Broadly Observed**
Comments	Generally, the creditor-debtor agreements provide for the mode of enforcement of security interest in movable properties. The recovery methods employed by the agents of many banks and financial institutions for repossession of the movable property (like vehicles, equipment, machinery, *etc.*) are not satisfactory. The Reserve Bank has issued guidelines reviewing the policy, practice and procedure involved in engagement of recovery agents in India by the banks. These guidelines contemplate performance of due diligence by banks before engaging recovery agents. The guidelines *inter alia* provide for the agents to undergo a certificate course on recovery, adherence to the Code formulated by the Banking Codes and Standards Board of India, use Lok Adalats for recovery of loans below Rs.10 lakh, utlilisation of credit counsellors and ban on engagement of recovery agents in certain cases. Once the measures indicated in the guidelines are put into practice by the banks, it is expected that order and discipline would be established in the process of enforcement of security interests in movable properties by banks. Law for public notice for creation of security on moveable assets are inadequate and restricted to charges created on company's moveable assets and on motor vehicles. There is no provision for public notice for creation of security interest

	on moveable assets of other entities like partnership, proprietorship *etc*,. The Central Registry envisaged under the provisions of SARFAESI Act, once constituted, would afford a good source/database on creation of security interest/charge under the SARFAESI Act and would also be an authentic source for public notice.
A4	**Registry Systems** **There should be an efficient, transparent, and cost-effective registration system with regard to property rights and security interests in the borrower's immovable assets. There should be an efficient, transparent and cost-effective means of providing notice of the possible existence of security interests in regard to the borrower's movable assets, with registration in most cases being the principal and strongly preferred method, with some exceptions. The registration system should be reasonably integrated, easily accessible and inexpensive with respect to recording requirements and searches of the registry, and should be secure.**
Legal Framework	The law recognises creation of security interest in all types of assets. There are separate registries for security interests of the value of Rs.100 and above in respect of immovable properties and security interests in motor vehicles, mortgages of patents and designs and charges created on the assets of companies (except pledge of movables). The registration in these registries would act as notice of the security interest creation to the general public. The priorities of the charges are also generally based on the date of execution.
A 4.1	**Land and Mortgage Registries** **Registries pertaining to land (or land use rights) and mortgages are typically established solely for recording of interests of this nature, although permanent fixtures and attachments to the land may be treated as being subject to recordation in the place of the underlying real property. Land and mortgage registries are typically established by jurisdiction, region or locale where the property is situated, and ideally should provide for integrated, computerised search features.**
Legal Framework	The provisions of the Registration Act, 1908 provide for registration of all documents affecting right, title and interest of the value of Rs.100/- and above in any immovable property. The Transfer of Property Act, 1882 also states that where the principal money secured is Rs. 100 or upwards, a mortgage, other than by deposit of title deeds can be effected only by a registered instrument signed by the mortgagor and attested by at least two witnesses. Consequently, mortgages and charges of the value of Rs. 100 and above relating to immovable properties

	are required to be compulsorily registered. The documents are required to be registered within four months from the date of its execution and the document would commence to operate from the date of its execution. The Registrar is empowered to accept the documents even after four months of its execution on payment of penalty (not exceeding ten times) of the amount of the proper registration. The Registration Act, 1908 gives priority to registered documents over unregistered or oral agreements. However, a mortgage by deposit of title deeds shall take effect against any mortgage-deed subsequently executed and registered. Any person is entitled to inspect and get copies of the register relating to transactions in immovable property, subject to the rules and payment of prescribed fees. The State Governments have been empowered to prescribe the fee for registration, searches and, copies and therefore, it varies from State to State. Presumption of notice has been provided for every registered instrument but practically it is very difficult to verify such mortgages/transfers *etc.* This is more so in case of creation of mortgage by deposit of title deed by banks and FIs as no registered document is in existence. There are instances where the owners forge original documents and deposit the same with different banks. As regards the charges created on the assets of a company, Part V of the Companies Act, 1956 makes provisions for registration of charges on the assets of a company incorporated under the said Act. The following charges (relating to immovable properties) are required to be registered within thirty days of its creation: (i) a charge for the purpose of securing any issues of debentures; (ii) a charge on any immovable property, wherever situated, or any interest there in; and (iii) a floating charge on the undertaking or any property of the company. As per the Companies (Amendment) Act 2006, charges with Registrar of Companies (RoC) are to be filed as per MCA 21. The RoC is required to issue a certificate evidencing the registration of any charge and the said certificate will be conclusive evidence of such charge and the registered charges are given priority even during the winding-up of the company. Once the registration of a charge over the property (under the Companies Act) has been done, any person acquiring such property or any part thereof, subsequently, shall be deemed to have notice of the charge. Any creditor or member of the company can inspect the register of charges kept in the company's Registered Office, during the hours fixed by the company without payment of any fee. Any person other than a creditor or member can also inspect the document by paying the prescribed fee. Similar inspection is also possible for the registration of charges/interest as per prescribed procedure under different Acts. The SARFAESI Act provides for setting up of a Central Registry (with branches across the country) by the Central Government where transactions of securitisation and asset reconstruction as well as transaction of creation of security

	interest as defined under that Act will be required to be registered. Consequently, the security interests in financial assets created in favour of banks and financial institutions covered by the SARFAESI Act would be required to be registered in the Central Registry. The provisions of the SARFAESI Act requiring registration in Central Registry are in addition to and not in derogation of the requirements of registration under other statutes like the Registration Act, 1908, Companies Act, 1956 *etc*,. The priority of charges and their validity would be governed by the registration procedures under the respective statutes. The public has a right to inspect the particulars entered in the Central Register on payment of the prescribed fees. However, such a Central Registry is yet to be set up.
Assessment	**Broadly Observed**
Comments	The system of registration of security interest in respect of immovable property, motor vehicles, intellectual property and in respect of assets of companies provide adequate notice of creation of the security interest to the general public. However, there is no registry which keeps a record of the security interests created in respect of movable properties. The Central Registry under SARFAESI Act, which can take care of a major part of the transactions of banks and financial institutions, is yet to be set up. The Central Registry should be set up urgently to have a central and reliable record of all security interests created by banks and financial institutions. The Central Registry should also be allowed to register all transactions creating security interests (both in movable as well as immovable property) by entities/ individuals in addition to those of banks/financial institutions. For this purpose, it may be appropriate to bring a separate legislation in respect of the Central Registry. In course of time, the Central Registry (with adequate number of branches all over the country) should be the sole registry for registration of all security interests over properties and the registries under various statutes should be wound-up with suitable amendments to the respective Acts dealing with registration of security interests. Till such time, the respective State registries can continue as such and the Central Registry apart from its functions under the SARFAESI Act may act as a central database with a statutory mandate to collect/ obtain information from various registries in the country. The details of all security interests should also be made available online. As security interest in respect of immovable properties is being registered in the offices of Sub-Registrar of Assurances where immoveable property is situated, it is difficult for creditors elsewhere to verify the records with the Sub-Registrar with regard to title and security interest. Computerised search features in land

	registries are available in some States. But a majority of the registries have not computerised their records. Therefore, there is an urgent need to computerise the records of Registrar of Assurances, provide online search facilities and link them to the Central Registry. Measures should be taken by all the State Governments in this regard.
A4.2	**Charge Registries** **Registries pertaining to movable assets of enterprises should be integrated and established nationally with filings made on the basis of the enterprise or business name, ideally in a centralised, computerised registry situated in the jurisdiction or location where the enterprise or business entity has been incorporated or has its main place of registration.**
Legal Framework	The SARFAESI Act provides for setting up of a Central Registry (with branches across the country) by the Central Government where transactions of securitisation and asset reconstruction as well as transaction of creation of security interest as defined under that Act will be required to be registered. Consequently, the security interests in financial assets created in favour of banks and financial institutions covered by the SARFAESI Act would be required to be registered in the Central Registry. The provisions of the SARFAESI Act requiring registration in Central Registry are in addition to and not in derogation of the requirements of registration under other statutes like the Registration Act, 1908, Companies Act, 1956, Motor Vehicles Act, 1988 *etc.* The priority of charges and their validity would be governed by the registration procedures under the respective statutes. The public have a right to inspect the particulars entered in the Central Register on payment of the prescribed fees. However, such a Central Registry is yet to be set up. The registration will be applicable to charge created in respect of moveable assets covered under the SARFAESI Act. As regards the charges created on the assets of a company, Part V of the Companies Act, 1956 makes provisions for registration of charges on the assets of a company incorporated under the said Act. The following charges are required to be registered within thirty days of its creation: (i) a charge for the purpose of securing any issue of debentures; (ii) a charge on uncalled share capital of the company; (iii) a charge on any immovable property, wherever situated, or any interest therein; (iv) a charge on any book debts of the company; (v) a charge, not being a pledge, on any movable property of the company; (vi) a floating charge on the undertaking or any property of the company including stock-in-trade; (vii) a charge on calls made but not paid; (viii) a charge on a ship or any share in a ship; and (ix) a charge on goodwill, on a patent or a licence under a patent, on a Trademark, or on a copyright or a licence under a copy right.

	The Registrar of Companies is required to issue a certificate evidencing the registration of any charge and the said certificate will be a conclusive evidence of such a charge and the registered charges are given priority even during the winding-up of the company. Once the registration of a charge over the property (under the Companies Act) has been done, any person acquiring such property or any part thereof, subsequently, shall be deemed to have notice of the charge. Any creditor or member of the company can inspect the register of charges kept in the company's Registered Office, during the hours fixed by the company without payment of any fee. Any person other than a creditor or member can also inspect the document by paying the prescribed fee. Clause 69 of the Companies Bill, 2008 seeks to provide for registration of charges created on all properties and assets of the company (situated in India and outside) along with a copy of the instruments creating such charge, within 30 days of creation of such charge. This is unlike the present provisions which contain certain exceptions from registration as in the case of pledge of movable properties.
Assessment	**Broadly Observed**
Comments	The existing system provides for registries for registration of security interests in movables relating to companies, motor vehicles, *etc.* However, there is no registry that keeps a record of security interests created in respect of all types of movable assets of enterprises. The available registries do not provide online search facilities and are not integrated. Please refer to the assessment made in respect of Principle A 4.1.
A4.3	**Specialised Registries** **Specialised registries are beneficial in the case of certain kinds of assets, such as aircraft, vessels, vehicles, and certain types of intellectual property (*e.g.,* trademarks, copyrights, *etc.*).**
Legal Framework	The Motor Vehicles Act, 1988 contains special provisions for registration of the interest of person(s) who have financed the purchase of vehicle. Any security interest like hypothecation, hire-purchase or lease in the vehicle is entered in the Certificate of Registration issued in respect of the vehicle. The Act prohibits registering authorities from making entries in respect of transfer of ownership of a vehicle (having a security interest entered in its certificate of Registration), without the written consent of the concerned creditor. The entry would be cancelled if proof is submitted of the termination of the agreement (creating security interest) and on an application of the parties concerned. The fees for the purpose of entering the security interest *etc.* are prescribed by the State Governments and as such vary from State to State.

	The Patents Act, 1970 provides that an assignment of a patent or of a share in a patent, a mortgage, licence or the creation of any other interest in a patent shall not be vested unless the same is in writing and the agreement between the parties incorporating all the terms is duly registered as provided. An equitable assignee or mortgagee of a patent has the right to get his notice of interest entered on the register. The assignments/mortgages/creation of any other interest in a patent would be valid only if the same is in writing (an agreement) and an application for registration is filed within six months from the execution of the agreement. The Designs Act, 2000 provides for registration of any interest in a registered design. The registries are situated in the metropolitan cities of Delhi, Mumbai, Kolkata and Chennai. The registers are open for public inspection in the manner prescribed. The registered interests are given priority. The Trade Marks Act, 1999 enables registration of assignments and transmissions in respect of registered Trademarks. The connected documents and registers are open for public inspection on payment of prescribed fee. However, there is no provision for registration of charges over Trademarks under the Trade Marks Act, 1999. The Merchant Shipping Act, 1958 provides for registration of a mortgage of ship or shares therein by the registrar of the ship's port of registry.
Assessment	**Broadly Observed**
Comments	There are specialised registries for registration of security interests in motor vehicles, vessels and intellectual properties (patent). There should be express provision for registration of charges over Trademarks under the Trade Marks Act, 1999.
A5 **A 5.1**	**Commercial Enforcement Systems** **Enforcement of Unsecured Debt** **A functional credit system should be supported by mechanisms and procedures that provide for efficient, transparent, and reliable methods for satisfying creditors' rights by means of court proceedings or non-judicial dispute resolution procedures. To the extent possible, a country's legal system should provide for executive or abbreviated procedures for debt collection.**
Legal Framework	Under the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (DRT Act), DRTs were established for expeditious adjudication and recovery of dues (including unsecured debts) to banks and financial institutions. However, at present, in case the amount of claim is less than Rs. 10 lakh, the said Act is not applicable. Any bank or financial institution which has to recover any debt above the aforesaid limit, from any person can make an application before the Tribunal having jurisdiction. On receipt of application, the Tribunal issues summons to the defendant to show cause. Then the defendant has to present a written statement in his defence, and may also claim set-off or counter-claim. The applicant can file a written statement in answer to the counter-claim. The Tribunal

	may make an interim order by way of injunction or stay or attachment against the defendant to debar him from transferring, alienating or otherwise, dealing with or disposing of any property or assets belonging to him without the prior permission of the Tribunal. Further, at any stage of the proceedings, if the Tribunal is satisfied that the defendant, with an intent to obstruct or delay or frustrate the execution of any order for recovery of debt is about to dispose of the whole or part of his property or is about to remove the whole or any part of the property from local limits of jurisdiction of the Tribunal or is likely to cause any damage or mischief to the property, the Tribunal may direct the defendant to furnish security or to produce and place the said property at the disposal of the Tribunal or to show cause. In case of failure to furnish security or to show-cause, the Tribunal may order the attachment of the whole or part of property. The Tribunal may appoint receiver in respect of the said property and also appoint a Commissioner for preparation of inventory of the properties of the defendants or for the sale thereof. On final adjudication of matters, the Presiding Officer of the Tribunal issues a certificate to the Recovery Officer and on receipt of the certificate, the Recovery Officer shall proceed to recover the amount of debt by different modes such as attachment and sale of movable or immovable property of the defendant, arrest of the defendant and his detention in prison and appointing a receiver for the management of the movable and immovable properties of the defendant. The Recovery Officer may recover any amount of debt by sale of defendant's movable property in the manner as laid down under the Income Tax Act, 1961 (Third Schedule). The application filed before the tribunal is required to be disposed within 180 days. The proceedings initiated by a bank/financial institution under the DRT Act would continue even during the liquidation of a debtor. In addition to this, the general mechanism provided under the Civil Procedure Code, 1908 (CPC) can be used by individuals as well as institutions (other than banks and financial institutions) for recovery of unsecured debt by filing suits before the Civil Courts. Recovery of unsecured debt of banks and financial institutions (below the monetary limit of Rs. 10 lakh under the DRT Act) requires filing of a suit in a Civil Court having the territorial and pecuniary jurisdiction. In the proceedings under CPC, the debtor is given an opportunity to defend his case and the creditor is required to prove his claim in the proceedings. When a decree is passed in favour of the creditor, the seizure and sale of the assets of the debtor, if required, is done under the supervision of the Court in the Execution Proceedings. There is no time-limit fixed for proceedings in Civil Courts. If the

	unsecured debt (decreed amount) is not paid by the debtor, the decree-holder has to take the Court's assistance for executing the decree. Under the Civil Procedure Code (CPC), when an attachment of any property is made, any private transfer or delivery of property attached or of any interest therein and any payment to the judgement debtor of any debt, dividend or other monies contrary to such attachment is void as against all claims enforceable under the attachment. However, for expeditious recovery of unsecured debt, provisions of Order XXXVII of CPC dealing with summary procedures can be used by a creditor for specified class of suits including suits in which the plaintiff seeks only to recover a debt or liquidated demand in money payable by the defendant with or without interest on a written contract. In the case of co-operative banks, they may file their claims before the Registrar of Co-operative Societies for grant of recovery certificate, which is then to be enforced on the lines of the procedure for recovery of arrears of land revenue. The legal system provides for recovery of advances made for agriculture and allied purposes to the agriculturists under the provisions of Agricultural Credit Act of the State concerned. Such Acts provide for recovery of unsecured debts by summary procedure by issuing a recovery certificate to the executive wing of the Government and the amount of debt is recoverable as arrears of land revenue. As regards non-judicial modes of recovering debt, there are no specific legal provisions that either enable or prohibit parties from deciding on their own default remedies. However, the remedies agreed upon should conform to the principles of the Indian Contract Act, 1872 and other laws for its enforceability. Sale/assignment of actionable claims (debt) is permitted under the provisions of the Transfer of Property Act, 1882. Under the DRT Act, the Recovery Officer has been empowered to require any person, from whom money is due to the debtor, to pay so much of the money as is sufficient to pay the amount of debt due from the debtor or the whole of the money when it is equal to or less than that amount. The persons paying in accordance with the above provisions would get a valid discharge as if he has made the payment to the debtor. The CPC also contains similar provisions. The DRT Act provides that the Recovery Officer may by order require any debtor to declare on affidavit the particulars of his assets at any stage of the execution. In case any debtor furnishes false information in respect of his assets, he will be liable for making a false statement in a declaration which is punishable under the provisions of Indian Penal Code, 1860.
Assessment	**Broadly Observed**
Comments	The general law as laid down in the CPC provides for recovery of debts by filing suits before the Civil Courts. As the Civil Courts are bound by the rules of Civil Procedure and Evidence, the recovery procedures are not sufficiently effective. The banks and financial institutions, which form a major part of the credit delivery system, have special and speedy methods for recovery of debts under DRT Act (for debts of Rs.10 lakhs above), the State Financial Corporations Act, 1951 (for

	State Financial Corporations) and the respective State Co-operative Societies Acts (for co-operative banks). However, in the case of unsecured credit, the mechanism for recovery is comparatively less efficient and in many cases proceedings are pending for execution before the Recovery Officers under DRT Act for lack of information about the properties of the debtors. As on March 31, 2007 about 65,000 cases involving an amount of about Rs. 94,000 crore are pending before DRTs. Therefore, the number of DRT benches should be increased and a separate bench be formed for cases involving Rs. 1 crore and above to deal with large unpaid debts. There is also provision for referring the matters to the 'Lok Adalat' which is an informal dispute resolution forum under the Legal Services Authorities Act, 1987.
A 5.2	**Enforcement of Secured Debt** **Enforcement systems should provide efficient, cost-effective, transparent and reliable methods (including both non-judicial and judicial) for enforcing a security interest over assets. Enforcement proceedings should provide for prompt realisation of the rights obtained in secured assets, designed to enable maximum recovery according to market-based asset values.**
Legal Framework	The Transfer of Property Act, 1882 provides for foreclosure of mortgage (in certain types of mortgages) of immovable property for the purpose of recovering the money advanced. The creditor is generally required to file a suit for foreclosure in a Court for enforcing the security. However, in case of simple mortgage and mortgage by deposit of title deed, suit for sale of the mortgaged property can be filed by banks and financial institutions. The procedure to be followed in such suits and the sale of mortgaged property are all in accordance with the provisions of the CPC. Further, special Tribunals like DRT & DRAT have been constituted under the DRT Act for enforcement of security interests by banks/FIs in respect of loans of Rs. 10 lakh and above and are designed to save time when compared to the normal proceedings before the Civil Courts. However, it is found that the average time taken by the DRTs is not less than the time taken by the Courts for grant of a decree. Once a case has been decided in favour of the bank/FI, DRT would issue a certificate of recovery and the same would be sent to the Recovery Officer for recovery *inter alia* by attachment and sale of the property of the debtor. The Supreme Court of India has, in a recent case, decided that the provisions of the DRT Act are not applicable to the co-operative banks. In any case, the recovery procedures under the respective Co-operative Societies Act are applicable to such banks.

	Further, SARFAESI Act permits enforcement of security interest (with certain exceptions) by banks and financial institutions without the intervention of the Court subject to the provisions of that Act. With the enactment of this statute, enforcement of security interests, in so far as banks and financial institutions are concerned, have become easy and efficient. Under the SARFAESI Act, there is a requirement of issuing demand notice in writing, by the secured creditor to the borrower, to discharge in full the liabilities within sixty days in case the borrower makes default in repayment of instalment and/or interest thereof and his account in respect of such debt is classified by the secured creditor as non-performing assets. In case the borrower fails to discharge his liability, the secured creditor is entitled to initiate measures including taking possession of the secured assets of the borrower and selling the same for realising the debt. Security Interest (Enforcement) Rules, 2002 deals with various provisions regarding the valuation of movable secured assets, reply to representation of the borrower, procedure after issue of notice, sale of movable secured assets, *etc.* The SARFAESI Act has been made applicable to co-operative banks and to certain housing financing companies registered under the National Housing Bank Act, 1987 also. The State Financial Corporations Act, 1951 provides for rights of State Financial Corporations in case of default by any industrial concern, which is under a liability to those Financial Corporations. Such rights include right to take over the management or possession or both of the industrial concern and right to transfer of property. Any such transfer of property made by the Financial Corporation, in exercise of its powers under the Act, shall vest in the transferee all rights in or to the property transferred as if the transfer had been made by the owner of the property. Further, certain contracts like hire-purchase contracts usually provide for repossession of the movable assets in case of default. This would depend upon the terms and conditions agreed upon by the borrower with the creditor while availing credit facilities and would be governed by the provisions of the Indian Contract Act, 1872. The Reserve Bank is in the process of finalising guidelines on the modalities to be adhered to for enforcing such security interests. However, Courts have given certain guidelines/suggestions in respect of the methods to be adopted for re-possession. In Manager, ICICI Bank Ltd Vs Prakash Kaur & Ors reported in (2007) 2 SCC 711 the Supreme Court has given some suggestions in this regard. With regard to debts of banks, which have become non-performing asssets (NPAs), the Reserve Bank has issued various directives/instructions for the guidance of banks including co-operative banks for framing policy/schemes on compromise settlement of NPAs. Such schemes, known as One-Time Settlement schemes, are outside the judicial framework. The existing legal framework also encourages the settlement of debts through the process of negotiation, arbitration, conciliation, *etc.* banks have constituted Settlement Advisory Committees to enter into compromise proposals with their borrowers.

	The creditors have also recourse of the Civil Court system for enforcement of their claims against debtors. However, the banks and financial institions can file suits for recovery in the Civil Courts only if the debt involved is less than Rs. 10 lakh. Cases filed before the Courts can be referred for conciliation and settlement under the Legal Services Authorities Act, 1987 (to Lok Adalats)/Code of Civil Procedure, 1908 (to Lok Adalats, arbitrators, conciliators and mediators).
Assessment	**Broadly Observed**
Comments	The legal system provides for a variety of enforcement mechanisms for secured claims especially for banks and financial institutions by way of both judicial and non-judicial modes of security interest enforcement. Other creditors, including NBFCs, do not have the benefit of the special provisions under the DRT Act and the SARFAESI Act. Co-operative banks (to whom the DRT Act does not apply) have special machinery set up under the respective State Co-operative Societies Acts. The enforcement mechanism mainly relies on courts and tribunals for enforcement of security interests. Non-judicial enforcement methods have been recognised, in respect of certain security interests (secured assets) created by banks and financial institutions, under the SARFAESI Act and SFC Act. Non-judicial enforcement methods are also recognised under certain enactments like the Transfer of Property Act, 1882 (for certain kinds of transactions). Contracts providing for the creditor taking over possession of the movable property in the case of hire-purchase are also recognised. Judicial enforcement methods generally take a longer period for adjudication compared to the proceedings before the tribunals like DRT. Some of the cases filed before Courts are being referred for alternate dispute resolution under the 'Lok Adalat' system monitored by the Legal Services Authorities (consisting of judges, advocates, *etc.*) set up under the Legal Services Authorities Act, 1987. DRT proceedings are limited to debts which are Rs.10 lakh and above. However, the Central Government has been given the power to make this Act applicable to debts of any amount not less than one lakh, which the Central Government may specify. Though it would be preferable if debts of Rs.1 lakh and above are covered under this Act, an equally important issue to be addressed would be the speed at which, at present, the DRTs are able to recover the debts. In the Report on the Trend and Progress of Banking in India, 2006-2007 the data regarding the NPAs recovered by scheduled commercial banks through various channels in the years 2005-2006 and 2006-2007 have been provided (a copy of

	Table III.24 extracted from the Report on Trend and Progress in Banking, 2006-2007 is given in **Appendix Table 1**). The data with respect to four channels for recovery of NPAs have been provided, *viz.,* One-Time Settlement Schemes, Lok Adalats, DRTs and SARFAESI Act. It is seen from the data that even though the number of cases referred to DRTs and the amount involved in such cases has increased, the amount of money recovered has come down. In the case of Lok Adalats, both the number of cases referred as well as the amount recovered has come down from 2005-2006 levels. There have been no guidelines on One-Time Settlement Schemes issued by the Bank in the year 2006-2007. The number of notices issued under SARFAESI Act has seen substantial increase, leading to rise in the amount of money recovered in the year 2006-2007. Since June 1991, when India began sustained economic liberalisation, there have been improvements in both law and procedures for better enforcement of creditors' rights. These have been due to several factors, such as stringent income recognition standards and norms for provisioning for NPAs. The two legislations, DRT Act and SARFAESI Act, passed during this period have also strengthened the hands of banks and FIs in instances of debt default. However, the single most important reason for a secular fall in the percentage of gross as well as net non-performing loans of banks and FIs has been the rapid economic growth in India, which has significantly raised revenues, profits and cash flows of corporate borrowers and has increased the value of their collateralised/hypothecated land and plants, leading defaulting borrowers to settle with banks and FIs. Even though legal principles governing enforcement mechanism are adequate and fair, there is some delay in implementation of those principles at the ground level. In order to ascertain the reasons for delay in resolution of cases filed in DRTs and civil cases pending in courts, an attempt was made to collect data from four major banks. Out of the four, only one bank could furnish data along with the time taken for resolution of the cases. Another bank has given a qualitative data on the delay in settlement of bankruptcy cases while the other two banks have informally expressed their inability to provide data on the time taken for resolution of the cases as they are not compiling such data. Calculation of mean and standard deviation based on the granular data provided by one bank was done. While it is recognised that the data analysis could suffer from small sample error, it was deemed worthwhile to carry out this exercise for even one bank, to broadly estimate the delay in the settlement of recovery related cases. The findings are as under: *DRT Cases*: Time for which the cases are pending in DRTs (based on the data set furnished by one bank) Mean – 8.2 years Standard Deviation – 4.5 years As per the information received from another bank, the DRTs takes a period of 2 to 4 years to pass an order and after that six months to one year is taken to obtain Recovery Certificates.

	Reasons for delay: There is a time-limit of 6 months, prescribed under the DRT Act. However, this time-line is not complied with in many cases. After obtaining the Recovery Certificate, the Recovery Officer has to attach the property and bring it for sale to recover the dues which takes further time. Non-availability of Presiding Officers and Recovery Officers, routine adjournments taken by advocates, filing of interim application by parties interested and appeals and stays against these orders also delay the cases. Cases pending with and decided by DRTs up to the year ended March 31, 2007 in relation to public sector banks are given in **Appendix Table 2**. *Civil Suits:* Time taken for settlement of civil suits pending in Courts (based on the data set furnished by one bank) Mean – 4 years Standard Deviation – 5 years As per the information received from one of the banks, it takes, on an average, 2 to 3 years to obtain a decree, and after that, execution of the decree will take another 3 to 4 years. Even though the number of new cases filed in the DRTs has come down owing to the enactment of the SARFAESI Act, the number of pending cases is still large. In order to minimise the delay, urgent steps should be taken to set up more DRTs and also the threshold limit for pecuniary jurisdiction of the DRTs may be fixed at Rs. 1 lakh in order to cover more cases under the summary procedure of DRTs. Certain laws creating first charge over the secured assets of borrowers have been a matter of concern for the secured creditors. Under the Income Tax Act, 1961 any security created during the pendency of proceedings/crystallisation of claims would be subservient to the claims of the Income Tax Department. The law should provide a time-limit within which claims towards the State's dues should be crystallised. The law should be amended to the effect that priority of charge for State dues should not operate in respect of prior mortgages created in favour of the secured creditors. Another issue is that of DRTs granting stay orders against sale of securities by banks/FIs under Section 13(4) of the SARFAESI Act. The fact that the SARFAESI Act itself has been enacted to empower the banks to enforce their security interest and sell their security without the intervention of the courts and with that objective, Section 34 of the SARFAESI Act even provides that civil courts shall

	not grant any injunction, DRTs granting injunctions *ex parte* is a matter of serious concern. Therefore, a suitable provision may be inserted in the SARFAESI Act to safeguard the interest of the lenders. Section 14 of the SARFAESI Act enables a secured creditor, for the purpose of taking possession or control of any secured asset, to request, in writing, the Chief Metropolitan Magistrate or the District Magistrate within whose jurisdiction any such secured asset or other documents relating thereto maybe situated or found, to take possession thereof. On such a request, the Chief Metropolitan Magistrate or the District Magistrate, as the case may be, shall take possession and forward the same to the secured creditor. It is stated that banks are facing abnormal delay in getting possession of properties when requests are made to District Magistrate under Section 14 of SARFAESI Act, on account of the burden of workload at the District Magistrate level. Therefore, there is a need to amend Section 14 of SARFAESI Act for providing an enabling provision for District Magistrate to delegate his powers under the SARFAESI Act to other Executive Magistrates in the District, so that the delay in taking possession/control of the secured asset may be obviated.
Part B. Risk Management and Corporate Workout	
B 1	**Credit Information Systems** **A modern credit-based economy requires access to complete, accurate and reliable information concerning borrowers' payment histories. Key features of a credit information system should address the following:**
B 1.1	**Legal Framework** **The legal environment should not impede and, ideally should provide the framework for, the creation and operation of effective credit information systems. Libel and similar laws have the potential of constraining good faith reporting by credit information systems. While the accuracy of information reported is an important value, credit information systems should be afforded legal protection sufficient to encourage their activities without eliminating incentives to maintain high levels of accuracy.**
Legal Framework	Chapter III A of the RBI Act empowers the Reserve Bank to collect credit information from banking companies and furnish such information on an application to banking companies. The names of the banking companies furnishing such information to the Reserve Bank are not to be disclosed. However, banks furnishing information are permitted to disclose such information to others, subject to the permission of the Reserve Bank. The Reserve Bank is also permitted to publish such information in a consolidated form and to disclose such information under the provisions of the RBI Act. Further, the Banking Regulation Act, 1949 empowers the Reserve Bank to publish any information obtained by it under that Act in a consolidated form. There are several laws relating to banks and financial institutions which impose restrictions on divulgence of information. The Banking Companies (Acquisition

	& Transfer of Undertakings) Act, 1970, the Banking Companies (Acquisition & Transfer of Undertakings) Act, 1980, the SBI Act, 1955 and the SBI (Subsidiary Banks) Act, 1959 have provisions restricting the respective banks from divulging credit information. Similarly, the Public Financial Institution (Obligations as to Fidelity and Secrecy) Act, 1983 also has a provision restricting Public Financial Institutions from divulging credit information. The Credit Information Companies (Regulation) Act, 2005 (CIC Act) has been enacted with an object to provide for regulation of credit information companies and for the sharing of credit information among credit institutions. The CIC Act requires all credit information companies to register with the Reserve Bank and all credit institutions are required to be a member of at least one credit information company and provide credit information to that credit information company. The Reserve Bank has been empowered to supersede the board of directors of credit information companies and appoint administrators, in public interest or in the interest of banking policy or credit system of the country, or for preventing the affairs of any credit information company being managed in a manner detrimental to the interest of banking policy or credit institutions or borrowers or clients or for securing the proper management of any credit information company. A credit information company may undertake *inter alia* the following businesses: (i) to collect, process and collate information on trade, credit and financial standing of the borrowers of the credit institution which is a member of the credit information company; (ii) to provide credit information to its specified users or to the specified users of any other credit information company or to any other credit information company being its member; (iii) to provide credit scoring to its specified users or specified users of any other credit information company or to other credit information companies being its members; and (iv) to undertake research project. The CIC Act also confers powers on the Reserve Bank with respect to determination of policy, issuance of directions, inspection, calling of reports, *etc.* The disputes amongst credit information companies, credit institutions, borrowers and clients, on matters relating to business of credit information are provided to be settled by conciliation or arbitration as provided in the Arbitration and Conciliation Act, 1996.

	CIC Rules, 2006 deals with the aspects of accuracy of data provided by credit institutions and credit information companies. In terms of the CIC Act, no suit or other legal proceedings or prosecution can lie against the Reserve Bank or the Central Government or any credit information company or credit institution, or their chairperson, director, member, auditor, adviser, officer or other employee, or agent or any person authorised by the Reserve Bank or the Central Government or credit information company or credit institution to discharge any function under that Act, for any loss or damage caused or as is likely to be caused by anything which is in good faith done or intended to be done, in pursuance of that Act or any other law. However, the CIC Act further provides that the above provision shall not affect the right of any person to claim damages against a credit information company, a credit institution or their chairperson, director, member, auditor, adviser, officer or other employee or agents, as the case may be, in respect of loss caused to him on account of any such disclosure made by anyone of them and which is unauthorised or fraudulent or contrary to provisions of that Act, or practices or usages customary among them.
Assessment	**Observed**
Comments	With the enactment of the CIC Act, law has enabled setting up of credit information companies which would collect credit information from credit institutions and distribute it to specified users. The restrictions imposed by several statutes on disclosure of credit information by banks and financial institutions have become redundant to an extent on account of the provisions of the CIC Act. There are also provisions protecting the Reserve Bank, the Central Government, credit information company, credit institutions and their officers, employees, agents and authorised persons from legal proceedings and prosecutions arising out of acts done in good faith in accordance with the provisions of the CIC Act. However, such a protection is not available in respect of unauthorised and fraudulent acts and acts in contravention of the provisions of CIC Act and customary usages/practices.
B 1.2	**Operations** **Permissible uses of information from credit information systems should be clearly circumscribed, especially regarding information about individuals. Measures should be employed to safeguard information contained in the credit information system. Incentives should exist to maintain the integrity of the database. The legal system should create incentives for credit information services to collect and maintain a broad range of information on a significant part of the population.**
Legal Framework	The CIC Act provides that a credit information company or credit institution or specified user, as the case may be, in possession or control of credit information, shall take such steps (including security safeguards) as may be prescribed, to ensure that the data relating to the credit information maintained by them is accurate, complete, duly protected against any loss or unauthorised access/use

	or unauthorised disclosure thereof. Security measures, both technological and physical are required to be taken by credit information companies. Regulation 11 of the CIC Regulations, 2006 specifically provides for the principles and procedure in respect of collection, solicitation, use and preservation of personal data. Credit information companies and specified users can collect, publish and disclose personal data only for the purposes relating to their functions in accordance with the provisions of the CIC Act or in the capacity of an employer of an individual. Regulation 9 of the CIC Regulations, 2006 permits the use of credit information for making effective credit decisions, to deter concurrent borrowing and serial defaulters, to review and evaluate the risk of customers, to discharge statutory and regulatory functions, to discharge the functions as a credit rating agency and to enable a person to know his own credit information. Under Regulation 11, the collection and distribution of personal data is limited to the purposes related to the functions of the credit information company, credit institution or specified user.
Assessment	**Observed**
Comments	The CIC Act and the Rules and Regulations framed thereunder provide for permissible uses of personal data and the measures to be undertaken by the credit information companies and specified users to safeguard that information. Failure to comply with the requirements of the Act, Rules or Regulations will attract penal provisions provided for under the Act. Further, the person to whom loss is caused due to unauthorised/fraudulent use (including use in contravention of the statutory provisions or rules/regulations) can institute proceedings against the concerned credit information company, specified user and their officers, directors, employees, *etc.* for recovery of damages on account of the loss caused to him by such disclosure. Therefore, there are several disincentives in not maintaining integrity of the database, including penal and other proceedings. Thus, CIC Act will ensure collection of credit information in respect of significant part of the population.
B 1.3	**Public Policy** **Legal controls on the type of information collected and distributed by credit information systems can be used to advance public policies. Legal controls on the type of information collected and distributed by credit information systems may be used to combat certain types of societal discrimination, such as discrimination based on race, gender, national origin, marital status, political**

	affiliation, or union membership. There may be public policy reasons to restrict the ability of credit information services to report negative information beyond a certain period of time, *e.g.,* five or seven years.
Legal Framework	The type of information that can be collected and distributed by credit information companies are specified in the CIC Act. Information relating to trade, credit and financial standing of the borrower can be collected and distributed. The information can be distributed to 'specified users' as defined under CIC Act. The information in respect of persons who have taken loans, guarantors, persons availing facilities such as letter of credit, guarantee, leasing, venture capital assistance, hire purchase, credit cards and persons who raise or seek to raise money by issue of securities (as defined in Securities Contracts Regulation Act, 1956) are all covered under the CIC Act. Apart from the above, any person whose financial standing has been assessed or is proposed to be assessed by a credit institution or any other person or institution as may, by notification, be directed by the Reserve Bank is also considered as a client for the purposes of the CIC Act. The Reserve Bank has been empowered to determine policy, issue directions, carry out inspections on the directions of Central Government and supersede the board of directors of a credit information company under certain circumstances. There are also provisions concerning the audit of credit information companies and submissions of statements and reports to the Reserve Bank.
Assessment	**Observed**
Comments	In terms of Regulation 10 (c) of the CIC Regulations, 2006 every credit information company and credit institution shall retain credit information collected, maintained and disseminated by them for a minimum period of seven years. However, there is no specific restriction on reporting of negative information beyond a certain period of time. It is felt that there are no compelling reasons of public policy to restrict reporting of negative information beyond a specified period of time (such as 5/7 years). The CIC Act or the rules/regulations framed thereunder do not contain any provision which takes care of societal discrimination, such as discrimination based on race, gender, national origin, marital status, political affiliation, or union membership. Regulation 10 (c) of the CIC Regulations, 2006 requires every specified user who is denying any credit or service to any borrower or client to *inter alia* furnish him with a copy of the credit information relied upon for such decision and also the name and address of the credit information company which had provided the credit information report. The Guidelines on Fair Practices Code for Lenders issued by the Reserve Bank specifically states that the lenders should convey in writing, the main reason/reasons which, in the opinion of the bank after due consideration, have led to rejection of the loan applications within stipulated time. The Code further stipulates that lenders must not discriminate on grounds of sex, caste and religion in the matter of lending. However, this

	does not preclude lenders from participating in credit-linked schemes framed for weaker sections of the society. The banks/financial institutions have been advised to frame their own codes based on the above-mentioned Guideline. Non-adherence to the guidelines framed can be taken up with the Banking Ombudsmen under the Banking Ombudsman Scheme, 2006. Therefore, there are ample provisions which discourage loan rejections based on societal discrimination.
B 1.4	**Privacy** **Subjects of information in credit information systems should be made aware of the existence of such systems and, in particular, should be notified when information from such systems is used to make adverse decisions about them. Subjects of information in credit information systems should be able to access information maintained in the credit information service about them. Subjects of information in credit information systems should be able to dispute inaccurate or incomplete information and mechanisms should exist to have such disputes investigated and have errors corrected.**
Legal Framework	In terms of the CIC Act, every credit information company, credit institution and specified user, is required to adopt the privacy principles in relation to collection, processing, collating, recording, preservation, secrecy, sharing and usage of credit information, namely: (a) the principles – (i) which may be followed by every credit institution for collection of information from its borrowers and clients and by every credit information company, for collection of information from its member credit institutions or credit information companies, for processing, recording, protecting the data relating to credit information furnished by, or obtained from, their member credit institutions or credit information companies, as the case may be, and sharing of such data with specified users; (ii) which may be adopted by every specified user for processing, recording, preserving and protecting the data relating to credit information furnished, or received, as the case may be, by it; (iii) which may be adopted by every credit information company for allowing access to records containing credit information of borrowers and clients and alteration of such records in case of need to do so;

	(b) the purpose for which the credit information may be used, restriction on such use and disclosure thereof; (c) the extent of obligation to check accuracy of credit information before furnishing of such information to credit information companies or credit institutions or specified users, as the case may be; (d) preservation of credit information maintained by every credit information company, credit institution, and specified user as the case may be (including the period for which such information may be maintained, manner of deletion of such information and maintenance of records of credit information); (e) networking of credit information companies, credit institutions and specified users through electronic mode; and (f) any other principles and procedures relating to credit information which the Reserve Bank may consider necessary and appropriate and may be specified by regulations. Further, Regulation 10 of the CIC Regulations, 2006 contains specific provisions for care in collection of, access to and modification of credit information. The CIC Act enables any person, who applies for grant or sanction of credit facility, from any credit institution, requiring such institution to furnish him (subject to payment of specified charges) a copy of the credit information obtained by such institution from the credit information company. If a credit information company or specified user or credit institution in possession or control of the credit information, has not updated the information maintained by it, a borrower or client may request all or any of them to update the information; whether by making an appropriate correction, or addition or otherwise, and on such request the credit information company or the specified user or the credit institution, as the case may be, shall take appropriate steps to update the credit information within thirty days after being requested to do so. However, the credit information company and the specified user is required to make the correction, deletion or addition in the credit information only after such correction, deletion or addition has been certified as correct by the concerned credit institution. Further, no such correction, deletion or addition can be made in the credit information if any dispute relating to such correction, deletion or addition is pending before any arbitrator or tribunal or court and in cases where such dispute is pending, the entries in the books of the concerned credit institution is to be taken into account for the purpose of credit information. Further, Regulation 10 (c) of the CIC Regulations, 2006 requires every specified user who is denying any credit or service to any borrower or client to *inter alia* furnish him with a copy of the credit information relied upon for such decision and also the name and address of the credit information company which had provided the credit information report.

	There are also provisions in the CIC Act restraining access to credit information, unless such access is authorised by that Act or any other law or on the direction of a Court of law or tribunal. Any person who obtains unauthorised access to credit information is liable to be punished with fine which may extend to one lakh rupees in respect of each offence and if he continues to have such unauthorised access, with further fine which may extend to ten thousand rupees for every day on which the default continues and such unauthorised credit information shall not be taken into account for any purpose. Rule 29 of the CIC Rules, 2006 deals with the obligation of the officers/employees/contractors/auditors, *etc.* of credit information companies/credit institutions/specified users for fidelity and secrecy in respect of credit information. The above institutions are required to frame policies in this regard.
Assessment	**Observed**
Comments	There are comprehensive provisions in the CIC Act, Rules and Regulations covering the principles on privacy.
B 1.5	**Enforcement/Supervision** **One benefit of the establishment of a credit information system is to permit regulators to assess an institution's risk exposure, thus giving the institution the tools and incentives to do it itself. Enforcement systems should provide efficient, inexpensive, transparent and predictable methods for resolving disputes concerning the operation of credit information systems. Both non-judicial and judicial enforcement methods should be considered. Sanctions for violations of laws regulating credit information systems should be sufficiently stringent to encourage compliance but not so stringent as to discourage operations of such systems.**
Legal Framework	The major regulators in the financial sector like the Reserve Bank, IRDA and SEBI have been empowered to collect credit information from the credit information companies. Even otherwise, the regulators have been empowered to inspect and collect information from the regulated entities under the respective laws. In terms of Section 18 of the CIC Act, if any dispute arises amongst credit information companies, credit institutions, borrowers and clients on matters relating to business of credit information and for which no remedy has been provided under that Act, such disputes are to be settled by conciliation or arbitration as provided in the Arbitration and Conciliation Act, 1996 (26 of 1996), as if the parties to the dispute have consented in writing for determination of

	such dispute by conciliation or arbitration and provisions of that Act shall apply accordingly. The arbitrator could be appointed by the Reserve Bank or it could direct the parties to appoint an arbitrator. The arbitrator is required to settle or decide the matter within a period of three months (which is extendable for a further period of six months on reasons to be recorded by the arbitrator). The CIC Act prescribes penalties for contraventions of the various provisions of that Act. These include punishment (imprisonment up to one year and fine) for knowingly or wilfully making false statement/omitting to make a material statement to the Reserve Bank. Up to Rs. one crore fine has been prescribed for violating the privacy principles. A similar fine has also been prescribed for wilfully providing false information to any other credit information company or credit institution or specified user or borrower or client. Contravention of the provisions of the Act and the rules/directions/orders made thereunder which has not been made punishable specifically has been made punishable with fine extending up to one lakh rupees and where a contravention or default is a continuing one, with a further fine extending to five thousand rupees for every day of such continuation.
Assessment	**Observed**
Comments	The major regulators in the financial sector like the Reserve Bank, IRDA and SEBI have been empowered to collect credit information from the credit information companies. In respect of disputes concerning the business of credit information companies, an alternate dispute resolution mechanism has been provided for under the CIC Act. Apart from this non-judicial remedy, judicial remedies to recover damages for losses caused, *etc.* would also be available to the affected persons. The penalties prescribed under the Act are sufficiently stringent to ensure compliance.
B 2	**Director and Officer Accountability** **Laws governing director's and officer's liability for decisions detrimental to creditors made when an enterprise is in financial distress or insolvent should promote responsible corporate behaviour while fostering reasonable risk taking. At a minimum, standards should hold management accountable for harm to creditors resulting from wilful, reckless or grossly negligent conduct.**
Legal Framework	As per the provisions of the Companies Act, any transfer of property or delivery of goods, payment, execution or other act relating to property made, taken or done by or against a company within six months before commencement of its winding-up (presentation of the petition in case of winding-up by Court/passing of resolution in case of voluntary winding-up) would be deemed to be fraudulent preference of its creditors and be invalid accordingly. Further, in case of transactions in good faith for valuable consideration, after the presentation of a petition for winding-up, the court would pass an order validating a transaction on being satisfied by credible evidence. Any transfer of property or delivery of goods (other than in the ordinary course of business or in favour of a purchaser in good faith for valuable consideration) made by the company within a period

	of one year from the date of filing the winding-up petition (or passing of resolution in voluntary winding-up) shall be void against the liquidator. The Companies Act, 1956 empowers the Court to assess damages against delinquent directors and compels them to repay the money or property with interest and to contribute a sum as compensation (in respect of misapplication, misfeasance, breach of trust, *etc.*) to the assets of the company. In terms of section 538 of the Companies Act, any past or present officer of a company who commits offences provided under the said provision, is liable for imprisonment for terms ranging from 2 years to 5 years (depending on the offence) or with fine or with both. Further, any officer or contributor (including members/shareholders), who has (during the pendency of winding-up proceeding) with the intention to defraud or deceive any person (including a creditor), destroyed, mutilated, altered, falsified or secreted any books, papers or securities and has made any false or fraudulent entry in any register, book of account or document belonging to the company, is liable to be punished with imprisonment upto seven years and fine. Penalty for frauds of the officers of the company, by inducing any person to give any credit to the company or by making gift or transfer or charge on the property of the company or by concealment or removal of any part of the company's property, is liable to be punished with imprisonment upto 2 years and fine. Liability for not keeping proper accounts throughout the period of winding-up or 2 years immediately preceding the commencement of winding-up extends to imprisonment upto one year. In fraudulent conduct of business, any person being party to the fraud shall be personally responsible for all or any of the debts of the company and imprisonment upto 2 years. The criminal proceedings can be initiated against the directors/officers of a company, depending on the offence by the Registrar, shareholders, persons authorised by the Central Government and creditors. The Companies Act also provides for investigation by inspectors (appointed by the Central Government) into the affairs of the companies, based on the report made by the Registrar. The Central Government is also empowered to prosecute persons for the offences found during such investigations. Under SICA, BIFR has been empowered to pass orders directing a person (including past or present directors, manager or officer or employee), who has taken part in the promotion, formation or management of the sick industrial company, who has been guilty of misfeasance, malfeasance or non-feasance or breach of trust in relation to the sick industrial company or has misapplied or

	retained or is liable or accountable for any property of the company, to repay or restore the money or property, with or without interest or contribute such sums to the assets of such sick industrial company. Such orders are passed after affording an opportunity to the person to present his case and the orders are appealable to the appellate authority constituted for that purpose. In terms of Section 421 of the Indian Penal Code, 1860 (IPC) whoever dishonestly or fraudulently removes, conceals or delivers to any person, or transfers or causes to be transferred to any person, without adequate consideration, any property, intending thereby to prevent, or knowing it to be likely that he will thereby prevent, the distribution of that property according to law among his creditors or the creditors of any other person, shall be punished with imprisonment of either description for a term which may extend to two years, or with fine, or with both. Further, under Section 422 of IPC, whoever dishonestly or fraudulently prevents any debt or demand due to himself or to any other person from being made available according to law for payment of his debts or the debts of such other person, shall be punished with imprisonment of either description for a term which may extend to two years, or with fine, or with both. These provisions could be invoked in appropriate cases of alienation of company's property by the directors/officers to prevent it from being distributed among the creditors.
Assessment	**Observed**
Comments	There are instances where the directors have absconded, after defrauding the creditors, including when winding-up petitions are initiated, making it difficult for the authorities/creditors to trace their whereabouts. Some such directors have also been successful in floating new companies. However, Companies (Amendment) Act, 2006 has brought in provisions for Director Identification Numbers (DIN) into the Companies Act, 1956 which would be helpful in tracing delinquent directors. This would also prohibit such directors (responsible for any violation/contravention) from floating/promoting new companies. The Companies Bill, 2008 also seeks to provide for having a DIN for being appointed as director. The said Bill also requires the Directors to indicate DIN in all returns, information and particulars required to be furnished under the proposed Act. The Companies Act has extensive provisions for dealing with delinquent directors in the course of winding-up proceedings or otherwise. There are adequate legal provisions as far as initiating proceedings against the Directors and officers responsible for committing frauds. However, these provisions have not been invoked in many cases. Towards this end, more action is needed. The provisions of the IPC cover cases where property is removed/concealed or action is taken for preventing its distribution among the creditors. Further, in terms of Section 543 of the Companies Act, the Court/Tribunal has power to assess damages against delinquent directors in respect of misapplication/retention/liability or accountability for any money or property of the company or any misfeasance or breach of trust in relation to the company. The Companies Bill, 2008 seeks to provide for (i) setting up of Special Courts for speedy trial of offenders (including delinquent directors) for offences under the proposed Act, (ii) for appointment

	of Company Prosecutors for the purpose of prosecution of such offenders, and (iii) initiation/continuation of investigation by inspectors into the affairs of the company even during the pendency of winding-up proceedings before the Tribunal.
B 3	**Enabling Legislative Framework** **Corporate workouts and restructurings should be supported by an enabling environment that encourages participants to engage in consensual arrangements designed to restore an enterprise to financial viability. An environment that enables debt and enterprise restructuring includes laws and procedures that:**
B 3.1	**Require disclosure of or ensure access to timely, reliable and accurate financial information on the distressed enterprise;**
Legal Framework	There are no legal provisions requiring a debtor to voluntarily disclose and ensure access to timely, reliable and accurate financial information on the distressed enterprise. However, agreements between the borrowers and the creditors usually contain clauses enabling the lenders to have access to the financial position of the borrower. Further, the informal restructuring mechanism operated through the Corporate Debt Restructuring Guidelines issued by the Reserve Bank, the lenders would decide on the scheme and proposals for fresh funding after analysing the financial position of the borrower. When the board of directors of a sick industrial company (of a specified industry) makes a reference to the BIFR under the SICA, it is mandatory for the officials of the company to assist the BIFR in rehabilitation. Any debtor who withholds information in violation of any provision of the Scheme, or any order of the BIFR, or the Appellate Authority, or whoever makes a false statement or gives false evidence to the BIFR or Appellate Authority, shall be punishable with simple imprisonment for a term which may extend to 3 years and shall also be liable to fine. The Companies Act, 1956 mandates that a statement of affairs of the company in the prescribed form verified by an affidavit and containing particulars of the assets of the company, its debts and liabilities, the details of creditors with details of the amounts of secured and unsecured debts, the debts due to the company and details of the debtors, and such other information is to be submitted by the company to the Official Liquidator. The said statement has to be filed within 21 days from the date of appointment of Provisional Liquidator or passing of winding-

	up order. For the companies incorporated under the Companies Act, there are elaborate provisions for maintenance of accounts, audit of accounts and investigation of the affairs of a company by the Central Government. In case of listed companies, there is provision for certification by the CEO/CFO of the company with regard to the accuracy of the financial statement and the fact that it does not contain any materially untrue statement. The plan for compromise or arrangement with the creditors is provided under section 391 of the Companies Act. Accordingly, both the company and its creditors or any class of them or the company and its members or any class of them can propose a plan for compromise or arrangement. The plan is to be submitted to the Company Court by the company or any creditor or member, or in the case of a company which is being wound-up, by the liquidator. Thereafter, the Court may order a meeting of the creditors or class of creditors or members or any class of members to be held. If a majority in number representing three-fourths in value of the creditors, or class of creditors or members or class of members, present and voting either in person or proxy at the meeting agree for the compromise or arrangement and if such compromise or arrangement is sanctioned by the Court, then it becomes binding on all the creditors or the class of creditors or members or class of members or in the case of a company that is being wound-up, on the liquidator and contributories of the company. The company or any other person making the application for approval of compromise or arrangement, shall disclose to the Company Court by affidavit or otherwise all material facts relating to the company such as the latest financial position of the company, the latest auditor's report of the accounts of the company and as such facts are made on oath, they have to reflect the true and correct picture of the financial health of the company. The Court would sanction the proposal only if there is such disclosure as provided under law. As regards the voting rights of creditors, the present provisions do recognise the majority in number representing three-fourths in value of the creditors or members class of creditors/members, as the case may be, present and voting, for the purpose of approval.
Assessment	**Observed**
Comments	In judicial/quasi-judicial proceedings relating to restructuring and workouts, the company is bound to disclose financial information. Whereas in informal workouts/restructurings the debtor-creditor contracts would provide for the disclosure of financial information by the debtor to the creditor/creditors. There are comprehensive provisions in respect of corporate governance under the Companies Act especially pertaining to accounts and audit.
B 3.2	**Encourage lending to, investment in or recapitalisation of viable financially distressed enterprises;**
Legal Framework	The SICA deals with rehabilitation of sick industrial undertakings (pertaining to an industry mentioned in the schedule to that Act). In terms of that Act, the board of directors of a sick industrial undertaking or the Central Government,

	the Reserve Bank, State Governments and a public financial institution, can make a reference to the BIFR set up under the provisions of the Act for determination of measures to be taken against that undertaking. BIFR will then make an inquiry into the working of the company and may direct any operating agency (which includes a public financial institution, state level institution and scheduled bank) to make a scheme for rehabilitation of the company and such scheme may be sanctioned by the BIFR. The scheme may provide for reconstruction, amalgamation, sale of assets, any other preventive, ameliorative and remedial measures, *etc.* The scheme may also provide for rehabilitation by giving financial assistance. Under SICA, the financial assistance for rehabilitation has to be agreed to by the agency giving the financial assistance. There is no priority for financial assistance given in rehabilitation proceedings under SICA. The CDR mechanism formulated by guidelines issued by the Reserve Bank also provides for funding in certain cases. However, the decision to lend or not is left to the majority (75 per cent) of the lenders in the consortium/syndication/aggregation. The terms and conditions are left to be decided by creditor-debtor agreements.
Assessment	**Broadly Observed**
Comments	Law enables and encourages lending/recapitalisation of viable financially distressed enterprises. In informal workouts, the terms and conditions subject to which the lending/recapitalisation is done is left to the discretion of the creditors/borrowers based on the agreement between them. However, there is a need to grant priority (by statute) to the financial assistance given to rehabilitate a company in financial distress. Such priority of claim should also extend while disbursing the assets in liquidation.
B 3.3	**Flexibly accommodate a broad range of restructuring activities, involving asset sales, discounted debt sales, debt write-offs, debt reschedulings, debt and enterprise restructurings, and exchange offerings (debt-to-debt and debt-to-equity exchanges);**
Legal Framework	The Companies Act, 1956 (section 391) contains provisions enabling the companies and/or its creditors or members to submit a scheme or arrangement for compromise or amalgamation of the distressed corporate entities. The scheme can contain all the provisions required for effective restructuring of the company including, debt write-offs, rescheduling of loans, debt-equity conversions. The Scheme formulated by the members/creditors has to be approved by the requisite majority of creditors and sanctioned by the Court for bringing it into effect.

	The SICA enables formulation of a scheme by an operating agency (financial institution/bank), which may provide for various measures including, financial reconstruction by providing loans, advances or guarantees from the Central Government, a State Government, any bank, public financial institution or any authority. Under SICA, the financial assistance for rehabilitation has to be agreed to by the agency giving the financial assistance. The SICA also does not expressly limit the methods of reconstruction/rehabilitation and the methods to be adopted are to be specified in the Scheme for rehabilitation. As such, there is ample flexibility to choose the mode of achieving such rehabilitation. The CDR mechanism functions on the basis of inter-creditor and debtor-creditor agreements subject to the guidelines issued by the Reserve Bank. Therefore, the mode of debt restructuring is left to the discretion of the Core Group/Standing Forum for CDR mechanism. The SARFAESI Act deals with situations where a debtor of a bank or financial institution (secured creditors) is unable to repay its debts. The law enables the secured creditors, after fulfilling certain notice requirements, to take over the management/business of the debtor and after realising his debts to hand over the same back to the debtor.
Assessment	**Observed**
Comments	The CDR mechanism has a lot of flexibility as regards the range of restructuring activities since it is through an agreement between the creditor and the debtor. In the restructurings under SICA and Section 391 of the Companies Act, the schemes can provide flexibility with the sanction of the BIFR and Court. Clause 201 of the Companies Bill, 2008 seeks to provide that all corporate debt restructuring (which may apparently include those covered by CDR guidelines issued by the Reserve Bank also) require the sanction of the Tribunal. In case the Bill is enacted as such, the flexibility of the CDR mechanism would be reduced to an extent by the provision requiring the sanction of the Tribunal in that case also.
B 3.4	**Provide favourable or neutral tax treatment with respect to losses or write-offs that are necessary to achieve a debt restructuring based on the real market value of the assets subject to the transaction;**
Legal Framework	The Income Tax Act, 1961 (Section 72) allows set-off of business losses against income and where such loss cannot be wholly so set-off, the provisions also allow carry forward of such losses to future assessment years. However, in certain circumstances (mentioned in Section 33B), the carry forward and set-off losses are available upto a period of eight years so as to enable an entity to re-establish, reconstruct or revive its business. The Income Tax Act (Section 72A) allows carry forward and set-off of accumulated loss and unabsorbed depreciation in amalgamation or demerger, *etc.* subject to the conditions mentioned therein. It (Section 72AA) also provides for carry forward and set-off of accumulated loss

	and unabsorbed depreciation of a banking company against the profits of a banking institution under a scheme of amalgamation sanctioned or approved by the Reserve Bank or the Central Government.
Assessment	**Broadly Observed**
Comments	The tax laws in India do not expressly take care of debt rescheduling or debt equity swaps for lenders. The provisions under the Income Tax Act would not cover situations where the transferor bank is a public sector bank or a RRB. The provisions do not cover any kind of amalgamations in which RRBs are involved, since RRBs are not covered under the definition of either 'banking company' or 'banking institution' as per 'Explanation' to Section 72AA of the Income Tax Act. Further, the benefit is also not available in case of acquisitions of a banking institution made by SBI and its subsidiaries. The benefit of Income Tax Act as stated above should be made available to all the banks.
B 3.5	**Address regulatory impediments that may affect enterprise reorganisations;**
Legal Framework	In the Scheme of reconstruction/compromise/arrangement filed under Section 391 of the Companies Act, as approved by the creditors/members of the company, the Court is required to issue a notice to the Registrar of Companies seeking his comments. This is to ensure that the affairs of the company were not conducted in a manner detrimental to the interests of the members or the public interest. However, there are no provisions in law requiring the Court to issue notice to regulators like the Reserve Bank, IRDA, SEBI, *etc.* in cases of companies other than banking companies and insurance companies.
Assessment	**Observed**
Comments	Ordinarily, the scope of interference by the regulators in the restructuring of a company is minimal except in the case of systemically important sectors like banking and insurance. Under the Companies Bill, 2008 a notice of the meeting for compromise/arrangement is required to be sent to the Central Government, the Reserve Bank, SEBI, respective stock exchanges, Official Liquidator, Competition Commission (if necessary) and all other authorities who are likely to be affected by such compromise/arrangement.
B 3.6	**Give creditors reliable recourse to enforcement as outlined in Section A and to liquidation and/or reorganisation proceedings as outlined in Section C of these Principles.**

<table>
<tr><td>Legal Framework</td><td>The creditors have a variety of legal provisions for enforcement of their security interests and for liquidation/restructuring of debtor companies under the provisions of the SARFAESI Act, DRT Act, Companies Act, the SICA, State Financial Corporations Act, the Code of Civil Procedure and various State Co-operative Societies Acts, depending upon the nature of the lender, the debtor and the debt involved, as the case may be. These provisions have been elaborately discussed in Sections A and C of these Principles.

Apart from the above, the creditors are now resorting to sale of assets (secured debt) to Securitisations/Reconstruction Companies at a negotiated price. These Securitisation/Reconstruction Companies deal with the debtors in accordance with the SARFAESI Act. Banks are also permitted to sell their secured assets to even other banks/NBFCs (which are not securitisation/reconstruction companies). The Reserve Bank has issued guidelines covering sale/purchase of secured debts by/to banks/financial institutions/NBFCs. There is no prohibition for banks assigning their secured debts to any other company or person under the general law. However, the securitisation/reconstruction procedures under the SARFAESI Act would not be available to companies other than Securitisation/Reconstruction Companies registered under the Act. The Reserve Bank has issued certificate of registration to six securitisation/reconstruction companies which are Asset Reconstruction Company (India) Ltd., ASREC (India) Ltd., Pegasus Assets Reconstruction Pvt. Ltd., Assets Care Enterprise Ltd., International Asset Reconstruction Company Pvt. Ltd. and Dhir & Dhir Assets Reconstruction & Securitisation Co. Ltd. The details of the assets acquired and the costs (in Rs. lakh) of such acquisition for the quarter ending September 30, 2007 are as under:
<table>
<tr><th>Particulars</th><th>ASREC</th><th>ARCIL</th><th>Pegasus</th><th>IARC</th><th>ACE</th><th>Dhir</th></tr>
<tr><td>Book Value of the assets acquired from banks/FIs</td><td>34,497.19</td><td>2,915,011</td><td>85,625</td><td>79.28</td><td>243</td><td>11,051.86</td></tr>
<tr><td>Cost of acquisition</td><td>6,368</td><td>812,863</td><td>19,529</td><td>75</td><td>218.72</td><td>3,475</td></tr>
</table>
Of the six companies having registration, only three have had actually started full-fledged business and the others are in the process of acquiring the assets for securitisation/reconstruction. In the case of two Securitisation Companies, some of the security receipts issued have already been redeemed. Banks and financial institutions also resort to sale of assets to other banks and companies (which are not SCs/RCs) either to bring down the level of non-performing assets or to concentrate on new borrowers/lending opportunities.</td></tr>
<tr><td>Assessment</td><td>Observed</td></tr>
<tr><td>Comments</td><td>Creditors have adequate mechanism for enforcement of their claims and have access to reorganisation/liquidation proceedings.</td></tr>
<tr><td>B 4
B 4.1</td><td>Informal Workout Procedures
An informal workout process may work better if it enables creditors and debtors to use informal techniques, such as voluntary negotiation or mediation or informal dispute resolution. While a reliable method for timely resolution</td></tr>
</table>

	of inter-creditor differences is important, the financial supervisor should play a facilitating role consistent with its regulatory duties as opposed to actively participating in the resolution of inter-creditor differences.
Legal Framework	The CDR scheme was implemented by the Reserve Bank in August 2001 (revised in February 2003), for facilitating timely restructuring corporate debts for viable corporate entities affected by internal or external factors through a transparent mechanism. The scheme is outside the purview of formal reorganisation/recovery procedures under BIFR, DRT and the Courts. The CDR mechanism is an informal and voluntary mechanism for workouts between creditors and debtors which applies only to standard and sub-standard accounts in multiple banking accounts/ syndication/consortium accounts with outstanding exposure of Rs. 20 crore and above by banks and institutions. Once the prescribed majority of lenders (in value and number) decide on the restructuring plan, then the same could be put into effect. Reference to CDR system could be triggered by (i) any one or more of the creditor who have minimum 20 per cent share in either working capital or term finance, or (ii) by the concerned corporate, if supported by a bank or financial institution having stake as in (i) above. Banks/FIs should disclose in their published annual Balance Sheet under 'Notes on Accounts' the total amount of loan assets subjected to restructuring under CDR, which is the sum of: (i) the amount of standard assets subjected to CDR; (ii) the amount of sub-standard assets subjected to CDR; and (iii) the amount of doubtful assets subjected to CDR. The Code regulates the negotiation, agreement and implementation of the restructuring plan based on Debtor-Creditor Agreement (DCA) and Inter-Creditor Agreement (ICA). The ICA would be legally binding agreement amongst the creditors with necessary enforcement and penal clauses, wherein the creditors would commit themselves to abide by the various elements of CDR system. A similar restructuring scheme was introduced in respect of small and medium enterprises on September 8, 2005. Small Enterprise is an undertaking in which investment in plant and machinery does not exceed Rs.1 crore, except in respect of certain specified items under hosiery, hand tools, drugs and pharmaceuticals, stationery items and sports goods, where this investment limit has been enhanced to Rs. 5 crore and units with investment in plant and machinery in excess of small enterprises' limit and up to Rs. 10 crore are treated as Medium Enterprises.
Assessment	**Observed**
Comments	The CDR mechanism, initiated by the Reserve Bank, is a typical example of an informal workout process which facilitates negotiation between the creditors and borrowers. However, CDR mechanism is for consortium/syndicate-lending and covers outstanding exposure of Rs.20 crore and above. It has scope for

	mediation also as the Group consists of members who may not be creditors. However, the decisions are taken by the prescribed majority of lenders themselves.
B 4.2	**Where the informal procedure relies on a formal reorganisation, the formal proceeding should be able to quickly process the informal, pre-negotiated agreement.**
Legal Framework	The mechanism under CDR scheme is an informal process, where no sanctions or orders are required to be obtained from any Court or Tribunal. However, this is done in accordance with the guidelines of the Reserve Bank.
Assessment	**Observed**
Comments	Once the prescribed majority of lenders (in value and number) decide on the restructuring plan, then the same could be put in to effect without any formalities (other than creditor-debtor agreement).
B 4.3	**In the context of a systemic crisis, or where levels of corporate insolvency have reached systemic levels, informal rules and procedures may need to be supplemented by interim framework enhancement measures to address the special needs and circumstances encountered with a view to encourage restructuring. Such measures are typically of an interim nature designed to cover the crisis and resolution period, without undermining the conventional proceedings and systems.**
Legal Framework	The SARFAESI Act contains provisions enabling a secured creditor (bank or financial institution having security interest) to change or take over the management of business of the debtor and also to sell/lease part or whole of business of the debtor. There are provisions for rescheduling the payment of debts of the borrower. The Reserve Bank is in the process of framing guidelines for the purposes of the above provisions and it is understood that the said guidelines would cover the circumstances in which the change/takeover of the business is to be effected, the procedure to be adopted in such change/takeover and the manner in which sale/lease of the business may be done. Apart from the above, the CDR mechanism also plays an important role in reducing the crisis in respect of standard, sub-standard and doubtful debts. Further, the Reserve Bank has also, from time to time, come up with One-Time Settlement Schemes enabling the public sector banks to negotiate and settle dues in non-performing accounts.
Assessment	**Observed**
Comments	The measures under the SARFAESI Act would enable the creditors to further bring down the volume of non-performing assets in their books by assuming direct control over the business of the debtors and is expected to lead to many informal workouts between creditors and debtors. In addition to above, for consortium/syndicate type of lending, the CDR mechanism is an informal, optional and ongoing arrangement to facilitate restructuring of debts, which may even provide for interim measures. On the other hand One-Time Settlement Schemes are interim measures for short periods, generally to cover particular types of accounts.

B 5 **B 5.1**	**Regulation of Workout and Risk Management Practices** **A country's financial sector (possibly with the informal endorsement and assistance of the central bank, finance ministry or bankers' association) should promote the development of a code of conduct on a voluntary, consensual procedure for dealing with cases of corporate financial difficulty in which banks and other financial institutions have a significant exposure, especially in markets where corporate insolvency has reached systemic levels.**
Legal Framework	See B 4.1. Apart from the CDR mechanism, the Reserve Bank has also enabled the banks to have informal workouts and settlements with certain debtors under the One-Time Settlement Schemes formulated by the former from time to time.
Assessment	**Observed**
Comments	The CDR mechanism is a completely voluntary effort based on consensus. The Reserve Bank, by issuance of guidelines, has facilitated such informal workouts among creditors and between creditors and debtors.
B 5.2	**In addition, good risk management practices should be encouraged by regulators of financial institutions and supported by norms that facilitate effective internal procedures and practices that support prompt and efficient recovery and resolution of non-performing loans and distressed assets.**
Legal Framework	The Reserve Bank has issued various guidelines and circulars in respect of exposure norms, prudential norms on income recognition, asset classification and provisioning, risk management and inter-bank dealings, capital adequacy, stress testing, corporate governance, asset liability management, management of operational risk, *etc.* for enabling the banks and financial institutions to follow good risk management practices.
Assessment	**Observed**
Comments	The Reserve Bank has been proactive in encouraging the banks and financial institutions to follow good risk management practices.
Part C. Legal Framework for Insolvency	
C1	**Key Objectives and Policies** **Though country approaches vary, effective insolvency systems should aim to:** **(i) Integrate with a country's broader legal and commercial systems;** **(ii) Maximise the value of a firm's assets and recoveries by creditors;** **(iii) Provide for both the efficient liquidation of non-viable businesses and**

	those where liquidation is likely to produce a greater return to creditors, and the reorganisation of viable businesses; **(iv) Strike a careful balance between liquidation and reorganisation, allowing for easy conversion of proceedings from one procedure to another;** **(v) Provide for equitable treatment of similarly situated creditors, including similarly situated foreign and domestic creditors;** **(vi) Provide for timely, efficient and impartial resolution of insolvencies;** **(vii) Prevent the improper use of the insolvency system;** **(viii) Prevent the premature dismemberment of a debtor's assets by individual creditors seeking quick judgments;** **(ix) Provide a transparent procedure that contains, and consistently applies, clear risk allocation rules and incentives for gathering and dispensing information;** **(x) Recognise existing creditor rights and respect the priority of claims with a predictable and established process; and** **(xi) Establish a framework for cross-border insolvencies, with recognition of foreign proceedings.**
Legal Framework	The Companies Act, 1956 covers provisions for compromises/arrangements, reconstructions/amalgamations and winding-up of companies. The provisions of the insolvency laws have been made applicable to companies in liquidation as regards debts provable and fraudulent preference in those proceedings. The Presidency Towns Insolvency Act, 1909 (which applies to the Metropolitan cities of Kolkata, Chennai and Mumbai) and the Provincial Insolvency Act, 1920 (which applies to other parts of the country) apply to insolvencies of all persons including individuals, association of individuals and partnership firms (other than companies and associations registered under any other enactment). The Banking Regulation Act, 1949 provides for reconstruction, amalgamation and winding-up of banking companies. The Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980 provide that a corresponding new bank (nationalised bank) can be placed in liquidation only by an order of the Central Government and in such manner as the Central Government may direct. Those Acts specifically empower the Central Government to make schemes for reconstitution/amalgamation/transfer of undertaking of a nationalised bank. As regards co-operative societies, the provisions of the respective State Co-operative Societies Act would be applicable for the purposes of liquidation and reconstruction of the co-operative societies including the co-operative banks. For example, the Gujarat Co-operative Societies Act, 1961 empowers the Registrar of Co-operative Societies to *suo moto* or on an application from the society (based on a resolution approved by three-fourths of the members) make an interim order directing winding-up the society. The Registrar has the power to confirm such interim order after giving an opportunity of hearing to the society. The Registrar is entitled to appoint any person as the liquidator. The liquidator has

	inter alia the power to effect a compromise and arrangement between the society and its creditors. However, in the case of an insured co-operative bank (insured with DICGC) the previous sanction in writing of the Reserve Bank is required. Further, the Registrar shall make an order of winding-up, if so required by the Reserve Bank. The Multi-State Co-operative Societies Act, 2002 deal with the winding-up of multi-state co-operative societies (including multi-state co-operative banks). The Central Registrar has been conferred with the power to direct winding-up of such co-operative societies (Section 86). The Central Registrar is required to make a winding-up order if so required by the Reserve Bank in respect of multi-state co-operative societies covered by the DICGC Act. In so far as insurance companies are concerned, the provisions of the Companies Act, 1956 relating to winding-up are applicable subject to the provisions of section 53 of the Insurance Act, 1938. Further, section 54 of the Insurance Act, 1938 prohibits the voluntary winding-up of a company except for effecting amalgamation or when it cannot continue its business by reason of its liabilities. Where the insurance business or any part of the insurance business of an insurance company (secondary company) has been transferred to another insurance company (principal company) under an arrangement, in pursuance of which the secondary company or its creditors are having claims against the principal company, then if the principal company is being wound-up, it shall also commence (subject to certain conditions), the winding-up proceedings against the secondary company, unless otherwise ordered by the Court. Section 58 of the Insurance Act, 1938 enables part of the business of an insurance company to carry on, while the remaining part is wound-up. However, composite insurance companies are not permitted by IRDA. The SICA deals with rehabilitation of sick industrial undertakings (pertaining to an industry mentioned in the schedule to that Act). In terms of the Act, the board of directors of a sick industrial undertaking can make a reference to the BIFR set up under the provisions of the Act for determination of measures to be taken against that undertaking. BIFR will then make an inquiry into the working of the company. BIFR has also been conferred with the powers to direct any person (including a public financial institution, State-level institution and scheduled bank) to make a scheme for rehabilitation of the company and such scheme may be sanctioned by BIFR. The scheme may provide for reconstruction, amalgamation, sale of assets, any other preventive, ameliorative and remedial

	measures, *etc.* The scheme may also provide for rehabilitation by giving financial assistance. The State Financial Corporations and other financial institutions are governed by their respective statutes. The Companies Act and rules provide procedure for realisation of assets. Adequate publicity is given to the proposed auction to invite maximum bidders, the sale is carried out by public auction under the supervision of the Court. Indian law does not recognise foreign bankruptcy proceedings. However, foreign judgments are recognised in India under the provisions of the Code of Civil Procedure. Recognition of foreign claims depends on the terms of agreement and applicability of Indian law to the situation. There is no provision in law enabling cross-border insolvency proceedings. The Companies Act provides that if a majority in number representing three fourth in value of the members or class of members present and voting either in person or in proxy at the meeting should agree and if sanctioned shall be binding on all the members or class of members and also on the company or the liquidator and the contributories of the company. Similar provisions for Rehabilitation as provided under SICA, 1985 have been inserted in the Companies Act, 1956 by Companies (Second Amendment) Act, 2002 which is yet to be notified. The proposed NCLT, (yet to be made operational) will have jurisdiction and power to consider revival/rehabilitation promoting reorganisation of insolvent companies. Further, the BIFR set up under the Sick Industrial Companies (Special Provisions) Act, 1985 is sought to be replaced with the NCLT. All debts and liabilities, present or future, certain or contingent, (except those which are incapable of being fairly estimated and demands in the nature of liquidated damages arising other than by reason of a contract or breach of trust) are considered as debts provable in winding-up. The rights of a secured creditor in a winding-up is recognised but such rights would be subject to the other provisions of the Companies Act like overriding preferential payments, preferential payments and *pari passu* charge in favour of workmen in secured assets of debtor along with the secured creditor. The *inter se* priority among secured creditors would be decided based on the provisions of the Transfer of Property Act, 1882.
Assessment	**Broadly Observed**
Comments	The existing legal framework covers insolvency proceedings against all the persons natural or legal under different enactments. The insolvency laws in the country are spread over many legislations depending upon the type of the entity involved in insolvency. The principles contained in those legislations are not uniform and in some cases it is left to the discretion of the authority deciding on the liquidation. (For example, nationalised banks can be liquidated by the Central Government by an order and the manner of liquidation is left to the discretion of the Government). Therefore, in such cases it could be stated that the

	predictability and transparency would be compromised. However, it is to be noted that there has not been any single instance of a nationalised bank getting placed under liquidation. In order to achieve a more transparent, predictable and sound insolvency system, ideally there is a need to consolidate all the separate laws dealing with insolvencies into a single, uniform and comprehensive bankruptcy code with a common forum, irrespective of the entity involved in such insolvency. But given the complexity of the Indian legal system (with powers being divided between the Union and the States) and the variety of entities that exist, such a measure would require amendments to the Constitution and various other laws. However, special provisions may continue to be provided in respect of entities like banks, insurance companies, *etc.* on account of their systemic importance. A common code for all banking institutions irrespective of the nature of the entity may also be thought of. Such a change would call for amendments to the Constitution and various other statutes like the State Co-operative Acts, SBI Act, *etc.* The Reserve Bank (being the regulator and supervisor) should have the ultimate say in all insolvencies related to banks irrespective of the nature of the entity (*i.e.,* company, statutory corporation, co-operative bank, *etc.*). The Companies Act treats all similarly situated creditors equally. The secured creditors are entitled to enforce their security interest outside the winding-up proceedings, subject to the *pari passu* charge in respect of workmen dues. Otherwise, the creditors are not allowed to dismember any of the debtor's assets. A sick industrial company eligible for rehabilitation under SICA is an 'industrial company' which has accumulated losses equal to or exceeding its entire net worth. Since the company's net worth is totally eroded in many cases, those companies find it hard to rehabilitate themselves. Further, on account of the limited number of BIFR benches (a minimum of one and maximum of three), they are unable to carry the heavy workload. Some members and administrative staff at BIFR are also not trained and equipped to handle matters involving accounting and auditing (such as auditing standards *etc.*). The winding-up petitions and cases referred to BIFR take a very long time for final disposal. In order to ascertain the reasons for delay in resolution of cases filed in BIFR and winding-up cases pending in High Courts, four major banks were requested to furnish the data on such cases. Out of the four, one bank has furnished the data along with the time taken for resolution of the cases. Another bank has given a qualitative data on the delay in settlement of bankruptcy cases, while the other

	two banks have expressed their inability to provide data on the time taken for resolution of the cases as they are not compiling such data. As regards the cases filed before BIFR, a frequency table for the data for the banking system as a whole has been obtained. An attempt has been made to find the mean and standard deviation of bankruptcy cases based on the granular data provided by one bank. While it is recognised that the data analysis could suffer from small sample error, it was deemed worthwhile to carry out this exercise for even one bank, to broadly estimate the delay in the settlement of bankruptcy related cases. For BIFR cases pending for more than 10 years, the average pendency has been assumed as 15 years for calculating the mean and standard deviation. The findings based on the data analysis are as under: *BIFR cases:* Based on the information on the pending BIFR cases for the banking system as a whole, the time for which cases are pending in the BIFR: Mean – 8.25 years Standard Deviation – 4.96 years *Reasons for delay:* The time taken for final resolution of the disputes depends upon various factors, such as number of lenders involved in dispute, level of support provided by each of the lenders, borrowers' ability to bear the additional cost of Draft Rehabilitation Schemes/restructuring and other legal machinery involved in speedy hearing of cases. In respect of Central PSUs/State PSUs, the stand taken by GoI/State Governments and labour unions are also important in deciding the fate of the unit and the time taken in resolution. Data on total number of cases registered and disposed off by BIFR for the period 2001-2005 is given in **Appendix Table 3**. The age-wise resolution of BIFR cases is provided in **Appendix Table 4**. *Winding-up Cases:* Time taken for settlement of winding-up cases (based on the data set furnished by one bank) Mean – 11.25 years Standard Deviation – 7.1 years As per the qualitative data furnished by one bank, winding-up cases take on an average 5-10 years for resolution. *Reasons for delay:* One reason for the delay is the disputes/litigation in respect of payment of workers' dues. Data on companies under liquidation is given in **Appendix Table 5** and details of companies under liquidation in four regions of the country are provided in **Appendix Table 6**. A cross-country comparison on closing the business in 'Doing Business Report' (2008) of the World Bank has analysed the main indicators for identifying the weaknesses in existing bankruptcy law and the main procedural and administrative bottlenecks in the bankruptcy process. These indicators include

	(i) average time to complete a procedure, (ii) cost of the bankruptcy proceedings, and (iii) the recovery rate, which calculates how many cents on the dollar the claimants (creditors, tax authorities, and employees) recover from an insolvent firm. The data regarding the above indicators have been provided region-wise as well as country-wise in the study conducted by the World Bank. The average time taken for bankruptcy proceedings in India is 10 years. The cost of bankruptcy proceedings in India is stated to be 9 per cent of the estate and the recovery rate (for claimants) is found to be 11.6 cents on the dollar. The comparative figures show that India lags behind in terms of average time taken to complete the bankruptcy proceeding and recovery rate involved in those proceedings *vis-à-vis* Central Asian & Eastern European regional and East Asian & Pacific regional averages. However, the cost of proceedings in India is lower than the Central Asian & Eastern European average of 13.7 per cent of the estate and the East Asian & Pacific average of 23.2 per cent of the estate. A table (taken from the 'Doing Business Report' (2008) website of World Bank Group) showing the averages of specific regions and countries pertaining to bankruptcy regimes is given in **Appendix Table 7**. 'Sick Industrial Companies', governed by the provisions of the SICA, may *suo moto* file applications before the BIFR for the purposes of rehabilitation. Once a reference is made to the BIFR, it automatically stays all actions/proceedings against the company concerned. The proceedings before BIFR take a long time during which the assets of the company further deteriorate and ultimately when it is referred for being liquidated, there would be practically very little assets left for realisation. Again, liquidation is seen as the last resort by creditors, especially secured creditors, because they feel that recovery would be much better and faster in proceedings other than liquidation/rehabilitation. Therefore, by the time a creditor takes a company to liquidation, considerable time would have passed and the assets would have deteriorated. This is also one of the reasons for the low recovery in liquidation. The management of the assets during the period of the pendency of the petition for winding-up, including the quality of investments of liquid assets are far from satisfactory, leading to deterioration of the assets and low returns on investments. There are no express provisions under the applicable laws to enable Courts to appoint professionals to take over and manage the assets of a company in liquidation (or pending liquidation).

	All the above mentioned factors add up to the recovery rates being low compared to other countries. However, this position would improve once the Companies (Second Amendment) Act, 2002 is made operational as the Act has provisions enabling the Tribunal to appoint professionals as Provisional Liquidators/ Liquidators and also provisions enabling the Tribunal to take measures to protect the assets of the company. Since NCLT would be a tribunal exclusively dealing with matters of insolvency including rehabilitation and liquidation (unlike High Court and BIFR) and it is also proposed to do away with the existing provisions under SICA for automatic stay of other proceedings, the time taken for insolvency proceedings is expected to considerably reduce. However, there is a need to provide adequate infrastructure and facilities to the NCLTs and also to open a reasonable number of benches of NCLTs, for these tribunals to become a success. The Companies (Second Amendment) Act, 2002 enacted with a view to bring about major changes in the insolvency regime, has not been operationalised on account of litigation (pending in the Supreme Court) and consequent stay of the provisions. As the Companies (Second Amendment) Act, 2002 provides for formation of rehabilitation and revival fund, appointment of professional liquidators and setting up of NCLT with powers to deal with liquidation as well as rehabilitation/reorganisation of a company, its operationalisation needs to be expedited. Though there is a provision for constitution of a Committee of Inspection (which includes creditors), for better creditor participation in the insolvency proceedings, there is a need for an express provision for constitution of creditor committee. The Act should provide for a time-frame to conclude the liquidation proceedings. The UNCITRAL Model Law on Cross-border Insolvency has not been adopted by India and, therefore, the foreign insolvency proceedings are not recognised in India. However, foreign judgments are recognised in India under the provisions of Code of Civil Procedure, 1908. The NCLT should have a separate bench to deal with rehabilitation matters involving a debt of Rs.10 crore and above to provide dedicated attention to cases involving higher amounts. The Companies Bill, 2008 seeks to provide for making the provisions in respect of winding-up applicable, *mutatis mutandis* for closure of the place of business of a foreign company in India as if it were a company incorporated in India. The Bill also seeks to enable the Tribunal to stay the winding-up proceedings for such time not exceeding 180 days and on such terms and conditions as it thinks fit, to provide an opportunity to revive and rehabilitate the company.
C 2	**Due Process: Notification and Information** **Effectively protecting the rights of parties in interest in a proceeding requires that such parties have a right to be heard on and receive proper notice of matters that affect their rights, and that such parties be afforded access to information relevant to protecting their rights or interests and to efficiently resolving disputes. To achieve these objectives, the insolvency system should:**

C 2.1	**Afford timely and proper notice to interested parties in a proceeding concerning matters that affect their rights. In insolvency proceedings, there should be procedures for appellate review that support timely, efficient and impartial resolution of disputed matters. As a general rule, appeals do not stay insolvency proceedings, although the court may have power to do so in specific cases.**
Legal Framework	In terms of Section 643 of the Companies Act, Supreme Court has been empowered to make rules, which are consistent with the Code of Civil Procedure, 1908 for the winding-up proceedings. The Companies (Court) Rules, 1959 has been made by the Supreme Court in exercise of the above powers. Rule 6 of the Companies (Court) Rules, 1959 provides that 'save as provided by the Act or these rules, the practice and procedure of the Court and the provisions of the Code so far as applicable, shall apply to all proceedings under the Act and these rules'. Therefore, the procedure under the Civil Procedure Code is made applicable. The Code contemplates issue of notice to the respondent. Rule 26 specifically provides for service of notice along with a copy of the petition on the respondent. This rule is applicable to all petitions filed in a company Court. However, in the case of winding-up petitions, Rule 96 will be applicable which gives discretion to the judge to issue notice to the company before giving directions as to advertisement of the petition. Pursuant to such a notice, the respondent can appear and contest the admission and advertisement of the winding-up petition. Rule 99 read with Rule 24 of the Companies (Court) Rules, 1959 provides for advertisement of the winding-up petition. The advertisements are to be made 14 days before the date fixed for hearing both in the Official Gazette of the State and in one issue each of an English language newspaper and a regional language newspaper having circulation in the State concerned. The Court is also empowered to issue a notice to the company for admitting the winding-up petition (Rule 96). The petitioner is required to serve notice and advertise the petition. In terms of Rule 113, a petitioner is required to advertise an order of winding-up a company. Under Rule 147, the liquidator is required to fix a date, on or before which the creditors are required to prove their debts or claims. In terms of Rule 148, the liquidator is required to give notice of such date (minimum period of notice being 14 days) through an English newspaper and a regional language newspaper having circulation in the State. The notice form (No.63) specifically states that any person who fails to submit his affidavit of proof within the specified date, will be excluded from the benefit of any distribution of dividend before his debt is provided. If any person stakes a claim, the liquidator is required

	to sent individual notice to him requiring him to attend the investigation of such debt at such time and place as shall be specified in the notice (Form 63). Rules 149 - 179 deal with the claims of creditors, which *inter alia* include proof of debts, value of debts, rights of liquidator during investigation, appeal by creditor on rejection of proof, procedure on failure to prove within prescribed time, *etc.* Section 557 of the Companies Act also empowers the Court to call for a meeting of the creditors or contributories, to ascertain their wishes in all matters relating to winding-up of a company. When creditors' wishes are ascertained, regard shall be had to the value of each creditor's debt. Apart from the above provision, liquidator is also empowered to call meeting of creditors/contributories (Rule 197). In terms of Rule 116, in every application for stay (under section 466 of the Companies Act) notice is required to be given to the parties and to the liquidator. In terms of Rule 26 of the BIFR Regulations, 1987 the BIFR is required to give notice to the sick company and give a reasonable opportunity of making their submissions. In terms of Section 18 (3) of SICA, the draft scheme (in brief) for rehabilitation is required to be published in the daily newspapers. In compromises/arrangements/reconstructions under Section 391 of the Companies Act, the Court orders the meeting of the creditors or members, as the case may be, and notices are required to be issued to all creditors/members in that regard. The Companies Act provides for appeals to the Company Court against certain decisions of the liquidator and for appeal from the orders of the company court to the Division Bench of the High Court. On operationalisation of the Companies (Second Amendment) Act, 2002 NCLAT shall have jurisdiction to hear appeal from the order of NCLT. Section 60 of the Insurance Act, 1938 imposes certain duties on the liquidator in the case of winding-up of an insurance company, when cash distribution of the assets is intended. It also confers certain privileges on the persons mentioned therein to give notice of disputing any value made by the liquidator.
Assessment	**Observed**
Comments	The provisions in respect of notices to interested parties in various stages in the insolvency proceedings and appeals are adequate.
C 2.2	**Require the debtor to disclose relevant information pertaining to its business and financial affairs in detail sufficient to enable the court, creditors and affected parties to reasonably evaluate the prospects for reorganisation. It should also provide for independent comment on and analysis of that information. Provision should be made for the possible examination of directors, officers and other persons with knowledge of the debtor's financial position and business affairs, who may be compelled to give information to the court and insolvency representative and creditors' committee.**

Legal Framework	The Companies Act mandates that a statement of affairs of the company in the prescribed form verified by an affidavit and containing particulars of the assets of the company, its debts and liabilities, the details of creditors with details of the amounts of secured and unsecured debts, the debts due to the company and details of the debtors, and such other information is to be submitted by the company to the Official Liquidator. The said statement has to be filed within 21 days from the date of appointment of Provisional Liquidator or passing of winding-up order. The creditors can, by payment of the prescribed fees, inspect the statements submitted by the company and take copies and extracts of such statements. Apart from the above provisions, the Court has been conferred with powers to pass interim orders to meet the ends of justice. When the board of directors of a sick industrial company makes a reference to the BIFR under SICA, it is *sine qua non* for the officials of the Company to assist the BIFR in rehabilitation. If the information is withheld by the debtor which amounts to violation of any provision of the Scheme, or any order of the BIFR or Appellate Authority, or whoever makes a false statement or gives false evidence to the BIFR or Appellate Authority shall be punishable with simple imprisonment for a term which may extend to 3 years and shall also be liable to fine. The Court (after the appointment of Provisional Liquidator) has the power to summon before it any officer of the company or person known or suspected to have in his possession any property or books or papers, of the company and direct him to produce such book or papers.
Assessment	**Observed**
Comments	There are adequate provisions requiring the debtor to disclose the details of assets to the liquidator/Court/BIFR in winding-up and reconstruction proceedings.
C 2.3	**Provide for the retention of professional experts to investigate, evaluate or develop information that is essential to key decision-making. Professional experts should act with integrity, impartiality and independence.**
Legal Framework	The insolvencies Acts (Provincial Insolvency Act, 1920 as well as the Presidency Towns Insolvency Act, 1909) provide for appointment of Official Receiver or Official Assignee on a presentation of petition by creditor or the debtor and also provide for appointment of interim receiver after the insolvency petition has been filed (in respect of individuals/firms/unincorporated bodies). The Companies Act, 1956 empowers the Court hearing the winding-up petition to make any interim order that it thinks fit including appointment of Interim Liquidator. Further, at any time after the presentation of winding-up petition and before

	the making of winding-up order, the Court/Tribunal may appoint the Official Liquidator provisionally. The Companies Act provides for appointment of Official Liquidators by the Central Government and are attached to each High Court on whole-time or part-time basis. Such liquidator should be law graduates with seven years' practice as an advocate. However, the Company Courts in exercise of their inherent power have been in certain cases nominating experts as Special Officers (such as retired Judges of High Court/other professionals) to oversee the business of the company and consider possible recovery/reconstruction methods for the benefit of the company. Apart from the above, the assistance of experts is also sought by the liquidators/Courts in technical matters such as valuation, *etc.* using the Courts' inherent powers. As per the Companies (Second Amendment) Act, 2002 (provision yet to be made operational), the Tribunal has been empowered to appoint a professional firm or body corporate as Official Liquidator.
Assessment	**Broadly Observed**
Comments	The Official Liquidators attached to the High Courts are legal professionals who are appointed solely for the purpose of administering the liquidation process. Even though there is no express provision empowering the appointment of other professionals, some Courts have in exercise of their inherent powers through interim orders appointed professionals for specific tasks, especially in the case of non-banking financial companies. The Companies (Second Amendment) Act, 2002 seeks to provide express powers to the Court to appoint professionals to act as Provisional Liquidators/Liquidators. The Companies Bill, 2008 also seeks to provide for appointment of professionals as Company Liquidators.
Commencement	
C 3	**Eligibility** **The insolvency proceeding should apply to all enterprises or corporate entities, including state-owned enterprises. Exceptions should be limited, clearly defined, and should be dealt with through a separate law or through special provisions in the insolvency law.**
Legal Framework	India does not have a uniform insolvency law governing all enterprises. The details of such laws have already been touched upon hereinabove. The Companies Act, 1956 covers provisions for compromises/arrangements, reconstructions/amalgamations and winding-up of companies (including Government companies). The provisions of the insolvency laws have been made applicable to companies in liquidation as regards debts provable and fraudulent preference in those proceedings. However, the Companies Act empowers the Government to issue notification directing that any provision of the Act shall not apply to a Government company. The Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980 provide that a corresponding new bank (nationalised bank) can be placed in liquidation only by an order of the Central Government and in such manner

	as the Central Government may direct. Those Acts specifically empower the Central Government to make schemes for reconstitution/amalgamation/transfer of undertaking of a nationalised bank. The State Financial Corporations and other financial institutions are governed by their respective statutes.
Assessment	**Partly Observed**
Comments	The Companies Act has been made applicable to Government companies. However, the Government has been empowered to issue notifications restricting its application to such companies. Corporations created by or under special statutes are governed by the provisions of those statutes and their winding-up/reorganisations are generally left to be performed by orders issued by the concerned Governments.
C 4 **C4.1**	**Applicability and Accessibility** **Access to the system should be efficient and cost-effective. Both debtors and creditors should be entitled to apply for insolvency proceedings**.
Legal Framework	Insolvency proceeding (both under the insolvencies Acts as well as the Companies Act) commences normally by filing of a petition by the debtor, company's shareholder, creditor, Central Government or regulatory agency. There is no bar for foreign creditors to initiate proceedings against debtors in Indian courts. Individuals normally file insolvency applications to get a discharge from the liabilities to their creditors. Regulatory non-compliance would empower the regulators to go to the Court for winding-up of the company. The Courts of jurisdiction in case of companies are the High Courts where the Registered Office of the debtor company is situated irrespective of where the company's assets are situated. An application for compromise/arrangement under Section 391 of the Companies Act can be filed by the company or the creditor or the member. Under the SICA, the company, the Central/State Governments, the Reserve Bank, a scheduled bank, public financial institution or State-level institution can apply to the BIFR for reconstruction of the company. The reorganisation plan can be brought forward by the debtor, or creditors or members/shareholders. SICA is sought to be replaced by the provisions of the Companies Act (Chapter VIA). Although the SICA (Repeal Act), 2005 has been enacted, the same has not yet been notified, on account of the stay on the implementation of the Companies (Second Amendment) Act, 2002.

Assessment	**Partly Observed**
Comments	Both debtors and creditors are entitled to apply for insolvency proceedings under the Companies Act. Under the SICA, apart from the sick company, the Central Government, the Reserve Bank, State Governments, public financial institutions, State-level institutions and scheduled banks may also make a reference to the BIFR for rehabilitation of a sick company. The long time taken in court proceedings and the expenses involved in the litigation are deterrents as regards the creditors. Often the outcome is also not satisfactory in the sense the full amount due with interest is mostly not recovered in the case of a winding-up. The re-organisation proceedings under the SICA have also been practically a failure on account of the time taken in those proceedings. A reference to the BIFR also imposes a statutory stay on the initiation of any recovery proceedings against the company under reference. Once the Companies (Second Amendment) Act, 2002 is made operational, it is expected that the problems on account of delay would be taken care of. The Companies Bill, 2008 seeks to provide for commencement of rehabilitation/ revival proceedings of sick companies on an application of a creditor of the company. However, before such an application is made the company should have failed to pay the debt within thirty days of a demand by secured creditors of the company representing 50 per cent or more of its outstanding amount of debt. The above proceedings are applicable to all sick companies and is not restricted to sick industrial companies only, unlike the Companies Act, 1956 (as inserted in the Companies (Second Amendment) Act, 2002).
C4.2	**Commencement criteria and presumptions about insolvency should be clearly defined in the law. The preferred test to commence an insolvency proceeding should be the debtor's inability to pay debts as they mature, although insolvency may also exist where the debtor's liabilities exceed the value of its assets, provided that the value of assets and liabilities are measured on the basis of fair market values**.
Legal Framework	The provisions of the Companies Act (Section 433 (e)), specifically provides that the company may be wound-up if it is unable to pay its debts. A company shall be deemed to be unable to pay its debts if a demand has been made by the creditor to pay the sum (exceeding Rs.500/-) and the company has for three weeks neglected to pay the sum. Alternatively, the Court can also be satisfied (by other means) that the company is unable to pay its debts, when the Court is required to take into account the contingent and prospective liabilities of the company. However, it is not incumbent upon the Court to wind-up a company even if it is proved that it is unable to pay its debts. Courts do also consider whether the company has reached a stage where it is obviously and commercially insolvent, that is to say, that its assets are such and its existing liabilities are such as to make the Court feel clearly satisfied that current assets would be insufficient to

	meet the current liabilities. (Ramaiya, *Guide to the Companies Act, 2004 Edition, Part 2,* pp. 3638-3639). Apart from the above, a company can be wound-up by the Court *inter alia* (i) if a default is made in delivering the statutory Report to the Registrar or in holding the statutory meeting, (ii) if the number of members is reduced (in the case of a public company below seven and in the case of private company below two) and (iii) if the court is of the opinion that it is just and equitable that the company should be wound-up. Some additional grounds for winding-up have been inserted by the Companies (Second Amendment) Act, 2002 which are yet to be operationalised. The company can by a special resolution resolve that the company may be wound-up by the Court or it can cause itself to voluntarily wind-up either by contributories or by the creditors. Besides the above grounds, which are available for winding-up of an insurance company, it may be also wound-up by the Court if one or more of the following grounds for winding-up are present in terms of section 53(2)(b) of the Insurance Act, 1938, on an application made by the IRDA: (i) the insurance company has failed to maintain the deposits with the Reserve Bank under section 7; (ii) the company, having failed to comply with any requirement of the Insurance Act, 1938 has continued such failure or having contravened any provision of the Insurance Act, 1938 has continued such contravention for a period of 3 months after notice of such failure or contravention has been conveyed to the company by IRDA; (iii) that it appears from any returns or statements furnished under the provisions of the Insurance Act, 1938 or from the results of any investigation made thereunder that the company is or is deemed to be insolvent; or (iv) that the continuance of the company is prejudicial to the interests of the policyholders or to the public interests generally. Further, under section 53(2) of the Insurance Act, 1938 apart from the above, additional grounds on which a winding-up order can be passed by the Court, on an application made by the shareholders/policyholders, are as under. (i) if with the previous sanction of the Court a petition is presented by shareholders who hold not less than 10 per cent of the equity capital and voting rights; or

	(ii) by not less than 50 policyholders holding policies of life insurance that are in force for not less than 3 years and are of the total value of not less than fifty thousand rupees. The creditor can file an application for compromise/arrangement also (section 391). However, three-fourths in value of the creditors present and voting should agree with the proposal for compromise/arrangement (Section 391). Both the Presidency Towns Insolvency Act as well as the Provincial Insolvency Act provide that a debtor may file a petition only if (a) his debts amount to five hundred rupees, or (b) he has been arrested and imprisoned in execution of the decree of any Court for the payment of money, or (c) an order of attachment in execution of such a decree has been made and is subsisting against his property. Under the SICA, reference can be made only by a scheduled bank, state level financial institution, Central Government, State Government or a public financial institution and not by all creditors. The entity making the reference should have sufficient reasons to believe that the industrial company has become a sick industrial company. Under SICA, 'sick industrial company' has been defined as 'an industrial company (being a company registered for not less than five years) which has at the end of any financial year accumulated losses equal to or exceeding its entire net worth.'
Assessment	**Observed**
Comments	The criteria for commencement of insolvency proceedings in all jurisdictions have been clearly spelt out. In the case of companies, the provision that a company shall be deemed to be unable to pay its debts, if a demand has been made by the creditor to pay a sum exceeding Rs. 500/- and the company has for three weeks neglected to pay the sum, then it shall be deemed to be unable to pay its debts, would enable even small creditors to initiate winding-up proceedings against the company. The Companies (Second Amendment) Act, 2002 has addressed this issue and the sum has been raised to Rs. one lakh.
C4.3	**Debtors should have easy access to the insolvency system upon showing proof of basic criteria (insolvency or financial difficulty).**
Legal Framework	The provisions of the SICA enable a company to approach the BIFR for rehabilitation when it is found to be sick. The Companies Act also facilitates a voluntary winding-up of the company in certain circumstances. Companies are also free to approach the Court for its winding-up under the supervision of the Court. Section 391 of the Companies Act also enables a company through its members to approach the Court for sanction of a scheme for reconstruction/ compromise/arrangement. The insolvency Acts (both Provincial as well as Presidency) enables a person to approach the Court for declaring him as insolvent. Both the Presidency Towns Insolvency Act as well as the Provincial Insolvency Act provide that a debtor may file a petition only if (a) his debts amount to five hundred rupees, or (b) he has been arrested and imprisoned in execution of the decree of any Court for the

	payment of money, or (c) an order of attachment in execution of such a decree has been made and is subsisting against his property.
Assessment	**Observed**
Comments	Section 391 of the Companies Act is the provision which is mostly invoked by the companies for reconstruction activities. The voluntary winding-up route is seldom taken, as the same would eventually lead to the complete dissolution of the company. Delay in proceedings has made winding-up with the supervision of the Court as the last resort for the companies. It is found that companies often use the SICA to prevent creditors from proceeding against them. This is on account of the statutory stay on initiation/continuation of suits or other legal proceedings once a reference is made to the BIFR. The Companies (Second Amendment) Act, 2002 seeks to correct this situation.
C4.4	**Where the application for commencement of a proceeding is made by a creditor, the debtor should be entitled to prompt notice of the application, an opportunity to defend against the application, and a prompt decision by the court on the commencement of the case or the dismissal of the creditor's application.**
Legal Framework	Rule 26 of the Companies (Court) Rules, 1959 specifically provides for service of notice along with a copy of the petition on the respondent. This rule is applicable to all petitions filed in a company Court. However, in the case of winding-up petitions, Rule 96 will be applicable which gives discretion to the judge to issue notice to the company before giving directions as to advertisement of the petition. Pursuant to such a notice, the respondent can appear and contest the admission and advertisement of the winding-up petition. Rule 99 read with Rule 24 of the Companies (Court) Rules, 1959 provides for advertisement of the winding-up petition. The advertisements are to be made 14 days before the date fixed for hearing both in the Official Gazette of the State and in one issue each of an English language newspaper and a regional language newspaper having circulation in the State concerned. The Court is also empowered to issue a notice to the company for admitting the winding-up petition (Rule 96). The petitioner is required to serve notice and advertise the petition. In terms of Rule 26 of the BIFR Regulations, 1987 the BIFR is required to give notice to the sick company and give a reasonable opportunity of making their submissions. In terms of Section 18 (3) of the SICA, the draft scheme (in brief) for rehabilitation is required to be published in such daily newspapers, as the BIFR may consider necessary.

Assessment	**Partly Observed**
Comments	There are ample provisions which provide for notice to the debtor. However, the decisions on the petitions filed by the creditors are not always quick. The constitution of a separate Tribunal as envisaged under the Companies (Second Amendment) Act, 2002 would help reduce the delays.
C 5 **C5.1**	**Provisional Measures and Effects of Commencement** **When an application has been filed, but before the court has rendered a decision, provisional relief or measures should be granted when necessary to protect the debtor's assets and the interests of stakeholders, subject to affording appropriate notice to affected parties.**
Legal Framework	In terms of section 443 (1) (c) of the Companies Act, the Court has been empowered to 'make any interim order that it thinks fit' on hearing a winding-up petition. In a case where the winding-up petition against a company is admitted and a Provisional Liquidator is appointed by the Court, no suit or legal proceeding can be commenced or proceeded with (if pending) without obtaining the leave of the Court. However, there are decisions of the Courts to the effect that the proceedings initiated by a bank or financial institutions in DRT would continue and criminal proceedings can be initiated and continued even after the filing of a winding-up petition and the appointment of a Provisional Liquidator. The Courts have, in certain cases, in exercise of their inherent powers, been issuing interim orders directing the Provisional Liquidator to engage security guards to protect the immovable assets of the company, the costs of which are being asked to be borne by the Petitioner. The Petitioners are given first charge over the assets of the company in respects of those costs. However, the Companies (Second Amendment) Act, 2002 has inserted express provisions enabling the Court/Liquidator to take a variety of measures to protect the properties of the company. During the pendency of the proceeding, the Court is empowered to appoint a Provisional Liquidator to administer the assets of the company. The Provisional Liquidator can exercise all the powers exercisable by a Liquidator, unless otherwise ordered by the Court. The Liquidators/Provisional Liquidators are entitled to use their own discretion (subject to the provisions of the Act) in the administration of the assets of the company. Under Section 18 of the Presidency Towns Insolvency Act, the Court can stay any suit or proceeding pending against the insolvent in any Court which is subject to the superintendence of that Court. Under the SICA, when an inquiry is commenced or scheme is pending or has been sanctioned, the operation of all contracts, agreements, settlements, awards, standing orders, *etc.* shall remain suspended and no suit for recovery of money for the enforcement of any security against the industrial company or any guarantee in respect of any loans granted against the industrial company shall lie or be proceeded with further, except with the consent of BIFR.

Assessment	**Broadly Observed**
Comments	The Companies Act empowers the Court to pass interim orders, which may include measures for protection of debtor's assets. The Companies (Second Amendment) Act, 2002 contains express provisions which would enable the NCLT/Liquidator to take certain measures to protect the properties of the company.
C5.2	**The commencement of insolvency proceedings should prohibit the unauthorised disposition of the debtor's assets and suspend actions by creditors to enforce their rights or remedies against the debtor or the debtor's assets. The injunctive relief (stay) should be as wide and all-encompassing as possible, extending to an interest in assets used, occupied or in the possession of the debtor.**
Legal Framework	Where the Court appoints the Provisional Liquidator, no suit or legal proceeding can be commenced or proceeded with (if pending) without obtaining the leave of the Court. The Court will have the power to entertain and dispose of any suit or proceeding in any other Court (other than a High Court or Supreme Court) pending against the company in liquidation. Therefore, the right of a person to preserve a claim against the company is not lost. On a winding-up order, the company's property would be taken over by the Official Liquidator and the liquidator has the power *inter alia* to carry on the business of the company so far as may be necessary for the beneficial winding-up of the company. Thereafter, the management of the company will not have any right to encumber or transfer the properties of the company and such transfers will be void. Any transfer of property, movable or immovable, delivery of goods, payment execution or other act relating to property made, taken or done by or against a company within six months before commencement of its winding-up shall be void. The secured creditors are, however, entitled to enforce their security interests outside the winding-up, subject to a *pari passu* charge on the claims of the workmen. The enforcement of security interest by secured creditors during the winding-up for realisation of security is permitted under Section 13(9) of the SARFAESI Act (as also Section 529 A of the Companies Act, 1956). However, the liquidator would have a *pari passu* charge in respect of workmen's dues on such realisation and the secured creditor is bound to deposit the workmen's dues with the Official Liquidator.

	Under the SICA, when an inquiry is commenced or scheme is pending or has been sanctioned, the operation of all contracts, agreements, settlements, awards, standing orders, *etc.* shall remain suspended and no suit for recovery of money for the enforcement of any security against the industrial company or any guarantee in respect of any loans granted against the industrial company shall lie or be proceeded with further, except with the consent of BIFR. Under the SICA, the stay on suits/contracts, *etc.* will remain effective throughout the proceedings and during the time of appeal. However, a reference made to the BIFR shall abate if the secured creditors (not less than three-fourth in value of the amount outstanding) have taken any measures to recover their secured debt under Section 13(4) of SARFAESI Act.
Assessment	**Broadly Observed**
Comments	The law provides for a general stay on suits and proceedings against the assets of the company. However, such a stay is not applicable to a secured creditor who enforces his security interest outside the winding-up proceedings. Until and unless the Court has passed an order in an insolvency petition, the company is free to deal with its properties and the same may erode the realisation, unless a Provisional Liquidator is appointed to manage the affairs. The law should provide for automatic stay of further liabilities being created on the company's assets and alienation of the company's assets, camouflaged as in the ordinary course of business on presentation of insolvency petition provided the petitioner serves the company with a notice. As a safeguard against abuse of such proceedings, the law should also provide for severe penalties against applicants for vexatious and *mala fide* petitions.
C5.3	**A stay of actions by secured creditors should be imposed in liquidation proceedings to enable higher recovery of assets by sale of the entire business or its productive units, and in reorganisation proceedings where the collateral is needed for the reorganisation. The stay should be of limited, specified duration, strike a proper balance between creditor protection and insolvency proceeding objectives, and provide for relief from the stay by application to the court based on clearly established grounds when the insolvency proceeding objectives or the protection of the secured creditor's interests in its collateral are not achieved. Exceptions to the general rule on a stay of enforcement actions should be limited and clearly defined.**
Legal Framework	See Legal Framework in respect of C 5.2. The Companies Act provides for automatic stay of proceedings by creditors against the debtor company, once the Provisional Liquidator is appointed. The secured creditors are entitled to enforce their security outside the winding-up proceedings, subject to *pari passu* charge in respect of workmen dues. However, if the secured creditors opt to participate in the winding-up proceedings, they would be subject to the provisions relating to winding-up including stay on initiation/continuation of recovery proceedings. The Court/BIFR is empowered to provide exception to the stay. However, practically, these exceptions are rarely used.

Assessment	**Partly Observed**
Comments	There are various provisions under law which provide for stay of recovery proceedings against the debtor and for protection of assets of the insolvent company. However, secured creditors are entitled to enforce their security outside the winding-up proceedings, subject to *pari passu* charge in respect of workmen dues.
Governance	
C 6	**Management**
C 6.1	**In liquidation proceedings, management should be replaced by an insolvency representative with authority to administer the estate in the interest of creditors. Control of the estate should be surrendered immediately to the insolvency representative. In creditor-initiated filings, where circumstances warrant, an interim administrator with limited functions should be appointed to monitor the business to ensure that creditor interests are protected.**
Legal Framework	During the pendency of the proceeding, the Court is empowered to appoint a Provisional Liquidator to administer the assets of the company. The Provisional Liquidator can exercise all the powers exercisable by a liquidator, unless otherwise ordered by the Court. The business and assets of the company are required to be handed over to the Provisional Liquidator as an interim measure. A Receiver for managing the assets of the company can be appointed with the leave of the Court. Courts have also appointed special officers to monitor the interests of the creditors, especially depositors. During the insolvency proceedings, the entire assets of the company are vested in the Official Liquidator. The Insolvency Acts (Provincial Insolvency Act, 1920 as well as the Presidency Towns Insolvency Act, 1909) provide for appointment of Official Receiver or Official Assignee on a presentation of petition by creditor or the debtor and also provide for appointment of interim receiver after the insolvency petition has been filed. The Insolvency Acts provide for duties and powers of the Receiver and Official Assignee. The Receiver/Official Assignee takes complete control of estate. The control is vested on the making of order of adjudication, but the control can also be vested as an interim measure. These appointees would perform subject to the statutory provisions, and shall with all convenient speed, realise the property of the debtor and distribute among the creditors entitled thereto and for that purpose may *inter alia* sell all or part of the property of the insolvent, carry on the business of the insolvent so far as may be necessary for the beneficial winding-up, and institution, defending or continuance of any suit or other legal proceeding relating to the property of the insolvent.

Assessment	**Observed**
Comments	There are provisions for appointment of an insolvency representative in the nature of a liquidator who will be in charge of assets and affairs of the company during the liquidation. Courts have been empowered to appoint the Official Liquidator attached to the High Court as the Provisional Liquidator as interim measure. Further, a Receiver for managing the assets of the company can be appointed with the leave of the Court.
C6.2	**There are typically three preferred approaches in reorganisation proceedings: (i) exclusive control of the proceeding is entrusted to an independent insolvency representative; or (ii) governance responsibilities remain invested in management; or (iii) supervision of management is undertaken by an impartial and independent insolvency representative or supervisor. Under the second and third approaches, complete administration power should be shifted to the insolvency representative if management proves incompetent, negligent or has engaged in fraud or other misbehaviour.**
Legal Framework	Under SICA, the reconstruction of the company would be based on a scheme prepared by an operating agency (bank or financial institution). Such schemes would *inter alia* provide for the proper management of the sick industrial company, by change in or takeover of the management of that company. The scheme may also provide for rationalisation of the managerial personnel, supervisory staff and workmen in accordance with law. In the case of proceedings under Section 391 of the Companies Act for compromise/arrangement/reconstruction, the scheme approved by the contributories/creditors would provide for the details of such compromise/ arrangement/reconstruction.
Assessment	**Observed**
Comments	The law provides ample flexibility to decide the manner in which company is to be administered at the time of reconstruction/compromise/arrangement. Scheme for reconstruction itself would provide as to who would be put in charge.
C 7	**Creditors and the Creditors' Committee**
C7.1	**The role, rights and governance of creditors in proceedings should be clearly defined. Creditor interests should be safeguarded by appropriate means that enable creditors to effectively monitor and participate in insolvency proceedings to ensure fairness and integrity, including by creation of a creditors' committee as a preferred mechanism, especially in cases involving numerous creditors.**
Legal Framework	The Provincial Insolvency Act, 1920 provides for appointment of a Committee of Inspection comprising of creditors who have proved their debts. The Companies Act, 1956 provides that a Committee of Inspection is appointed at the direction of the Court to act with the liquidator, after a winding-up order is passed by the Court. Such a Committee shall consist of not more than twelve members, being creditors and contributories of the company in such proportions

	as may be agreed upon by the meetings of creditors and contributories, or in case of difference of opinion as regards constitution, as may be determined by the Court. The liquidator is required to call for meeting of Committee of Inspection. The Committee of Inspection shall meet as it may from time to time appoint and the liquidator or any member of the committee may also call a meeting of the Committee as and when he thinks necessary. The quorum for a meeting of the Committee shall be one-third of the total number of the members, or two, whichever is higher. The Committee may act by a majority of its members present at a meeting but shall not act unless a quorum is present. A member of the Committee may be removed at a meeting by an ordinary resolution. It is through the Committee of Inspection that the creditors assert their rights and safeguard their interest. Its duty in essence is to assist in the administration of the assets of the company. As per the Companies (Court) Rules, 1959 as soon as possible after the holding of the meeting of Committee of Inspection, the Official Liquidator shall report to the Court. The Court is not bound to accept the decision of Committee of Inspection and all the decisions are to be approved by the Court. The Committee of Inspection is empowered to inspect the accounts of the liquidator at all reasonable times. The Committee of Inspection neither has power to appoint liquidator nor veto decisions of the liquidator. In all matters relating to winding-up of a company, the Court may, for ascertaining the wishes of creditors, call for their meeting and to report the result thereof to the Court. The liquidator shall cause the account when audited or a summary thereof to be printed and shall send a printed copy of the account or summary by post to every creditor and to every contributory. If any complaint is made regarding the conduct of affairs of the company in liquidation to the Central Government by any creditor, the Central Government may take such action thereon as it may think expedient. The power includes the power to remove the liquidator from office. However, this may not include replacing the Court-appointed liquidator with the creditors' appointee. The Central Government may also direct the investigation to be made of the functioning of such a liquidator. According to Section 448 of the Companies Act consequent to the Companies (Second Amendment) Act, 2002 (which is yet to be brought into force), the Tribunal may remove the OL on sufficient cause being shown.
Assessment	**Partly Observed**
Comments	Although the Companies Act does not contain provisions for appointment of an exclusive creditors' committee, the Committee of Inspection consists of creditors

	also. However, the Committee of Inspection can be appointed only at the time of passing of winding-up order, when the scope for revival of the company is out of question. It may be appropriate to have a Creditors' Committee at the initial stage of insolvency proceedings to consider the reorganisation of the company. They may also oversee the winding-up of the company. In case of creditors' voluntary winding-up, the creditors are empowered to nominate liquidator. In other situations also, the law should provide for appointment of creditor-nominated liquidator. This may become possible once provisions relating to appointment of liquidator under Companies (Second Amendment) Act, 2002 are brought into operation. There should be a provision for exclusive Creditors' Committee/Assembly in the insolvency laws, when the liquidator is not a creditor-nominated liquidator. Such Committees may be empowered to take decisions along with the liquidator and to file report independently to the Court/Tribunal for improving liquidation proceedings.
C 7.2	**Where a committee is established, its duties and functions, and the rules for the committee's membership, quorum and voting, and the conduct of meetings should be specified by the law. It should be consulted on non-routine matters in the case and have the ability to be heard on key decisions in the proceeding. The committee should have the right to request relevant and necessary information from the debtor. It should serve as a conduit for processing and distributing that information to other creditors and for organising creditors to decide on critical issues. In reorganisation proceedings, creditors should be entitled to participate in the selection of the insolvency representative.**
Legal Framework	The Committee of Inspection consisting of representatives from the creditors have the right to inspect the accounts of the liquidator. The Committee can meet from time to time and the provision governing its quorum, removal of its members, *etc.* have been given in the Companies Act. However, the Committee of Inspection can only oversee the winding-up and not the re-organisation of the company. Presently, the creditors have no say in the appointment of the liquidator (except in case of creditors' voluntary winding-up), as the Companies Act provides only for the appointment of the Official Liquidator who is an officer attached to the Court. However, the Companies (Second Amendment) Act, 2002 has brought in provisions which enable the Court to appoint a creditor-nominated liquidator also (these provisions are yet to be operationalised). Under SICA, the operating agency (which is a bank or financial institution) can frame a scheme and seek the approval of the BIFR. In such a scheme, there could be a creditor-nominated representative to manage the company. However, there are no express provisions requiring the BIFR to appoint a creditor-nominated representative to manage the affairs.
Assessment	**Partly Observed**
Comments	Please see assessment of C 7.1. In reorganisation proceedings under the SICA also, there should be a provision for appointment of creditor-nominated representatives/committee.

Administration	
C 8	**Collection, Preservation, Administration and Disposition of Assets**
C8.1	**The insolvency estate should include all the debtor's assets, including encumbered assets and assets obtained after the commencement of the case. Assets excluded from the insolvency estate should be strictly limited and clearly defined by the law.**
Legal Framework	Only secured assets are excluded from the winding-up proceedings under the Companies Act. Even then, such assets have a *pari passu* charge in favour of the workmen. All other assets are available to the creditors in their order of priority. Under SICA, the BIFR through an operating agency prepares a complete inventory of all assets of the company. Under the insolvency Acts once an order of adjudication is passed by the Court, the property of the insolvent, wherever situated, will vest in the Official Assignee. (Section 17 of Presidency Towns Insolvency Act). However, Section 60 of the Code of Civil Procedure, 1908 lists out the properties that are not liable to attachment under any proceeding, including an insolvency proceeding. The list *inter alia* includes the necessary wearing apparel, cooking vessels, houses and other buildings (with the materials and the sites thereof and the land immediately appurtenant thereto and necessary for their enjoyment) belonging to an agriculturalist or a labourer or a domestic servant and occupied by him, wages of labourers and domestic servants and salary to the extent of the first one thousand rupees and two-thirds of the remainder. Under the SICA also, all the assets of the company included in the rehabilitation process are protected, including secured assets and these assets are protected from claims during the reference. The contributories (as defined in section 428 of the Companies Act) of a company, having unpaid dues, are liable to pay to the company in liquidation, the money due from them, on receipt of an order to that effect from the Court. However, in the case of insurance companies, while ascertaining the solvency, the amount due on shares not paid up should not be taken into account.
Assessment	**Partly Observed**
Comments	In the winding-up of companies the secured assets are exempted, subject to *pari passu* charge of the workmen. In the case of insolvencies of individuals, certain personal articles are exempted from attachment. Otherwise, all assets are covered.
C8.2	**After the commencement of the insolvency proceedings, the court or the insolvency representative should be allowed to take prompt measures to**

	preserve and protect the insolvency estate and the debtor's business. The system for administering the insolvency estate should be flexible and transparent and enable disposal of assets efficiently and at the maximum values reasonably attainable. Where necessary, the system should allow assets to be sold free and clear of security interests, charges or other encumbrances, subject to preserving the priority of interests in the proceeds from the assets disposed.
Legal Framework	The insolvency Acts (the Provincial Insolvency Act, 1920 and the Presidency Towns Insolvency Act, 1909) provide for duties of insolvent in discovery of the property and to aid in the realisation of his property and the distribution of the proceeds among his creditors. Further, the insolvency Acts provide for Court's power to discover the insolvent's property. It is the duty and power of the Receiver/Official Assignee to realise the property of the debtor and to institute, defend or continue any suit or other legal proceedings relating to the property of the insolvent. Under Companies Act, where the Court/Tribunal has made a winding-up order, a statement of affairs of the Company containing its assets shall be submitted and verified by the Directors or Officers of the Company. Once the properties are identified, the liquidator or the Provisional Liquidator shall take the custody of such property to which the company is or appears to be entitled as per procedure provided. The liquidator shall have powers with the sanction of the Court/Tribunal to dispose of property and actionable claims of the company by public auction or private contract, with power to transfer the whole thereof to any person or body corporate or to sell the same in parcel. A provision (yet to be brought into operation) to allow sale of whole undertaking of the company as a going concern has been inserted by the Companies (Second Amendment) Act, 2002. The Companies Act provides for disclaimer of onerous property in case of a company which is being wound-up. Liquidators have the power to recover property improperly transferred at the time of insolvency. The liquidator has the power, with the sanction of the Court, to institute any legal proceedings in the name and on behalf of the company. The Companies Act provides that on hearing a winding-up petition, the Court may make any interim order that it thinks fit. In exercise of this power, the Court may appoint Special Officers to protect and preserve the assets of the company between the date of winding-up petition and the date of appointment of liquidator. Under the Companies (Second Amendment) Act, 2002 there are provisions (yet to be operationaliased) empowering the liquidator to appoint security guards to protect the property of the company taken into custody and to appoint valuer or professionals to assess the value of the Company's assets. Under the SICA, the BIFR, through the operating agency, shall prepare a complete inventory of all assets of the company. The BIFR may cause the assets of the company to be sold.
Assessment	**Broadly Observed**

Comments	The Companies Act does not contemplate sale of assets with security interests, unless the secured creditors opt to participate in the liquidation proceedings. The Companies Act enables the secured creditors to enforce their security outside the winding-up. As regards the other assets, the priority of payments is in accordance with the provisions of the Act. The Companies Act empowers the Court to pass interim orders *inter alia* for the assets of the company. The Companies (Second Amendment) Act, 2002 once made operational would provide express powers to the liquidator/Court to protect the assets of the company and to even sell the undertaking as a going concern. The Scheme under SICA may provide for the sale of assets and undertakings of the company in the course of its rehabilitation. Once the Companies (Second Amendment) Act, 2002 is made operational, the mechanism for preserving the assets, disposing the assets to obtain maximum value, flexibility and transparency can be achieved in an efficient manner. In terms of clause 276 of Companies Bill, 2008 if any contributory/person having property of the company is trying to quit India or to abscond or is about to remove or conceal any of such property, for the purpose of evading payment of calls or avoiding examination respecting the affairs of the company, the Tribunal can cause such person to be arrested and kept in custody until such time as the Tribunal may order, and books and papers and moveable property can be ordered to be seized from him and safely kept till such time as the Tribunal may order. The Companies Bill, 2008 provides for a scheme of revival and rehabilitation containing measures *inter alia* for sale or lease of a part or whole of any asset or business of the sick company or amalgamation of sick company with any other company or for takeover of sick company by a solvent company.
C 8.3	**The rights and interests of a third party owner of assets should be protected where its assets are used during the insolvency proceedings by the insolvency representative and/or the debtor in possession.**
Legal Framework	The liquidator can take possession of and have control over only the properties, actionable claims and effects to which the company is entitled to. Unless the company has a right over the property, the liquidator will not have any powers. As regards leases and other contracts entered into by the company and tenancy rights, *etc.* flowing therefrom, the liquidator would be representing the company in the place of the management. The liquidator and the counterparties would be bound by the terms of such contracts.
Assessment	**Observed**

Comments	The Companies Act does not empower the liquidator to use a third-party asset during the proceedings, with the exception of continuation of contractual rights and obligations *vis-à-vis* third parties in accordance with the terms and conditions of such contracts.
C 9	**Stabilising and Sustaining Business Operations**
C9.1	**The business should be permitted to operate in the ordinary course. Transactions that are not part of the debtor's ordinary business activities should be subject to court review.**
Legal Framework	Under the SICA, the authority providing or intending to provide any financial assistance to the sick company may make an application to the BIFR agreeing to an arrangement for continuing the operation of that sick industrial company. However, the alienation of any assets of the company is prohibited except with the approval of the BIFR. The SICA provides for BIFR appointing a special director to the sick undertaking. However, the special director is to discharge his duties in accordance with the directions of BIFR. The statute is silent on the powers and functions of the special director. In the case of winding-up proceedings under the Companies Act, the Provisional Liquidator or Liquidator, as the case may be, has been empowered to carry on the business of the company so far as may be for the beneficial winding-up of the company. This power can be exercised without the sanction or intervention of the Court. However, such power will be subject to supervision of the Court/Tribunal. Any person aggrieved by any act or decision of the liquidator may apply to the Court/Tribunal and the Court/Tribunal may confirm, reverse or modify the act or decision of, and make such further order as it thinks just in the circumstances. In case the Provisional Liquidator is not appointed, the debtor is entitled to continue to operate its business, subject to any orders passed by the Court. During the consideration of the scheme for compromise/reconstruction/ arrangement under Section 391 of the Companies Act, the company is free to carry on the business in the ordinary course.
Assessment	**Observed**
Comments	The provisions are adequate in respect of carrying on the business during reorganisation/winding-up/rehabilitation proceedings. The powers of the insolvency representative are subject to the sanction of the Court.
C9.2	**Subject to appropriate safeguards, the business should have access to commercially sound forms of financing, including on terms that afford a repayment priority under exceptional circumstances, to enable the debtor to meet its ongoing business needs.**
Legal Framework	There is no priority for financial assistance given in rehabilitation proceedings under SICA. Even in Part VIA (inserted by the Companies (Second Amendment) Act, 2002 (yet to be brought into operation) incorporating provisions relating to revival and rehabilitation of sick industrial company), there is no provision for priority funding and safeguards available to the provider of such financial

	assistance. Under SICA, in the event of rehabilitation of a company, every bank which has lent to the company in consortium has to provide financial assistance (lend) pro rata to such company. The provisions of the Companies Act do not enable the insolvency representative or the company to create new security interests on assets already secured. However, in winding-up proceedings the amount deposited by the petitioner for expenses may be given first charge at the discretion of the Court. In terms of Rule 292, where a company in liquidation has no available assets, the Official Liquidator may, with the leave of the Court, incur any necessary expenses in connection with the winding-up out of any permanent advance or other fund provided by the Central Government and the expenses so incurred shall be recouped out of the assets of the company in priority of the debts of the company.
Assessment	**Broadly Observed**
Comments	There is a need to provide for priority to the financial assistance given at the time of rehabilitation while disbursing the assets in liquidation, by inserting specific provision in the Companies Act. It is felt that the law should provide for extension of financial aid during the rescue process only to such entities that have suffered losses as a result of matters beyond their control and not to those entities who have suffered losses due to maladministration and recklessness.
C 10	**Treatment of Contractual Obligations**
C10.1	**To achieve the objectives of insolvency proceedings, the system should allow interference with the performance of contracts where both parties have not fully performed their obligations. Interference may imply continuation, rejection or assignment of contracts.**
Legal Framework	The contractual obligations may be overridden by specific statutory provisions. Under Section 531A of the Companies Act, any transfer of property, movable or immovable, or any delivery of goods, made by the company, not being a transfer or delivery made in the ordinary course of its business or in favour of a purchaser or encumbrancer in good faith and for valuable consideration, if made within a period of one year before the date of presentation of winding-up petition, is void against the liquidator. Generally, the liquidator is bound by the contractual obligations (except unprofitable contracts) in ordinary course of business or transfers in good faith and for valuable consideration. In case of unprofitable contracts, the liquidator

	may at any time within twelve months after the commencement of the winding-up or such extended period as may be allowed by the Court, disclaim the property. On the winding-up of company, outstanding contracts do not become *ipso facto* inoperative. They are binding until disclaimed or rescinded. The counterparty to the contract disclaimed or rejected is entitled to assert a damage claim for breach of contract. The liability under these contracts creates, in any case, only an ordinary debt which ranks for claim to payment *pro rata* along with other creditors. On winding-up, third parties are not automatically released from performing their obligations under pending contracts. Likewise, unless it can be construed to be an unprofitable contract, the liquidator is also under an obligation to perform his end of the bargain and his non-performance may be regarded as breach thereof unless he can point out extenuating circumstances which prevented his performance. Further, in exercise of his powers under Section 546 of the Companies Act, the liquidator can make a compromise or arrangement (with the sanction of the Court) with even creditors having future or contingent claims. If a sanctioned scheme is under implementation under SICA, all contracts to which such industrial company is a party are suspended for a period of upto seven years. Part VI A (similar to the provisions of SICA has been inserted in the Companies Act, 1956 by Companies Amendment Act, 2002 (yet to be operationalised)), which provides for revival and rehabilitation of sick companies. In case the borrower fails to discharge his liabilities in full within the period specified, the secured creditor under SARFAESI Act may take over the management of the business of the borrower including the right to transfer by way of lease, assignment or sale for realising the secured asset, to appoint manager to manage the secured asset, possession of which has been taken over by the secured creditor and for restoration of management of business on realisation of his debt in full. The provisions of set-off provided under the Provincial Insolvency Act, 1920 and the Presidency Towns Insolvency Act, 1909 are similarly applicable in case of companies. The Companies Act, 1956 provides for payment of debts due by contributory and extent of set-off. The rule is applicable when all the creditors have been paid in full, any money due on any account whatever to a creditor from the company may be allowed to him by way of set-off against any subsequent call. Section 61 of the Insurance Act, 1938 empowers the Court to reduce the amount of the insurance contracts in winding-up. It also empowers the Court to reduce the amount of insurance contracts in place of making a winding-up order where an insurance company has been proved to be insolvent.
Assessment	**Observed**
Comments	The law specifically provides that transactions other than in the ordinary course of business or done in good faith for valuable consideration, up to one year before the presentation of the winding-up petition, would be treated as void

	against the liquidator. Apart from this, all other contracts are valid and enforceable against the liquidator. The liquidator has been given a limited power to disclaim unprofitable contracts. In terms of clause 305 of the Companies Bill, 2008 any transfer or assignment by a company of all its properties or assets to trustees for benefit of all its creditors shall be void.
C 10.2	**To gain the benefit of contracts that have value, the insolvency representative should have the option of performing and assuming the obligations under those contracts. Contract provisions that provide for termination of a contract upon either an application for commencement, or the commencement of insolvency proceedings, should be unenforceable subject to special exceptions.**
Legal Framework	The treatment of 'contractual termination rights' like close-out contracts has not been specifically discussed in law. There are no specific provisions in the laws dealing with automatic termination or closing out of contracts. However, it may be noted that the insolvency laws do not come in the way of bilateral netting of currently enforceable outstandings. In the case of close-out netting by way of contract also, the same principle can be applied. Even if the liquidator refuses to acknowledge the liability as a currently enforceable liability and treats it as a future liability, the fact that the debt has not matured when the insolvency/winding-up commenced would not be of material consequence, as the winding-up/insolvency would accelerate the date on which the set-off should be effected and make the commencement of the winding-up/insolvency the time for that purpose. (Please see the Full Bench decision in Isaac v. Palai Central Bank Ltd reported in [1963] 33 Comp Cas 799 (Ker.) and the decision of the Madras High Court in K. Anantaraman v. Official Liquidator, Travancore National & Quilon Bank Ltd. reported in [1939] 9 Comp Cas 285 (Mad.)). This position would hold good under the Companies Act, 1956, Provincial Insolvency Act, 1920 and Presidency Towns Insolvency Act, 1909. The position of law in this regard with respect to 'financial contracts' such as derivatives, *etc.* is yet to be tested in the Courts.
Assessment	**Partly Observed**
Comments	The law recognises mutual set-off of obligations. However, it is silent on closing-out of contracts and their netting. The Parliament has enacted the Payment and Settlement Systems Act, 2007 which *inter alia* provides for legal protection to netting including multilateral netting and close-out netting in insolvency proceedings. However, this protection is only available to contracts within a

	payment system. The definition of 'payment system' specifically excludes 'stock exchanges'. Even though, certain rules and bye-laws of the stock exchanges provide for close-out mechanism in respect of a member's obligation to a stock exchange during his insolvency and these rules and bye-laws have been held to be statutory and enforceable by Courts, there is no specific provision in any statute covering such contracts in stock exchanges. Since the provisions of the Act are not applicable to stock exchanges and clearing corporations of such stock exchanges regulated by SEBI, the protection afforded to netting and close-out contracts in the case of insolvency is not available to transactions done on stock exchanges. Therefore, it is necessary that similar provisions should also be made in the Securities Contracts (Regulation) Act, 1956 to provide protection to the contracts entered on recognised stock exchanges.
C 10.3	**Where the contract constitutes a net burden to the estate, the insolvency representative should be entitled to reject or cancel the contract, subject to any consequences that may arise from rejection.**
Legal Framework	In terms of section 535 of the Companies Act, the liquidator has been empowered to disclaim any onerous property (including land of any tenure burdened with onerous covenants, shares and unprofitable contracts) with the leave of the Court, within twelve months after the commencement of the winding-up or such extended period as may be allowed by the Court. Rule 268 of the Companies (Court) Rules, 1959 states that a disclaimer shall not be operative until it is filed in the Court by the liquidator. The Presidency Towns Insolvency Act also contains similar provisions. As per the provisions of the Companies Act, unless it can be construed to be an unprofitable contract within the meaning of this section, the liquidator is under an obligation to perform his end of the contract. The aggrieved party can claim damages against the estate and creates, in any case, only an ordinary debt which ranks for claim to payment on *pro rata* along with other creditors. The insolvency Acts provide that it is the duty of the Receiver to carry on the business of the insolvent so far as may be necessary for the beneficial winding-up of the same. Similar provision exists under the Companies Act and the Official Liquidator can exercise this power with the sanction of the Court. The necessity has to be determined by the Court having regard to all the circumstances of the case and it will include 'mercantile necessity'.
Assessment	**Observed**
Comments	There are clear provisions enabling the insolvency representative to disclaim unprofitable contracts. The aggrieved party is entitled to file a suit for damages.
C 10.4	**Exceptions to the general rule of contract treatment in insolvency proceedings should be limited, clearly defined and allowed only for compelling commercial, public or social interests, such as in the following cases: (i) upholding general set-off rights, subject to rules on avoidance; (ii) upholding automatic termination, netting and close-out provisions contained in financial contracts; (iii) preventing continuation and assignment of contracts for irreplaceable and personal services where the law would not require acceptance of**

	performance by another party; and (iv) establishing special rules for treating employment contracts and collective bargaining agreements.
Legal Framework	There are no express provisions in the Companies Act on set-off rights, netting and close-out provisions and for contracts for personal services. However, mutual set-off rights have been recognised under the Civil Procedure Code, 1908. The claims of workmen are given overriding preferential treatment and are placed *pari passu* with those of the secured creditors. The Companies Act does not deal with the rejection, continuation and modification of labour contracts. The same are left to be decided by the liquidator during the course of liquidation. The Parliament has enacted the Payment and Settlement Systems Act, 2007 which *inter alia* provides for legal protection to netting including multilateral netting in insolvency proceedings. However, this protection is only available to contracts within a payment system. Certain Rules and Bye-laws of the stock exchanges also provide for close-out mechanism in respect of a member's obligation to a stock exchange during his insolvency. These rules and bye-laws have been held to be statutory and enforceable by Courts. However, there are no specific statutory provisions in this regard. Under section 55(2) of the Insurance Act, 1938 the Court is vested with the power to reduce the amount of contracts of any insurance company and for this purpose the value of assets and liabilities and all claims in respect of policies shall be ascertained by it in terms of the seventh schedule. Section 56 of the Insurance Act, 1938 lays down that the value of the assets and the liabilities of the insurer in respect of life insurance business shall be ascertained separately from the value of any other assets or any other liabilities of the said insurer. The said section further lays down that no such assets shall be applied to the discharge of any liability other than that of life insurance business except in so far as those assets exceed the liabilities in respect of life insurance business.
Assessment	**Partly Observed**
Comments	The claims of workmen are given overriding preferential treatment and are placed *pari passu* with those of the secured creditors. The law recognises mutual set-off of obligations. The Parliament has enacted the Payment and Settlement Systems Act, 2007 which *inter alia* provides for legal protection to netting including multilateral netting and close-out contracts in insolvency proceedings.

	It may be worthwhile to have express provisions dealing with the treatment of set-off rights, netting and close-out contracts, personal contracts and labour contracts during reorganisation and winding-up. A limited extent of certainty has been introduced by way of the Payment and Settlement Systems Act, 2007 in respect of contracts in a payment system. However, the position regarding treatment of Over-the-Counter transactions in derivatives settled outside 'payment systems' regulated under the Payment and Settlement Systems Act, 2007 especially the closing-out provisions in such contracts, is yet not free from doubt. Since the provisions of the Payment and Settlement Systems Act, 2007 are not applicable to stock exchanges and clearing corporations of such stock exchanges regulated by SEBI, the netting and close-out contract protection afforded in the case of insolvency is not available to transactions done on such stock exchanges. Therefore, it is necessary that similar provisions should also be made in the Securities Contracts (Regulation) Act, 1956 to provide protection to the contracts entered on recognised stock exchanges.
C 11	**Avoidable Transactions**
C 11.1	**After the commencement of an insolvency proceeding, transactions by the debtor that are not consistent with the debtor's ordinary course of business or engaged in as part of an approved administration should be avoided (cancelled), with narrow exceptions protecting parties who lacked notice.**
Legal Framework	Any transfer of property, movable or immovable, delivery of goods, payment execution or other act relating to property made, taken or done by or against a company within six months before commencement of its winding-up (or against an individual insolvent within three months before presentation of insolvency petition) may be treated as fraudulent preference and as void. Under Section 531A of the Companies Act, any transfer of property, movable or immovable, or any delivery of goods, made by the company, not being a transfer of delivery made in the ordinary course of its business or in favour of a purchaser or encumbrancer in good faith and for valuable consideration, if made within a period of one year before the date of presentation of winding-up petition is void against the liquidator. The same principles would be applicable to transactions even after the commencement of the winding-up. After the commencement, the creditors may apply for stay against the disposal of the assets of the company. Further, once a Provisional Liquidator is appointed he would take control over the assets and business of the company.
Assessment	**Observed**
Comments	There are adequate provisions under law wherein only transactions in the ordinary course of business or those with a purchaser in good faith for valuable consideration are treated as valid.
C 11.2	**Certain transactions prior to the application for or the date of commencement of the insolvency proceeding should be avoidable (cancelable), including**

	fraudulent and preferential transfers made when the enterprise was insolvent or that rendered the enterprise insolvent.
Legal Framework	See C 11.1.
Assessment	**Observed**
C 11.3	**The suspect period, during which payments are presumed to be preferential and may be set aside, should be reasonably short in respect to general creditors to avoid disrupting normal commercial and credit relations, but may be longer in the case of gifts or where the person receiving the transfer is closely related to the debtor or its owners.**
Legal Framework	The suspect period (for deeming it as fraudulent) is six months before the date of commencement of winding-up and three months in the case of individual insolvency in the case of transfer of property, delivery goods, payments, *etc.* The transfer of property or delivery of goods other than in the ordinary course of business or for persons purchasing in good faith and for valuable consideration, the suspect period is one year for considering it to be void against the liquidator.
Assessment	**Observed**
Comments	The suspect periods of six months and one year appears to be reasonable. Moreover, transactions in the ordinary course of business and purchases for *bonafide* consideration have been exempted.
Claims and Claims Resolution Procedures	
C 12 **C12.1**	**Treatment of Stakeholder Rights and Priorities** **The rights of creditors and priorities of claims established prior to insolvency proceeding under commercial or other applicable laws should be upheld in an insolvency proceeding to preserve the legitimate expectations of creditors and encourage greater predictability in commercial relationships. Deviations from this general rule should occur only where necessary to promote other compelling policies, such as the policy supporting reorganisation or to maximise the insolvency estate's value. Rules of priority should enable creditors to manage credit efficiently, consistent with the following additional principles:**
Legal Framework	The rights of secured creditors are recognised in the liquidation proceedings. However, their rights are subject to a *pari passu* claim over the dues of workmen. Among the secured creditors having security interest over the same assets, the

	priority is determined in accordance with the general law. In the case of immovable property, the *inter se* priority among secured creditors having security interest over the same immovable property would be governed by the provisions of the Transfer of Property Act, 1882. Registration is required for the protection of the secured creditors against subsequent creditors and for enforcement of his rights. This is subject to the exception that equitable mortgage of immovable properties and transfer of movable properties does not require compulsory registration. After the overriding preferential payments stated hereinabove, all revenues, taxes, cess, *etc.* due from the company to the Governments or local authorities and having become due and payable within twelve months before the date of appointment of Provisional Liquidator, all wages/salaries of an employee (in respect of services rendered to the company) which is due for a period not exceeding four months within the twelve months mentioned hereinbefore, all accrued holiday remuneration to an employee or his legal heir, employee's dues towards Employees' State Insurance Act/Workmen's Compensation Act, all sums payable to an employee from provident fund/pension fund/gratuity fund/other welfare fund of the company and the expenses of any investigation held under certain sections of the Companies Act, *etc.* all have preferences over other debtors. The administrator retains such sums as may be necessary for the costs and expenses of the winding-up and after that the preferential claims are discharged. The insolvency Acts (the Presidency Towns Insolvency Act and the Provincial Insolvency Act) provides for the rights of secured creditors. The right of the secured creditors to realise or otherwise deal with his security is not affected or stayed upon insolvency as per the insolvency Acts. The Schemes under the SICA and Section 391 of the Companies Act can override the interests of the secured creditors, if approved and passed in accordance with provisions of those Acts.
Assessment	**Observed**
Comments	The claims of secured creditors (not participating in the winding-up) in respect of their securities and of the workmen have overriding preferences over other claims. Thereafter, claims of Governments/local authorities towards taxes, revenues, *etc.* the statutory liabilities for the benefit of employees and the salary/wages and other claims of employees have preferences over other ordinary creditors. In rehabilitation proceedings, the claims of secured creditors can be overridden by the Scheme for such rehabilitation. However, this is in the nature of an exception for the beneficial rehabilitation of the sick company. Certain laws creating first charge, in favour of Governments, over the secured assets of borrowers have been a matter of concern for the secured creditors. Under the Income Tax Act, 1961 any security created during the pendency of proceedings/crystallisation of claims would be subservient to the claims of the Income Tax Department. There are also certain other State laws of similar nature.

	The law should provide for a time-limit within which claims towards the State's dues should be crystallised. The law should be amended to the effect that priority of charge for State dues should not operate in respect of prior mortgages created in favour of the secured creditors.
C12.2	**The priority of secured creditors in their collateral should be upheld and, absent the secured creditor's consent, its interest in the collateral should not be subordinated to other priorities granted in the course of the insolvency proceeding. Distributions to secured creditors should be made as promptly as possible.**
Legal Framework	Secured creditor's security is in no way affected by insolvency unless he relinquishes his security. Therefore, he is entitled to realise or deal with it as if there is no insolvency. However, their rights are subject to a *pari passu* claim over the dues of workmen. In case of secured creditors and workmen's dues, whose debts are paid in priority to all other debts, they shall abate in equal proportions if the assets are insufficient to meet them. In the case of a Scheme sanctioned under the SICA, the Scheme can provide for overriding the priority of claims of the secured creditors also and the secured creditors would be bound by the provisions of the Scheme. The Scheme under Section 391 can also override the rights of secured creditors if approved by the requisite number of creditors in that class and with the approval of the Court. However, the aggrieved creditors can prefer an appeal to the Appellate Authority under the SICA. Certain laws creating first charge, in favour of Governments, over the secured assets of borrowers have been a matter of concern for the secured creditors. Under the Income Tax Act, 1961 any security created during the pendency of proceedings/crystallisation of claims would be subservient to the claims of the Income Tax Department. There are also certain other State laws of similar nature.
Assessment	**Broadly Observed**
Comments	The law should be amended to the effect that priority of charge for State dues should not operate in respect of prior mortgages created in favour of the secured creditors. The time taken for distribution of the assets is an area of concern both in winding-up proceedings and in proceedings under SICA. It is hoped that the Companies (Second Amendment) Act, 2002 once bought into operation would help cure this lacunae.
C12.3	**Following distributions to secured creditors from their collateral and payment of claims related to costs and expenses of administration, proceeds available**

	for distribution should be distributed *pari passu* to the remaining general unsecured creditors, unless there are compelling reasons to justify giving priority status to a particular class of claims. Public interests generally should not be given precedence over private rights. The number of priority classes should be kept to a minimum.
Legal Framework	See C 12.1. As per the insolvency Acts, notice of every order of adjudication of a debtor as insolvent, stating the name, address and description of the insolvent, the date of the adjudication, the court in which the adjudication is made and the date of presentation of the petition shall be published in the Official Gazette and in such manner as may be prescribed. The notice of adjudication shall ordinarily be given by serving notice in the required form upon each of the creditors of the insolvent by personal delivery or registered post depending on the place of residence or business of the creditor. Similar provisions are provided in the Companies (Court) Rules,1959 and accordingly, the liquidator shall give not less than 14 days notice of the date fixed for the creditors to prove their debts in one issue of a daily newspaper in English and in the regional language circulating in the State or Union Territory concerned, as he shall consider suitable. The liquidator shall also give not less than 14 days notice of the date fixed to every creditor to the last known address or place of abode of such person. Such notice shall be sent to each creditor by pre-paid letter post under certificate of posting. The administrator retains such sums as may be necessary for the costs and expenses of the winding-up and after that the preferential claims are discharged. Mutual dealings and set-off between the insolvent and a creditor are allowed. When there are mutual dealings between an insolvent and creditor proving or claiming to prove a debt, an account shall be taken of what is due by the one party to the other in respect of such mutual dealings, and the sum due from one party shall be set-off against any sum due from the other party and the balance of the account and no more shall be claimed or paid on either side, respectively. Claim is filed when the order of adjudication of insolvency of the debtor is made. No limitation period is prescribed in the insolvency Acts during which a creditor should apply for proof of his debt. However, such matters are left to the discretion of the Court. As per the Insolvency Acts, the creditors shall produce proof of their respective debts by producing evidence of the amount and particulars and the Court shall by order determine the persons who have proved themselves to be creditors of the insolvent in respect of such debts and shall frame a schedule of such persons and debts. Under the insolvency Acts, the Creditors' Committee shall consider the circumstances of the insolvency and the insolvent's schedule and his explanation thereof and generally as to the mode of dealing with the property of the insolvent. The Court determines the persons who have proved themselves to be creditors of the insolvent in respect of such debts and shall frame a schedule of such

	persons and debts. The Court can also hold a public sitting of which notice shall be given to the creditors, for examination of the insolvent and the insolvent shall be examined as to his conduct, dealings and property.
Assessment	**Partly Observed**
Comments	Apart from the overriding preferential payments in respect of secured creditors and workmen, there are other preferential payments to the State, the employees, *etc.* which rank before the claims of ordinary creditors. In practice, the unsecured creditors are left with not much assets to satisfy their claims.
C12.4	**Workers are a vital part of an enterprise, and careful consideration should be given to balancing the rights of employees with those of other creditors.**
Legal Framework	Workers are given the highest priority, ranking them at par with the secured creditors and even imposing a *pari passu* claim on the secured assets along side the secured creditors. The dues (to a certain extent) of other employees are also given preferential treatment (under section 531 of the Companies Act) compared to the claims of ordinary creditors. In rehabilitation proceedings under the SICA, the rights of the workers can be curtailed to a certain extent in accordance with the provisions of other related laws. The aggrieved party can prefer an appeal to the Appellate Authority under the SICA.
Assessment	**Observed**
Comments	There are adequate provisions to take care of the interests of the workmen in winding-up. In rehabilitation, there could be certain measures affecting the interests of workmen. However, the same are adopted for the recovery of the company and therefore would ultimately be beneficial to the workmen.
C12.5	**In liquidation, equity interests or the owners of the business are not entitled to a distribution of the proceeds of assets until the creditors have been fully repaid. The same rule should apply in reorganisation, although limited exceptions may be made under carefully stated circumstances that respect rules of fairness that entitle equity interests to retain a stake in the enterprise.**
Legal Framework	The equity interests receive the last preference in the case of winding-up. Distribution to them would only happen if surplus is left after all other liabilities are met. In the case of reorganisation proceedings, both under Section 391 and under the SICA, the status of their equity rights and the element of their control over the business, *etc.* would be subject to the Scheme framed for that purpose and approved by the Court or BIFR, respectively.

Assessment	**Observed**
Comments	Equity-holders are not entitled to distribution of the assets until all the claims of the creditors, Government and the administrative expenses are satisfied and there is a surplus.
C 13	**Claims Resolution Procedures** **Procedures for notifying creditors and permitting them to file claims should be cost-effective, efficient and timely. While there must be a rigourous system of examining claims to ensure validity and resolve disputes, the delays inherent in resolving disputed claims should not be permitted to delay insolvency proceedings.**
Legal Framework	Under Rule 147 of the Companies (Court) Rules, 1959 the liquidator is required to fix a date, on or before which the creditors are required to prove their debts or claims. In terms of Rule 148 the liquidator is required to give notice of such date (minimum period of notice being 14 days) through an English newspaper and a regional language newspaper having circulation in the State. The notice form (No.63) specifically states that any person who fails to submit his affidavit of proof within the specified date, will be excluded from the benefit of any distribution of dividend before his debt is provided. If any person stakes a claim, the liquidator is required to send individual notice to him requiring him to attend the investigation of such debt at such time and place as shall be specified in the notice (Form 63). Rules 149 - 179 deal with the claims of creditors, which *inter alia* include, proof of debts, value of debts, rights of liquidator during investigation, appeal by creditor on rejection of proof, procedure on failure to prove within prescribed time, *etc.* Section 557 of the Companies Act also empowers the Court to call for a meeting of the creditors or contributories to ascertain their wishes in all matters relating to winding-up of a company. When creditors' wishes are ascertained, regard shall be had to the value of each creditor's debt. Apart from the above provision, liquidator is also empowered to call meeting of creditors/contributories (Rule 197). The provisions of insolvency Acts regarding debts provable, the valuation of annuities and future and contingent liabilities and respective rights of secured and unsecured creditors have been made applicable to the proceedings even under the Companies Act, 1956. Subject to the provisions of Sections 531 (fraudulent preference), 531A (avoidance of voluntary transfer), 534 (Invalidity of certain floating charges) and 536 (disposition of property including actionable claims after commencement of winding-up void) of the Companies Act, all other contracts are treated as valid and enforceable. A debt has to be proved (unless otherwise ordered by the Court) to stake a claim in the liquidation proceeds. The liquidator has been empowered to conduct investigations for that purpose (Rules 149-179 of the Companies (Court) Rules). Further, in exercise of the his powers under Section 546 of the Companies Act, the liquidator can make a compromise or arrangement (with the sanction of the Court) with even creditors having future or contingent claims.

Assessment	**Broadly Observed**
Comments	There are elaborate provisions in respect of calling for claims and their adjudication. In case of any dispute the matter is placed before the Court for its decision. However, in practice the disputes with respect to claims take long to be resolved and the claims of the other creditors are also held up due to such disputes. The implementation of the provisions relating to receipt of claims and their process needs to be improved to cut down on the delay.
C 14	**Re-organisation Proceedings**
C14.1	**The system should promote quick and easy access to the proceeding, assure timely and efficient administration of the proceeding, afford sufficient protection for all those involved in the proceeding, provide a structure that encourages fair negotiation of a commercial plan, and provide for approval of the plan by an appropriate majority of creditors. Key features and principles of a modern reorganisation proceeding include the following:**
Legal Framework	Presently, the SICA provides for identification of sickness in industrial companies, registered for not less than seven years on the basis of the symptomatic indices of cash losses for two consecutive years and accumulated losses equalling or exceeding the net worth of the company as at the end of the second financial year. The Board of Directors of a sick industrial company has to make a request for rehabilitation. Where the Central Government or the Reserve Bank is satisfied that an industrial company has become sick, it may make a reference to the BIFR. Likewise, if any State Government, scheduled bank or public financial institution having an interest in an industrial company is satisfied that the industrial company has become sick, it may also make a reference to the BIFR. The BIFR may seek suggestions on the scheme from any shareholder or any creditors or employees and may make such modifications. A rehabilitation scheme which provides for giving financial assistance shall be circulated to every person required by the scheme to provide financial assistance for his consent. Since suggestions are taken from shareholders/creditors, even the interests of the minority will be taken care of. Preparation and sanction of schemes with respect to such company provides for any one or more of the following measures: (i) the proper management of the sick industrial company by change in, or takeover of, management of the sick industrial company; and (ii) the rationalisation of managerial personnel, supervisory staff and workmen in accordance with law.

	It has been recognised that in order to fully utilise the productive industrial assets, afford maximum protection of employment and optimise the use of the funds of the banks and financial institutions, it would be imperative to revive and rehabilitate the potentially viable sick industrial companies as quickly as possible. It would also be equally imperative to salvage the productive assets and realise the amounts due to the banks and financial institutions, to the extent possible, from the non-viable sick industrial companies through liquidation of those companies. Change in, or takeover of, management of the sick industrial company has been provided under SICA. For the purpose of winding-up of the sick industrial company, the High Court may appoint any officer of the operating agency, as the liquidator of the sick industrial company. If an enquiry in respect of an industrial company is pending or any scheme is under preparation or consideration or a sanctioned scheme is under implementation or where an appeal relating to an industrial company is pending, then no proceedings for the winding-up of the industrial company or for execution, distress or the like against any of the properties of the industrial company or for the appointment of a Receiver in respect thereof and no suit for the recovery of money or for the enforcement of any security against the industrial company or of any guarantee in respect of any loans or advance granted to the industrial company shall lie or be proceeded with further, except with the consent of the BIFR or, as the case may be, the Appellate Authority. The operating agency is appointed by an order of the BIFR to prepare a scheme for rehabilitation and its powers and discharge its functions in order to secure proper implementation of the scheme. BIFR monitors the implementation of the scheme, gives appropriate orders for removal of difficulties in the implementation of the scheme and sanctions modified or fresh schemes, if necessary. The operating agency prepares the scheme within a period of 90 days from the date of the order passed by the BIFR. Afterwards, the BIFR is given powers for fixing the time-limits for various purposes. The SICA provides for calling for suggestions/objections by the BIFR on the scheme prepared by the operating agency. The BIFR shall decide on these objections and may carry out appropriate modifications to the scheme. Apart from the above, Section 391 of the Companies Act provides for restructuring/ compromise. In these proceedings, both the company and its creditors or any class of them or the company and its members or any class of them can propose a plan for compromise or arrangement and obtain the sanction of the Court. The Companies (Second Amendment) Act, 2002 brings in a new part providing for revival and rehabilitation of sick industrial companies. Once brought into effect, it will repeal similar provisions under the SICA.
Assessment	**Partly Observed**
Comments	Presently, the mechanism of rehabilitation through the SICA has been a failure. In the event of rehabilitation of a sick industrial company, the operating agency

	(bank/financial institution) has to obtain the consent of all the secured creditors. If any one secured creditor objects to the proposal, rehabilitation canot be finalised. It is felt that the new provisions introduced in the Companies Act vide the Companies (Second Amendment) Act, 2002 once brought into operation, would improve the rehabilitation mechanism available to sick industrial companies. The proceedings under Section 391 of the Companies Act have been successfully resorted to by many companies for compromises/restructuring. The law should provide for constitution of Creditors' Committee and vest it with certain powers to improve the rehabilitation of an insolvent company. The law should provide for nominating unsecured creditors in the Creditors' Committee to ensure their participation and for safeguarding their interest. NCLT, once made operational, should be provided with adequate infrastructure for timely disposal of references. The Companies Bill, 2008 also provides for compromise and arrangement by company with its creditors. Clause 201 of the Bill requires the company to file an affidavit along with an application for sanction of scheme, *inter alia* stating that the scheme for corporate debt restructuring is consented to by not less than 75 per cent of the secured creditors in value and should include (i) a creditor's responsibility statement, (ii) safeguards for protection of other secured and unsecured creditors, (iii) where the company proposes to adopt the corporate debt restructuring guidelines specified by the Reserve Bank of India, a statement to that effect, and (iv) a valuation report in respect of the shares and the property and all assets (tangible and intangible/movable and immovable) of the company by a registered valuer. Chapter XVII of the Bill contain comprehensive provisions for registration of valuers (chartered accountants, company secretaries, cost and work accountants and persons possessing qualifications as prescribed by the Central Government) for the purpose of undertaking valuations as per the requirements of the proposed Act. Further, a notice of the meeting for compromise/arrangement is required to be sent to the Central Government, the Reserve Bank, SEBI, respective stock exchanges, Official Liquidator, Competition Commission(if necessary) and all other authorities who are likely to be affected by such compromise/arrangement. The Bill also provides for appointment of interim administrator/company administrator by the Tribunal for the purposes of rehabilitation/revival. The scheme of rehabilitation/revival is sought to be prepared by the company administrator.

C14.2	***Plan Formulation and Consideration:*** **A flexible approach for developing a plan consistent with fundamental requirements designed to promote fairness and prevent commercial abuse.**
Legal Framework	As regards companies registered under the Companies Act, the plan for compromise or arrangement with the creditors is provided under section 391 of the Companies Act, as an alternative to liquidation. Accordingly, both the company and its creditors or any class of them or the company and its members or any class of them can propose a plan for compromise or arrangement. The plan is submitted to the Company Court by the company or any creditor or member or in the case of a company which is being would up, by the liquidator. Thereafter, the Court may order a meeting of the creditors or class of creditors or members or any class of members to be held. If a majority in number representing three-fourths in value of the creditors, or class of creditors or members or class of members, present and voting either in person or proxy at the meeting agree for the compromise or arrangement and if such compromise or arrangement is sanctioned by the Court, then it becomes binding on all the creditors or the class of creditors or members or class of members or in the case of a company that is being wound-up, on the liquidator and contributories of the company. The company or any other person making the application for approval of compromise or arrangement, shall disclose to the Company Court by affidavit or otherwise all material facts relating to the company such as the latest financial position of the company, the latest auditor's report of the accounts of the company and the like and the Court shall sanction the proposal only if there is such disclosure as provided under law. In case of an application for approval of an arrangement or compromise made between a banking company and its creditors or any class of them or between such company and its members or any class of them, the Company Court shall sanction the same only if it is certified by the Reserve Bank in writing as not being incapable of being worked and as not being detrimental to the interests of the depositors of such a banking company. Further, in the case of section 391 proceedings in the Company Court in respect of banking companies, the Court has powers to direct the Reserve Bank to make inquiry into the affairs of the banking company and submit a report to the Court. In terms of the SICA, the board of directors of a sick industrial undertaking can make a reference to the BIFR for determination of measures to be taken against that undertaking. BIFR will then make an inquiry into the working of the company. BIFR has also been conferred with the powers to direct any person (including a public financial institution, state-level institution and scheduled bank) to make a scheme for rehabilitation of the company and such scheme may be sanctioned by BIFR. The scheme may provide for reconstruction, amalgamation, sale of assets, any other preventive, ameliorative and remedial measures, *etc.* The scheme may also provide for rehabilitation by giving financial assistance. Under the SICA, the financial assistance for rehabilitation has to be agreed to by the agency giving the financial assistance. There is no priority of claim for financial assistance given in rehabilitation proceedings under the SICA.

	Part VIA has been inserted by the Companies (Second Amendment) Act, 2002 (yet to be brought into operation) incorporating provisions relating to Revival and Rehabilitation of sick industrial companies, but there is no concept of priority funding and no safeguards are available to provider of financial assistance.
Assessment	**Broadly Observed**
Comments	The details of the plan of re-organisation or reconstruction or compromise under Section 391 of Companies Act can be worked out independent of the Court. The law gives the conditions under which the Company Court can approve the plan. The scheme after filing in the Court may undergo modifications pursuant to the meetings of creditors during the pendency of court proceedings. The Courts generally approve the amalgamation schemes of the banks without much delay as the scheme is already prepared or certified by Reserve Bank of India and the Courts do not normally substitute their judgment as against the judgment of the Reserve Bank. In the corporate sector, there is no statutory obligation cast on any body as such to prepare the scheme of amalgamation or reconstruction or compromise except in the case of sick industrial company as defined in the SICA. In case of rehabilitation or amalgamation schemes of sick industrial companies, the power of approval is conferred on BIFR. In the case of rehabilitation of such industrial companies, the law does not provide for voting rights to the creditors. However, creditors are provided with an opportunity to file their objections on the scheme.
C14.3	***Plan Voting and Approval:* For voting purposes, classes of creditors may be provided with voting rights weighted according to the amount of a creditor's claim. Claims and voting rights of insiders should be subject to special scrutiny and treated in a manner that will ensure fairness. Plan approval should be based on clear criteria aimed at achieving fairness among similar creditors, recognition of relative priorities and majority acceptance, while offering opposing creditors or classes a dividend equal to or greater than they would likely receive in a liquidation proceeding. Where court confirmation is required, the court should normally defer the decision of the creditors based on a majority vote. Failure to approve a plan within the stated time period, or any extended periods, is typically ground for placing the debtor into a liquidation proceeding.**
Legal Framework	As regards the voting rights of creditors, the present provisions do recognise the majority in number representing three-fourths in value of the creditors or class of creditors or members or class of members, as the case may be, present and

	voting, for the purpose of approval. The majority opinion binds all creditors subject to the sanction of the Court. There are no special legal provisions for limiting voting rights of insiders. Generally, the insiders are recognised as a class of members or creditors. The outsiders as regard the companies are the creditors who are not members of the company. Plan for compromises or arrangements under the Companies Act requires approval by majority in number, representing three-fourths in value of the creditors or class of creditors or members or class of members, present and voting in person or by proxy. Under the provisions of Companies Act, the schemes require approval of Company Court. Where the scheme is not approved in pending winding-up proceedings, the company is normally liquidated. In other cases where companies come up voluntarily for amalgamation and the scheme is not approved for any reason, then the Court has been empowered, either on its own motion or based on an application filed by an interested person, to order winding-up of the company. Under the BR Act, in case of banking companies, the plan means a plan for amalgamation of a banking company with another and the plan in draft has to be placed before the shareholders of each of the banking companies concerned separately and approved by resolution passed by a majority in number representing two-thirds in value of the shareholders of each of the banking company present and voting in person or by proxy. The dissenting shareholders are entitled to the value of the shares held by him as determined by the Reserve Bank when sanctioning the scheme and such determination of value shall be final. The plan of amalgamation of banking companies does not require approval of Court. It becomes final and binding if sanctioned by the Reserve Bank. The Central Government also has power to provide for amalgamation of two or more banking companies after consulting the Reserve Bank. There is no time-limit for approval of plan. Under the SICA, the operating agency (a bank or a financial institution) shall prepare a scheme ordinarily within 90 days from the date of order passed by the BIFR with respect to the sick industrial company. There is no approval of plan by shareholders or sanction by the Court. The BIFR sanctions the scheme and it becomes binding on the sick company, the transferee company and the shareholders, creditors and guarantors and employees of the said companies. Even though the objections/comments of the creditors, *etc.* are considered, there is no provision for their voting or approval. The aggrieved party can prefer an appeal before the Appellate Authority under the SICA.
Assessment	**Broadly Observed**
Comments	The provisions of Section 391 of the Companies Act provides for consideration, voting and approval of the scheme for reconstruction/compromise/arrangement by the creditors/contributories and thereafter the sanction of the Court. There is absolutely no time-limit set by law for approval of plans. Moreover, different schemes/modified versions of the earlier schemes may be brought up from time

	to time. This practice is more resorted to by companies which are insolvent. The law should provide setting time-limits for approval of a plan. It would be necessary for the legal provisions to limit the number of plans that can be submitted for sanction before the Court or provide for automatic lapse of a scheme if the same is not approved within a specified period, say three months or six months from the date of submission. In the case of a scheme under the SICA, there is no requirement for voting and approval by creditors or contributories, the scheme is prepared by an operating agency and approved by the BIFR, which would be binding on all, including the creditors. The Companies Bill, 2008 seeks to provide for approval of scheme for rehabilitation/revival by creditors of a sick company within a period of 60 days from the appointment of company administrator. This period could be extended upto 120 days by Tribunal.
C14.4	***Plan Implementation and Amendment:*** **Effective implementation of the plan should be independently supervised. A plan should be capable of amendment (by vote of the creditors) if it is in the interests of the creditors. Where a debtor fails or is incapable of implementing the plan, there should be grounds for terminating the plan and liquidating the insolvency estate.**
Legal Framework	Implementation of a sanctioned scheme under Section 391 of the Companies Act is done by the Company Court that has approved the scheme. Section 392 of the Companies Act provides that the Court has the power to supervise the carrying out of the compromise or arrangement between a company and its creditors or members or class of creditors or members. Section 392 of the Companies Act provides that if the Court is satisfied that a compromise or an arrangement sanctioned by it cannot be worked out satisfactorily with or without modifications, it may make an order for winding-up the company. The implementation of the schemes in the case of sick companies is in the hands of BIFR established under the SICA and in case of the amalgamation schemes of banking companies, the Reserve Bank supervises its implementation.
Assessment	**Broadly Observed**
Comments	Implementation of a plan is left to the company and the legal provisions do not require any reporting of implementation of the plan by the company periodically to the Court. It often happens that after sanction of schemes, some companies do not implement the scheme and in such cases the creditors/members of the company are again compelled to move the company court. There is a necessity

	for incorporating provisions which would compel the companies to report the implementation of its plan periodically to the Regional Director/Department of Company Affairs (similar to the banks reporting to the Reserve Bank) till all the terms and conditions of the plan are substantially complied with and thereafter there should be a provision for the Court to pass final orders to that effect. The implementation of the schemes in the case of sick companies is in the hands of BIFR established under the SICA and the scheme may be modified with the approval of BIFR. There are also provisions enabling BIFR to recommend liquidation of the sick company, when the rehabilitation scheme fails. The Companies Bill, 2008 seeks to provide for appointment of company administrator for the purpose of preparation and implementation of scheme of rehabilitation/revival.
C14.5	***Discharge and Binding Effects:*** **The system should provide for plan effects to be binding with respect to forgiveness, cancellation or alteration of debts. The effect of approval of the plan by a majority vote should bind all creditors, including dissenting minorities.**
Legal Framework	The law provides for alteration of debts and claims as part of the rehabilitation or restructuring scheme under the SICA. Once the scheme or plan is approved by the BIFR, then it becomes binding on the company, creditors, shareholders, liquidator, *etc.* Any amendment or change in the approved plan would require further approval of BIFR. In the case of a Scheme under Section 391 of the Companies Act, the Scheme once voted in favour of by the requisite majority of creditors and approved by the Court becomes binding and effective on all persons including the other creditors.
Assessment	**Observed**
Comments	There are clear provisions regarding the binding nature of the scheme, even on the dissenting minorities.
C14.6	***Plan Revocation and Closure:*** **Where approval of the plan has been procured by fraud, the plan should be reconsidered or set aside. Upon consummation and completion of the plan, provision should be made to swiftly close the proceedings and enable the enterprise to carry on its business under normal conditions and governance.**
Legal Framework	Fraud is a ground recognised by Court to set aside a plan that has been approved under Section 391 of the Companies Act. Generally, such cases are very rare as the plan is approved after taking a good conduct certificate from the Registrar regarding the affairs of the company and also certify that the interest of the members or the public is not prejudiced by the company. Further, under the SICA, if the information is withheld by the debtor which amounts to violation of any provision of the Scheme, or any order of the BIFR, or the Appellate Authority, or whoever makes a false statement or gives false

	evidence to the BIFR or Appellate Authority shall be punishable with simple imprisonment for a term which may extend to 3 years and shall also be liable to fine. Further, the BIFR may recommend for winding-up the sick company in case it is of the opinion that the sick company is not likely to make its net worth exceed its accumulated losses.
Assessment	**Observed**
Comments	Section 392 enables the Court to supervise the implementation of the scheme (under Section 391) and further provides that if the Court is satisfied that a compromise or an arrangement sanctioned by it cannot be worked out satisfactorily with or without modifications, it may make an order winding-up the company. Under SICA, there are provisions dealing with revocation and closure of schemes.
C 15	**International Considerations** **Insolvency proceedings may have international aspects, and a country's legal system should establish clear rules pertaining to jurisdiction, recognition of foreign judgments, cooperation among courts in different countries and choice of law. Key factors to effective handling of cross-border matters typically include:** **(i) A clear and speedy process for obtaining recognition of foreign insolvency proceedings;** **(ii) Relief to be granted upon recognition of foreign insolvency proceedings;** **(iii) Foreign insolvency representatives to have access to courts and other relevant authorities;** **(iv) Courts and insolvency representatives to co-operate in international insolvency proceedings;** **(v) Non-discrimination between foreign and domestic creditors.**
Legal Framework	In insolvency, the foreign creditors are treated at par with Indian creditors. There is no prohibition for foreign creditor to commence the insolvency proceedings provided if he otherwise fulfills the requirements under provisions of the law which govern the insolvency. Foreign judgments are recognised by Indian Courts as per the provisions of Civil Procedure Code, 1908. However, mostly the insolvency proceedings initiated elsewhere are not in the final form of a judgment or a decree which can be recognised by Indian Courts. Further, there are no legal provisions casting obligations on the companies or Courts in India to provide assistance to different countries. The single entity concept of

	jurisdiction has not been recognised so far in the country. The courts follow the general principle that, '*the courts of a country dealing with the winding-up of the company can ordinarily deal with the assets within the jurisdiction and not with assets of the company outside their jurisdiction'*. [1962(XXXII) COMPCAS 1 SC]. Each branch or office registered by a company in India and outside are treated as separate entities and entity-wise liquidation is contemplated at present.
Assessment	**Broadly Observed**
Comments	Foreign judgments are recognised in India under the provisions of Code of Civil Procedure, 1908. Recognition of foreign claims depends on the terms of agreement and applicability of Indian law to the situation. There is no provision in law enabling cross-border insolvency proceedings. It is necessary for the country to adopt the UNCITRAL Model Law on Cross-border Insolvency as suggested by various committees. While adopting UNCITRAL Model Law, conflict with existing laws should be considered. It is advisable to keep the banking laws and insolvency procedures separate from the insolvency relating to ordinary companies. On adoption of UNCITRAL Model Law, the interest of the regional depositors of banks may not get any protection over and above the global depositors as there would be pooling of assets of various countries belonging to the companies. The Companies Bill, 2008 seeks to provide for making the provisions in respect of winding-up applicable, *mutatis mutandis* for closure of the place of business of a foreign company in India as if it were a company incorporated in India.
Part D. Implementation: Institutional and Regulatory Frameworks	
D 1	**Role of Courts** **D1.1 *Independence, Impartiality and Effectiveness:* The system should guarantee the independence of the judiciary. Judicial decisions should be impartial. Courts should act in a competent manner and effectively.** **D1.2 *Role of Courts in Insolvency Proceedings:* Insolvency proceedings should be overseen and impartially disposed of by an independent court and assigned, where practical, to judges with specialised insolvency expertise. Non-judicial institutions playing judicial roles in insolvency proceedings should be subject to the same principles and standards applied to the judiciary.** **D1.3 *Jurisdiction of the Insolvency Court:* The court's jurisdiction should be defined and clear with respect to insolvency proceedings and matters arising in the conduct of these proceedings.** **D1.4 *Exercise of Judgment by the Court in Insolvency Proceedings:* The court should have sufficient supervisory powers to efficiently render decisions in proceedings in line with the legislation without inappropriately assuming a governance or business administration role for the debtor, which would typically be assigned to the management or the insolvency representative.**

	D1.5 ***Role of Courts in Commercial Enforcement Proceedings:*** **The general court system must include components that effectively enforce the rights of both secured and unsecured creditors outside of insolvency proceedings. If possible, these components should be staffed by specialists in commercial matters. Alternatively, specialised administrative agencies with that expertise may be established.**
Legal Framework	The Constitutional provisions ensure the independence of the Supreme Court and High Courts in India. The appointment of judges, their tenure, salary, removal, *etc.* are all enshrined in the Constitution itself, which cannot be altered by the executive to their detriment. The lower Courts function under the administrative and judicial control of the High Courts and the Supreme Court. The judges of the higher Courts are generally considered to be highly impartial in exercise of their powers. **Companies Act, 1956:** In terms of the said law, the High Court of a State is conferred the jurisdiction to decide all the issues relating to the liquidation/insolvency/compromise/arrangement/reconstruction proceedings of a company. Normally, in terms of the rules of the High Court, a bench of the High Court is specified as a 'Company Court' and all the matters pertaining to the Companies Act, 1956 including the liquidation proceedings, restructuring proceedings, *etc.* are listed before and heard and decided by such a bench. The rules, however, do not specify that the judges of the company court should be specialised in bankruptcy-related issues. However, under the Companies (Second Amendment) Act, 2002 if brought into force without effecting any substantial changes, a NCLT is proposed to be set up, which would *inter alia* be conferred with the jurisdiction of trying liquidation proceedings, restructuring proceedings, and would consist of judicial members and technical members. One of the alternate requisite qualifications for being so appointed is to be a member of the Indian Company Law Service which is a specialised service. The Orders passed by the Court in exercise of the jurisdiction conferred under the Companies Act, 1956 (as on force today) would be binding on all the creditors and members of the company, including dissenting members/creditors, if any, and would cover all the assets of the company. In so far as restructuring schemes are concerned, although the jurisdiction of the Court is not so wide and the Court may have to pass orders on the scheme as approved by the requisite majority of the creditors and members of the company, the Supreme Court of India in the case of Miheer H. Mafatlal v. Mafatlal Industries Ltd. (reported in (1997) 1 SCC 579), has, while recognising that the power of the Court is only supervisory and not appellate in nature *vis-*

	à-vis the commercial wisdom of the parties, observed that the scheme should not be illegal, unconscionable, unfair or violative of any public policy and that in appropriate cases the Court can pierce the veil of apparent corporate purpose underlying the scheme. The High Courts play a more supervisory role in the sanction of schemes under Section 391 of the Companies Act and also while dealing with winding-up matters. In winding-up matters, the administrative duties and the details of implementation are performed by the Official Liquidators attached to each High Court. **Presidency Towns Insolvency Act, 1909 and the Provincial Insolvency Act, 1920:** The provisions of the said laws deal with insolvency of persons other than incorporated entities. The District Court, having jurisdiction over a particular District (under the Provincial Act) and the High Court (under the Presidency Act) is conferred the power to decide all issues pertaining to the debtor, whether of title or priority, or of any nature whatsoever, and whether involving matters of law or of fact, which may arise in any case of insolvency coming within the cognisance of the Court, or which the court may deem it expedient or necessary to decide for the purpose of doing complete justice or making complete distribution of property in any such case. Both the laws enable a debtor, after the making of an order of adjudication, to submit a proposal for a composition in satisfaction of his debts, or a proposal for a scheme of arrangement of his affairs, empower the court to pass orders on it (approving or refusing the scheme) and such order is binding on all the creditors of the insolvent. The court has also got powers to refuse the scheme under the said law. The Court plays a supervisory role in insolvency matters and the administrative duties are left to the Receiver or the Official Assignee appointed by the Court. The rehabilitation proceedings under SICA are handled by BIFR constituted exclusively for that purpose and not by ordinary Courts. The BIFR consists of judicial as well as technical/expert members. There are different fora through which banks and financial institutions (who are the major creditors) can enforce their commercial rights. Such creditors can file suits for recovery of money/enforcement of mortgage, *etc.* in the ordinary Civil Courts under the general law of the land and they can also invoke the jurisdiction of a specialised Tribunal set up for that purpose called the DRT. The proceedings before this Tribunal is summary in nature and the recover certificate issued by this Tribunal is executed through the machinery of a Recovery Officer attached to that Tribunal. The presiding officer of DRT would be a person having knowledge of law, but not necessarily a judge.
Assessment	**Broadly Observed**
Comments	The existing law does not provide for specialised insolvency Courts. Presently, the High Courts take up insolvency matters in addition to their other jurisdictions, although in certain States there are special benches designated as 'Company Courts'. As regards insolvency proceedings of individuals, the jurisdiction is conferred on district courts/high courts (original jurisdiction) who take up such

	cases in addition to the routine civil cases. In view of the same, whether it is insolvency proceedings of corporate entities or individuals, the courts are not in a position to devote their entire attention to insolvency matters. In the present set up, High Courts do not get adequate time to take up company matters as they are burdened with more pressing Constitutional matters. In many High Courts, the company matters are taken up only in one or two days during the week, resulting in delays. The BIFR under SICA for rehabilitation, even though was a specialised body set up exclusively for the purpose, was not a complete success on account of the delay in the framing and implementation of the schemes. As regards corporate entities, if the Companies (Second Amendment) Act, 2002 is brought into operation, the specialised tribunals (NCLTs) can deal with insolvency proceedings, schemes of arrangement, sick companies, *etc.* under 'one roof' and specialist approach could be achieved.
D 2	**Judicial Selection, Qualification, Training and Performance** **D2.1** ***Judicial Selection and Appointment:*** **Adequate and objective criteria should govern the process for selection and appointment of judges.** **D2.2** ***Judicial Training:*** **Judicial education and training should be provided to judges.** **D2.3** ***Judicial Performance:*** **Procedures should be adopted to ensure the competence of the judiciary and efficiency in the performance of court proceedings. These procedures serve as a basis for evaluating court efficiency and for improving the administration of the process.**
Legal Framework	The Judges of the High Court and the Supreme Court are appointed under the provisions of the Constitution, more particularly, Articles 217 and 124 which in turn do not provide for requirement of expertise in any particular field of law. However, it is pertinent to note that the said provisions prescribe certain minimum experience at the bar and/or at the bench. For example, for being appointed as a Judge of the Supreme court a person should *inter alia* have been a judge of the High Court(s) for at least 5 years or an advocate of a High Court(s) for 10 years. Similarly, for being appointed as a judge of the High Court, a person should have *inter alia* held a judicial office for at least 10 years or practiced as an advocate of the high court(s) for at least 10 years. By virtue of their experience they are deemed to be well-versed in the law as also be specialised in certain

	branches of law. Further, the National Judicial Academy, at Bhopal, India conducts training programmes on a periodical basis for Judges of the High Courts, District Courts, *etc.,* and ministerial officers of the Supreme Court, High Courts and other Courts, in the areas of case management, administrative decision-making, latest trends in decision-making, judicial reforms, *etc.* which also provide a platform for interaction among the judges and raise their knowledge levels to cope up with the varied litigations being heard by them. Similar Judicial Academies have been set up by many High Courts in their respective jurisdictions. An approach to require expertise was sought to be introduced by way of an amendment to the Companies Act, 1956 vide the Companies (Second Amendment) Act, 2002 by setting up a NCLT and a NCLAT in which persons having expertise in the fields pertaining to accountancy, law, economics, science and technology, banking, *etc.* are appointed as members to decide the proceedings. As regards the mechanism for evaluating the insolvency Courts, it may be observed that there is no exclusive mechanism to conduct such evaluation. However, the appeal mechanism provided does act as a controlling mechanism on the exercise of powers by the insolvency courts, thereby acting as an indirect evaluation. Further, the Courts follow the doctrine of judicial precedents, whereby the decisions rendered by earlier courts on law and/or under certain facts and circumstances are followed in the latter decisions rendered by the Courts in similar facts and circumstances. In view of the same, there is considerable consistency in judicial decision-making, thereby reducing the necessity of evaluating a Court/judge on a case-to-case basis. Even otherwise, there is a Judge's (Inquiry) Act, 1968 which details the investigation procedure and proof of misbehaviour or incapacity of a Judge of the Supreme Court or of a High Court and based on the outcome of the investigation, a judge may be impeached and removed from the post. In the absence of such impeachment or resignation, *etc.* the Judge of Supreme Court holds office till he attains 65 years of age and the Judge of a High Court holds office till he attains the age of 62 years. Such guarantee of tenure also ensures that the Judges are free and fair in their dealing thereby impacting on their decision-making process.
Assessment	**Broadly Observed**
Comments	The legal framework does provide for a minimum experience requirement for appointment as judges, guarantee of tenure, evaluation in the nature of appeal processes, *etc.* Further provision of training to the judges on a periodical basis also enhances their knowledge level. However, lack of time, enormity of litigation, lack of proper appreciation of issues pertaining to insolvency and of expertise due to continuous change in business processes, do sometimes result in substantial delay in deciding the proceedings. However, it is felt that setting up of the NCLT would be a step ahead in achieving the aim of blending expertise in insolvency litigation with judicial decision-making, thereby improving the performance of insolvency courts.

D 3	**Court Organisation** **The court should be organised so that all interested parties – including the attorneys, insolvency representative, debtor, creditors, public and media – are dealt with fairly, timely, objectively and as part of an efficient, transparent system. Implicit in that structure are firm and recognised lines of authority, clear allocation of tasks and responsibilities, and orderly operations in the courtroom and case management.**
Legal Framework	The Courts are funded by the Central Government and the judges of the Supreme Court and High Courts are paid by charging on the Consolidated Fund of India. Under the Allocation of Business Rules, 1961, Department of Justice under the Ministry of Law and Justice has been given power in all these respects. The Judges of the Supreme Court and the High Court are appointed by the President of India. Further, the appointments of officials of the Supreme Court or High Courts are made by the Chief Justice of India or the Chief Justice of the High Court or such other Judge or Officer of the Court as he directs. District Judge is appointed by the Governor of the State and persons other than District Judges to the judicial service of State is appointed by the Governor of the State in accordance with rules made by him in that behalf after consultation with the State Public Service Commission and the High Court. Thus, the procedure ensures independence of judiciary and also ensures that the Courts are fair in their dealings. Similarly, in case of liquidation proceedings, the liquidation administrators (known as Official liquidators) are paid employees of the Central Government (except bank liquidators) and are attached to the High Courts of various States. Their remuneration does not depend upon the amount of assets they recover or amount of liabilities they meet for corporate entities under liquidation to ensure fair dealing. The salaries of the other lower Courts in various States are paid by the respective State Governments. The Chief Justice of India is also the administrative head of the Supreme Court and is in-charge of all the administrative matters of the Supreme Court. Similar is the case with the Chief Justices of the various High Courts and the District Judge in District Courts. Every High Court has superintendence over all courts and Tribunals throughout the territories in relation to which it exercises jurisdiction. The Supreme Court Rules, 1966 and the rules framed by the various High Courts determine the procedure for case management in the Supreme Court and the High Courts, respectively. The said rules generally provide for the procedure to be followed by litigants. These rules are available in the market as priced editions and persons having access to the internet can download the same (in case of Supreme Court and certain High Courts) and use them. The Chief Justice of the Supreme Court and of the High

	Courts allocate the cases to the various Judges, generally category-wise. Similar is the case with the District Courts where the District Judge allocates the work to the various judges sub-ordinate to him. The Judges of the Supreme Court are assisted by Court officials and day-to-day work of the Court is managed by a Registry headed by the Court Administrator-cum-Registrar-General and the work of the Registry has been divided into 45 sections. Division of judicial work in various sections is based mainly on geographical basis, *i.e.*, State/High Court-wise. Also, there are ancillary judicial sections such as Filing Section, Listing and Computer Sections, Record Room, Paper Book Section, Decree Sections, Copying Branch where certified copies are issued, Receipt and Issue Branch, and Editorial Branch which publishes the judgments of the Court vide a journal namely Supreme Court Reports. Then, there are two subordinate wings, *i.e.,* Judges' Library and Court Masters' wing. The subjects dealt with by each section under the supervision of Section Officer are well-defined and duties and responsibilities of each employee are duly earmarked. They work under the supervision of a Deputy Registrar/Joint Registrar. Judicial Sections are controlled by two Registrars, who are assisted by Additional Registrars. The Registrar has to publish yearly, monthly and daily list of cases. The Registrar has the duty to fix the date of hearing of appeals, petitions or other proceeding and issue notices thereof, to settle the index in cases where the record is prepared in the court, to make an order for change of advocate on record with the consent of advocate on record, to direct any amendment of record, to grant leave to inspect and search the records of the Court and order the grant of copies of document of parties to proceedings, *etc.* Similar arrangement is also there in High Courts and other lower courts. The head of the Registry of various courts are primarily responsible for the functioning of case management. The head of the Registry of various courts are primarily responsible for the functioning of case management. In addition to the above, in the case of specialised proceedings like insolvency proceedings, the respective laws, *viz.*, Provisional Insolvency Act, 1920 and Presidency Towns Insolvency Act, 1908 (as regards personal insolvency) and Companies Act, 1956 and the rules made thereunder (as regards insolvency of companies) also contain provisions detailing the procedures to be adopted by the Courts.
Assessment	**Observed**
Comments	The existing legal framework ensures that the parties to the proceedings are dealt with in a free, fair and just manner and publicly available court procedures ensure transparency. The delegation of powers with respect to case management also ensures specialised attention to the various issues pertaining to the proceedings at various stages of the proceedings. There are standardised and institutionalised mechanisms for court proceedings.
D 4	**Transparency and Accountability** **An insolvency and creditor rights system should be based upon transparency and accountability. Rules should ensure ready access to relevant court records, court hearings, debtor and financial data and other public information.**

<table>
<tr><td>Legal Framework</td><td>Issue of notice and publication of order
The provisions of the Provincial Insolvency Act, 1920 in case of individuals and the Companies (Court) Rules, 1959 in case of companies, provide for issuance of notice to the concerned parties in case of initiation of insolvency proceedings. The notice is given to the debtors, creditors, contributories, members, as the case may be, regarding existence of the proceedings, due dates for filing claims, appointment of the liquidator, holding of meetings of shareholders, fixing a date for creditors to prove debts, notice of filing list, prove debts, date of settlement of list, etc. However, in the case of companies, if the Court is of the view that it may not be in the interest of the company, issuance of such a notice can be dispensed with. In case of companies, the notice should be given in such a manner that there is a period of 14 days between publication and date of hearing of the petition.

The procedure to be followed in issuing the notice is in terms of the provisions of the Code of Civil Procedure, 1908. Under the Companies (Court) Rules, 1959 notice is required to be given of the petition, etc. by way of advertisement in newspapers also. Further, information regarding the books of accounts, balance sheet, and the Report of the BoD of the company are distributed for information. Once the Court has heard the insolvency petition, as per the requirement of the Code of Civil Procedure, the judgment is pronounced by the Court. Further, the order of adjudication or the winding-up order, as the case may be, is required to be published and in case of companies, the winding-up order is required to be advertised in newspapers in the prescribed format.

The details regarding the number of companies that have gone into liquidation and/or have been struck off from the Register is provided in the Annual Report regarding the Statistical Review of Corporate Structure maintained by the Ministry of Corporate Affairs.

Court Proceedings

Generally, the Court proceedings are conducted in open Court except in some cases where the Court may direct in-camera or in-chamber proceedings on the grounds of public policy or in exercise of any power vested in it. The hearing dates are publicly available. The case lists of the cases filed before the High Courts and the Supreme Court are also available on the internet.

The court files are available for inspection on requirement. Copies of the court files are also made available on application. However, this is subject to the rules of the High Court. The High Court Rules lay down the procedure to be adopted</td></tr>
</table>

	by the applicant to access the information or to get copies of the records which can be done during the working hours of the Court. The rules also provide for the fees/charges to be paid by the person to access the records or to get copies of the same. The time period to get the information sought for may vary and depend on the rules of procedure applicable to the respective Court. However, in case of urgency, the copies can be obtained on the same day, by filing an urgent application and affixing additional fee stamps. The online facility for accessing information on court cases is available 24 hours. In this case, the person can submit a query in the appropriate place in the webpage of the website of the relevant Court.
Assessment	**Observed**
Comments	The law provides for transparency and accountability of insolvency proceedings right from the initiation of proceedings to the passing of the order by the Court, both in case of an individual and a company. There are adequate provisions for issue of notice of the insolvency proceedings to the parties concerned, access to the case files, pronouncement of judgment after hearing the matter and the publication/advertisement of the adjudicatory order/winding-up order, which would enable the affected persons to be aware of the happenings in the case. The advent of internet facility has added to accessibility to the public, thereby bringing in more transparency in the court proceedings. Making available online certified copies of court orders may help in improving the efficiency and utility of the system.
D 5	**Judicial Decision Making and Enforcement of Orders** **D5.1** ***Judicial Decision Making:*** **Judicial decision making should encourage consensual resolution among parties where possible and otherwise undertake timely adjudication of issues with a view to reinforcing predictability in the system through consistent application of the law.** **D5.2** ***Enforcement of Orders:*** **The court must have clear authority and effective methods of enforcing its judgments.** **D5.3** ***Creating a Body of Jurisprudence:*** **A body of jurisprudence should be developed by means of consistent publication of important and novel judicial decisions, especially by higher courts, using publication methods that are conventional and electronic (where possible).**
Legal Framework	The Arbitration and Conciliation Act and the Code of Civil Procedure provides for settlement of disputes outside the Courts. The Arbitration and Conciliation Act, 1996 enables the parties to settle the issues consensually. With respect to the matters which have reached the Court, in terms of the provisions of the Code of Civil Procedure, if it appears to the Court that there exist an element of settlement which may be acceptable to the parties, the Court may refer the case, after framing of the issues, for settlement either by way of arbitration, conciliation, mediation, or judicial settlement including settlement through Lok Adalat. If the parties fail to get their disputes settled through any of the alternate disputes resolution

	method, only then the suit would proceed further before the Court. The Reserve Bank has issued certain guidelines known as 'Corporate Debt Restructuring' to banks and financial institutions whereby companies indebted to many banks and/or financial institutions could get their debts restructured. In case of litigations, normally the litigants approach an Advocate/Solicitor for legal advice for filing the cases as well as for conducting the cases. The institutions/ incorporated bodies may have full-fledged departments/sections consisting of legal professionals or advocates on retainership basis or otherwise to provide the necessary consultation prior to litigation. In case of suits, the court proceedings get initiated when the plaint is filed before the Court having jurisdiction. In case of winding-up (insolvency) proceedings against incorporated companies, it is initiated by filing a petition for winding-up. Once the case is filed, normally it will be taken up for hearing the next day and in urgent matters urgent motions are also moved for hearing on the same day of filing the case. The parties filing the suit/petition have to incur costs which include Court Fees and legal assistance fees payable to Advocates. In order to file an insolvency petition against a company, the same can be initiated before the High Court having jurisdiction and in case of initiation of insolvency proceedings against individuals, it may be initiated before the District Court having jurisdiction over the area where the debtor resides/carries on business/works for gain, *etc.* It would be sufficient for the party to engage an Advocate and initiate and continue the proceedings. *Judicial Decision-Making* Generally, the judges try to be consistent in their views, which in turn would result in predictability. There is a judicially devised mechanism of following precedents set by earlier decisions of the Courts. In terms of Article 141 of the Constitution, the law laid down by the Supreme Court is binding on all Courts and authorities throughout the Country. In case of High Courts, the High Courts exercise revisional jurisdiction over other authorities and tribunals within their territorial jurisdiction. Consequently, the Courts and tribunals sub-ordinate to the respective High Court will have to follow the law laid down by that High Court. The hierarchical system of courts and decision-making helps in building predictability, maintaining consistency, assuring stability and creating confidence in the system. While deciding the cases, the Courts exercise their discretion to the extent of allowing distinction based on facts. For applicability of the law, the Courts generally follow precedents. In case it is felt that the earlier decision is

	not correct or the law laid down is not correct, there is a procedure to refer to larger benches to take a decision. Further, *per incuriam* decisions are not binding. The Supreme Court usually follows its own decisions, although it may, at times find it necessary to differ from its own previous rulings in the interests of development of law and justice. In terms of the Code of Civil Procedure, the courts are required to pronounce the judgment within 30 days from the date of final hearing of the case and in exceptional circumstances, within 60 days from the date of final hearing. Apart from the Appeal Court, no other body has the power to overrule the decisions of a Court of law. Once the decisions are recorded and signed, with the approval of the Courts, they are reported in various journals and reporters that are available for being purchased from the market. Further, decisions of the Supreme Court and many of the High Courts are available on the internet. *Appeals* The Companies Act provides for a right to appeal against any order made or decision given in the matter of winding-up of a company. There is no substantial limitation on the grounds on which appeals could be filed. The time taken for disposing of appeals would depend on many circumstances and the rules of procedure and practice in vogue in the respective High Court. The judges of the High Court and the Supreme Court are appointed under the provisions of the Constitution which do not provide for requirement of expertise in any particular field of law. The requirement of specialisation was sought to be introduced by way of an amendment to the Companies Act, 1956 (vide the Companies (Second Amendment) Act, 2002) by setting up a NCLT and a NCLAT in which persons having expertise in the fields pertaining accountancy, law, economics, science and technology, banking, *etc.* are to be appointed as members. However, the Central Government has not brought those amendments into force in view of certain Court cases challenging the amendment. The decisions of the Company Courts are enforced as though it is a decree of a Court. An order passed by one Court can be enforced in any place in India by any other Court as though such other court had jurisdiction over the company. As regards other entities, the normal procedure followed is the one contemplated under the Civil Procedure Code. In case of contempt of the court orders, the provisions of the Contempt of Courts Act, 1971 which provides for the procedures to file contempt of court petition and the liabilities for the contempt of court, would be applicable.
Assessment	**Observed**
Comments	The law provides and encourages arbitration, conciliation, mediation and other means of out-of-court settlements. In case of pending cases also, the Court has discretion to refer the matter for settlement through mediation, arbitration, conciliation, *etc.* This would to a large extent avoid cases from reaching the Court and reduce the work load in the Courts. The lack of judicial time, lack of

	expertise and consequent lack of proper appreciation of issues pertaining to insolvency, are causing delay in deciding the court cases. This can to a large extent be solved if the NCLT and the NCLAT are set up by bringing into operation the proposed amendments in the Companies Act. Further, referring the matters for mediation, conciliation and to the Lok Adalats can also solve the problem. In case of contempt of the court orders, the provisions of the Contempt of Courts Act, 1971 which provides for the procedures to file contempt of Court petition and the liabilities for the contempt of court, would be applicable. The law declared by the Supreme Court is binding on all courts in the country and the law laid down by the High Courts binds the courts and tribunals subordinate to the High Court. The Courts, therefore, maintain consistency in giving decisions by following precedents, which in turn results in predictability.
D 6	**Integrity of the System** **D6.1** ***Integrity of the Court:*** **The system should guarantee security of tenure and adequate remuneration of judges, and personal security for judicial officers and court buildings. Court operations and decisions should be based on firm rules and regulations to avoid corruption and undue influence.** **D6.2** ***Conflict of Interest and Bias:*** **The court must be free of conflicts of interest, bias and lapses in judicial ethics, objectivity and impartiality.** **D6.3** ***Integrity of Participants:*** **Persons involved in a proceeding must be subject to rules and court orders designed to prevent fraud, other illegal activity and abuse of the insolvency and creditor rights system. In addition, the court must be vested with appropriate powers to enforce its orders and address matters of improper or illegal activity by parties or persons appearing before the court with respect to court proceedings.**
Legal Framework	As regards tenure, integrity, remuneration, *etc.* of the judges and matters relating to Court operations and decisions, see the Legal Framework in D1, D2, D3 and D4. Under the Companies Act, the Courts have power to deal with various offences antecedent to or in the course of winding-up. The liquidator appointed by the Court has got powers to summon any person who is aware of the affairs of the company under liquidation, based on which he makes a report. The Court may, if found necessary, take necessary action, including criminal prosecution against any person who is responsible for the abuse of bankruptcy proceedings.

	The prosecutions take place as per prescribed rules and near-uniformity is achieved. Further, there exist certain checks and balances in the legal system in the form of appeals, appointment of the Official Liquidator who may not have any interest in the subject matter and independence of judiciary which would to a large extent avoid corruption and undue influence in insolvency proceedings. The Judge's Inquiries Act, which enables monitoring and enforcing the standards of conduct of judiciary would also act as a mechanism to prevent corruption. In view of the aforesaid mechanism, the instances of corruption in insolvency proceedings are very rare. Instances of judicial corruption are also very rare. The creditors are also very much active in the proceedings and they are entitled to inspect the liquidator's accounts and even approach the Court directly with grievances.
Assessment	**Observed**
Comments	See assessments of D1, D2, D3 and D4. The provisions for appeals, appointment of Official Liquidator and the independence of judiciary act as checks and balances against instances of bias, corruption and other abuse of the bankruptcy proceedings. Further, the Companies Act empowers the Courts to deal with various offences antecedent to or in the course of winding-up. There are statutory provisions to deal with abusive practices during winding-up. The Liquidators appointed for winding-up function are subject to the supervision of the Court. These provisions prevent the abuse of bankruptcy proceedings to a large extent.
D 7	**Role of Regulatory or Supervisory Bodies** **The bodies responsible for regulating or supervising insolvency representatives should:** **- Be independent of individual representatives;** **- Set standards that reflect the requirements of the legislation and public expectations of fairness, impartiality, transparency and accountability; and,** **- Have appropriate powers and resources to enable them to discharge their functions, duties and responsibilities effectively.**
Legal Framework	The Companies Act and Rules framed thereunder extensively provide the manner in which and the procedure to be followed for effective winding-up of the company by the Administrators (Liquidators, Receivers, *etc.*) who are appointed for the winding-up of the company. In India, the liquidators are whole-time or part-time officers of the Government whose qualifications, conditions of service, *etc.* are fixed by the Government. Being public servants, their conduct is governed by their respective service rules, in terms of which they can be tried for misconduct and be punished. There are no professional or non-statutory bodies, which have supervisory functions in the insolvency system. The work of insolvency administration is supervised by the Courts under the Companies Act and the Code of Civil Procedure. The Liquidators are supervised by the High

	Courts and the Official Assignees and Receivers (in the case of individual insolvency) by the District Courts.
Assessment	**Broadly Observed**
Comments	Since the liquidators appointed for winding-up of the companies are public servants, who can be tried for misconduct, they are accountable and the chances of fraud and other illegalities during the course of winding-up are rare. Further, the Court supervises the insolvency proceedings conducted by the liquidators. This enables the insolvency proceedings to be conducted in a fair, impartial and transparent manner. The infrastructure of the Official Liquidators needs to be further strengthened to deal with the large number of proceedings attended to by them. However, on operationalisation of the Companies (Second Amendment) Act, 2002 professionals/firms can be appointed as Liquidators, reducing the load on Official Liquidators.
D 8	**Competence and Integrity of Insolvency Representatives** **The system should ensure that:** **- Criteria as to who may be an insolvency representative should be objective, clearly established and publicly available;** **- Insolvency representatives be competent to undertake the work to which they are appointed and to exercise the powers given to them:** **- Insolvency respresentatives act with integrity, impartiality and independence; and** **- Insolvency respresentatives, where acting as managers, be held to director and officer standards of accountability and be subject to removal for incompetence, negligence, fraud or other wrongful conduct.**[33]
Legal Framework	The Liquidators under the Companies Act are officials attached to the High Court. The Liquidators appointed for insolvency proceedings are public servants, who may be whole-time or part-time officers of the Government. They being Central Government employees, their conditions of service are fixed by the Central Government and are salaried government servants. An Official Liquidator, appointed by the Central Government is attached to each High Court, who will be the liquidator for the purpose of Companies Act. The Liquidators appointed by the Courts have to report to the Court from time to time about the various

[33] See Principle B2

	proceedings and obtain sanction from the Court, if necessitated by the Statute or by the orders of the Court. In case of banks, the BR Act provides for appointment of Court Liquidators to be appointed by the Central Government. Where an application is made by the Reserve Bank in this behalf, the Reserve Bank, the SBI or any other bank notified by the Central Government or any individual as stated in the application will be appointed as Official Liquidator. As on date, the law does not permit corporate institutes to act as Administrators. However, in the event of the Companies (Second Amendment) Act, 2002 being brought into force, it would be possible to permit the same. The administrators (Liquidators) being public servants, can be punished for any misconduct as per the Service Rules. Due to this and due to the provision for supervision of the liquidators during insolvency proceedings, the instances of corruption, *etc.* are rare. Nevertheless, in case of incompetence on the part of the liquidators, fraud, mishandling of a case and other improprieties, the Court can be approached to remove and replace the liquidators.
Assessment	**Observed**
Comments	Since the Administrators are public servants whose conduct of service and qualifications are prescribed in the Service Rules, a certain standard of competence and expertise is built-in. Further, since they can be tried for misconduct, incompetence, mishandling of cases, *etc*, as per the Service Rules, instances of fraud, misconduct, *etc.* are very rare. Apart from the Service Rules, they are also under the supervision of the Courts in their conduct of insolvency proceedings. This would to a large extent result in integrity, impartiality and independence of the liquidators. The Companies (Second Amendment) Act, 2002 when brought into operation would enable the Tribunal to appoint professionals as insolvency representatives. There should be clear provisions for dealing with the misconduct and irregularities of such insolvency representatives.

Appendix Table 1: NPAs Recovered by Scheduled Commercial Banks through Various Channels

(Amount in Rs. Crore)

Item	2005-06			2006-07		
	No. of cases referred*	Amount involved	Amount recovered	No. of cases referred*	Amount involved	Amount recovered
1	2	3	4	5	6	7
i) One-time settlement/ compromise schemes	10,262	772	608	-	-	-
ii) Lok Adalats*	2,68,090	2,144	265	1,60,368	758	106
iii) DRTs	3,534	6,273	4,735	4,028	9,156	3,463
iv) SARFAESI Act	41,180#	8,517	3,363	60,178#	9,058	3,749

* The scheme for OTS for SME accounts by public sector banks was closed on June 30, 2006.
# Number of notices issued under Section 13(2) of the SARFAESI Act.
Source: Report on Trend and Progress of Banking in India, 2006-2007, Reserve Bank of India.

Appendix Table 2: Cases Pending with and Decided by DRTs up to Year-ended March 31, 2008 – Commercial Banks

(Amount in Rs. Crore)

Particulars	Cases pending	Amount involved	Cases decided	Amount involved	Amount recovered	Cases filed	Amount involved	Filing costs
1	2	3	4	5	6	7	8	9
Public Sector Banks	29,519	54,516	38,649	45,169	16,476	67,968	98,054	626
Private Sector Banks	4,334	12,097	5,864	10,750	4,592	10,198	22,846	158
Foreign Banks	428	2,674	575	2,800	472	1,003	5,476	20
Total	**34,281**	**69,287**	**45,088**	**58,719**	**21,540**	**79,169**	**1,26,378**	**804**

Source: Reserve Bank of India

Appendix Table 3: Cases Registered and Disposed by BIFR						
Year	Total Cases Registered during the Year	Cases Disposed during the Year				Bench Month *
		Cases under Revival	Cases Revived	Winding-up Recommended	Dismissed	
1	2	3	4	5	6	7
2001	463	22	47	127	116	36
2002	559	46	34	131	241	36
2003	430	50	40	141	257	36
2004	399	43	29	85	90	16
2005	180	42	67	26	180	36
Total	**2031**	**203**	**217**	**510**	**884**	**160**

* Bench Months is arrived at on the basis of number of benches functioning in each year.

Note: 1. As a company normally takes 5 to 7 years to be revived, the format indicates companies revived in the year in which net worth became positive and companies were discharged from the purview of SICA.

2. Figures of companies revived after the successful implementation of scheme, as well as those where net worth became positive at the inquiry stage itself, have been clubbed together.

3. Above figures are according to the calendar year.

Source: Board for Industrial and Financial Reconstruction website.

Appendix Table 4: Age-wise Resolution of BIFR Cases					
Particulars	1 to 3 Years (Average: 2)	3 to 5 Years (Average: 4)	5 to 10 Years (Average: 7.5)	More than 10 years (Average: 15)	Total
1	2	3	4	5	6
Age of BIFR reference	1,009	1,022	1,542	1,754	5,417
Of which:					
Resolved by BIFR	333	632	1,234	1,659	3,858
Of which:	(33)	(62)	(80)	(94)	(72.4)
Mode of resolution:					
(i) Reference dismissed	313	544	515	398	1,770
(ii) De-listed from BIFR on account of Net worth becoming positive	9	20	26	40	95
(iii) Wound-up	4	25	501	782	1,312
(iv) Scheme sanctioned by	7	43	192	439	681
BIFR Balance (pending)	676	390	308	95	1,469
	(67)	(38)	(20)	(06)	(27.6)

Note: Figures in brackets are percentages.

Source: Board for Industrial and Financial Reconstruction website,

Appendix Table 5: Data on Companies under Liquidation

No. of Years under Liquidation	No. of Companies in Liquidation
1	2
Up to 5 years	266
5 years to 10 years	309
10 years to 20 years	190
20 years to 25 years	92
Above 25 years	114
Total companies	**971**

Note: Average number of cases added during a year is around 75.
Source: Office of the Official Liquidator, High Court, Mumbai.

Appendix Table 6: Details of Companies under Liquidation in Four Regions

Companies in Liquidation	Compulsory	Voluntary
1	2	3
Northern Region		
Delhi	606	70
Allahabad	259	07
Chandigarh	240	45
Jaipur	83	07
Jammu	12	12
Western Region		
Mumbai	964	332
Ahmedabad	463	125
Indore	47	02
Nagpur	44	04
Goa	08	07
Southern Region		
Chennai	743	59
Kochi	142	23
Hyderabad	335	—
Bangalore	335	93
Eastern Region		
Kolkata	843	222
Cuttack	57	01
Guwahati	11	04
Patna	39	03
Ranchi	20	03

Source: Ministry of Corporate Affairs.

Appendix Table 7: Cross-country Comparison on Closing a Business

This topic identifies weaknesses in existing bankruptcy law and the main procedural and administrative bottlenecks in the bankruptcy process. The table below shows the main indicators. They include:

- average time to complete a procedure,
- cost of the bankruptcy proceedings, and
- the recovery rate, which calculates how many cents on the dollar, the claimants (creditors, tax authorities, and employees) recover from an insolvent firm.

'No practice' means that there have been less than 60 completed insolvency cases in the past 20 years.

Region or Economy	Time (years)	Cost (% of estate)	Recovery rate (cents on the dollar)
1	2	3	4
East Asia & Pacific	2.7	23.2	28.1
Eastern Europe & Central Asia	3.2	13.7	28.9
Latin America & Caribbean	3.2	16.4	25.9
Middle East & North Africa	3.7	13.9	25.8
OECD	1.3	7.5	74.1
South Asia	5.0	6.5	20.1
Sub-Saharan Africa	3.4	20.0	17.1
Afghanistan	no practice	no practice	0
Albania	no practice	no practice	0
Algeria	2.5	7	41.7
Angola	6.2	22	10.8
Antigua and Barbuda	3.0	7	35.7
Argentina	2.8	12	34.4
Armenia	1.9	4	42.0
Australia	1.0	8	79.2
Austria	1.1	18	72.4
Azerbaijan	2.7	8	31.5
Bangladesh	4.0	8	23.2
Belarus	5.8	22	33.2
Belgium	0.9	4	85.5
Belize	1.0	23	63.5
Benin	4.0	15	22.6
Bhutan	no practice	no practice	0
Bolivia	1.8	15	38.7
Bosnia and Herzegovina	3.3	9	35.0
Botswana	1.7	15	59.8
Brazil	4.0	12	14.6
Brunei	2.5	4	45.3
Bulgaria	3.3	9	32.4
Burkina Faso	4.0	9	25.6
Burundi	no practice	no practice	0
Cambodia	no practice	no practice	0
Cameroon	3.2	15	25.5
Canada	0.8	4	88.8

(Contd.)

(Contd.)

Cape Verde	no practice	no practice	0
Central African Republic	4.8	76	0
Chad	no practice	no practice	0
Chile	4.5	15	23.8
China	1.7	22	35.9
Colombia	3.0	1	58.3
Comoros	no practice	no practice	0
Congo, Dem. Rep.	5.2	29	2.9
Congo, Rep.	3.0	24	20.4
Costa Rica	3.5	15	23.1
Côte d'Ivoire	2.2	18	33.0
Croatia	3.1	15	30.2
Czech Republic	6.5	15	21.3
Denmark	1.1	4	87.0
Djibouti	5.0	18	15.9
Dominica	no practice	no practice	0
Dominican Republic	3.5	38	8.4
Ecuador	5.3	18	16.9
Egypt	4.2	22	16.6
El Salvador	4.0	9	28.4
Equatorial Guinea	no practice	no practice	0
Eritrea	no practice	no practice	0
Estonia	3.0	9	39.1
Ethiopia	3.0	15	33.1
Fiji	1.8	38	20.2
Finland	0.9	4	88.2
France	1.9	9	47.4
Gabon	5.0	15	15.2
Gambia	3.0	15	19.3
Georgia	3.3	4	22.8
Germany	1.2	8	53.4
Ghana	1.9	22	24.0
Greece	2.0	9	44.8
Grenada	no practice	no practice	0
Guatemala	3.0	15	28.1
Guinea	3.8	8	20.4
Guinea-Bissau	no practice	no practice	0
Guyana	3.0	29	17.4
Haiti	5.7	30	3.1
Honduras	3.8	15	20.3

(Contd.)

Hong Kong, China	1.1	9	79.0
Hungary	2.0	15	38.4
Iceland	1.0	4	80.3
India	10.0	9	11.6
Indonesia	5.5	18	12.6
Iran	4.5	9	19.0
Iraq	no practice	no practice	0
Ireland	0.4	9	87.1
Israel	4.0	23	43.6
Italy	1.8	22	61.8
Jamaica	1.1	18	64.3
Japan	0.6	4	92.6
Jordan	4.3	9	27.8
Kazakhstan	3.3	18	23.4
Kenya	4.5	22	31.0
Kiribati	no practice	no practice	0
Korea	1.5	4	81.2
Kuwait	4.2	1	33.6
Kyrgyz Republic	4.0	15	15.6
Lao PDR	no practice	no practice	0
Latvia	3.0	13	34.6
Lebanon	4.0	22	19.1
Lesotho	2.6	8	34.9
Liberia	3.0	43	7.8
Lithuania	1.7	7	49.2
Luxembourg	2.0	15	41.6
Macedonia, FYR	3.7	28	15.8
Madagascar	no practice	no practice	0
Malawi	2.6	30	13.2
Malaysia	2.3	15	38.3
Maldives	6.7	4	18.2
Mali	3.6	18	21.3
Marshall Islands	2.0	38	17.9
Mauritania	8.0	9	7.8
Mauritius	1.7	15	34.3
Mexico	1.8	18	63.9
Micronesia	5.3	38	3.1
Moldova	2.8	9	28.8
Mongolia	4.0	8	20.1
Montenegro	2.0	8	42.8
Morocco	1.8	18	35.3
Mozambique	5.0	9	13.9
Namibia	1.5	15	41.3
Nepal	5.0	9	24.5
Netherlands	1.1	4	86.7
New Zealand	1.3	4	77.1
Nicaragua	2.2	15	34.6

(Contd.)

Niger	5.0	18	14.2
Nigeria	2.0	22	27.5
Norway	0.9	1	90.7
Oman	4.0	4	35.5
Pakistan	2.8	4	39.1
Palau	1.0	23	38.2
Panama	2.5	18	32.3
Papua New Guinea	3.0	23	23.9
Paraguay	3.9	9	14.6
Peru	3.1	7	24.7
Philippines	5.7	38	4.2
Poland	3.0	22	27.8
Portugal	2.0	9	74.0
Puerto Rico	3.8	8	54.1
Romania	3.3	9	28.9
Russia	3.8	9	29.0
Rwanda	no practice	no practice	0
Samoa	2.5	38	15.2
São Tomé and Principe	no practice	no practice	0
Saudi Arabia	2.8	22	29.3
Senegal	3.0	7	32.4
Serbia	2.7	23	23.1
Seychelles	no practice	no practice	0
Sierra Leone	2.6	42	8.5
Singapore	0.8	1	91.3
Slovakia	4.0	18	45.2
Slovenia	2.0	8	46.6
Solomon Islands	1.0	38	23.3
South Africa	2.0	18	33.2
Spain	1.0	15	76.9
Sri Lanka	1.7	5	44.6
St. Kitts and Nevis	no practice	no practice	0
St. Lucia	2.0	9	41.8
St. Vincent and the Grenadines	no practice	no practice	0
Sudan	no practice	no practice	0
Suriname	5.0	30	7.4
Swaziland	2.0	15	36.0
Sweden	2.0	9	74.7
Switzerland	3.0	4	47.1
Syria	4.1	9	30.8

(Concld.)

Taiwan, China	1.9	4	80.2
Tajikistan	3.0	9	23.6
Tanzania	3.0	22	20.5
Thailand	2.7	36	41.8
Timor-Leste	no practice	no practice	0
Togo	3.0	15	26.3
Tonga	2.7	22	25.3
Trinidad and Tobago	no practice	no practice	0
Tunisia	1.3	7	51.5
Turkey	3.3	15	20.3
Uganda	2.2	30	41.0
Ukraine	2.9	42	9.1
United Arab Emirates	5.1	30	10.1
United Kingdom	1.0	6	84.6
United States	1.5	7	75.9
Uruguay	2.1	7	44.8
Uzbekistan	4.0	10	18.7
Vanuatu	2.6	38	39.3
Venezuela	4.0	38	6.6
Vietnam	5.0	15	18.0
West Bank and Gaza	no practice	no practice	0
Yemen	3.0	8	28.6
Zambia	2.7	9	28.4
Zimbabwe	3.3	22	0.1

Source: http://www.doingbusiness.org/ExploreTopics/ClosingBusiness/?direction=Asc&sort=0

Annex II

Effective Insolvency and Creditor Rights Systems
A Peer Review of the Advisory Panel Report

By Thomas C. Baxter, Jr.[34]

On March 27, 2008 Dr. Rakesh Mohan, Deputy Governor of the Reserve Bank of India, invited me to act as a peer-reviewer and to consider India's assessment as to how well it adheres to the World Bank Principles for Effective Insolvency and Creditor Rights. I accepted the Deputy Governor's invitation. This memorandum contains my written comments on the 'Draft Report on Assessment of Effective Insolvency and Creditor Rights Systems – 2005' (hereafter 'Draft Report') sent to me under cover of a letter dated May 9, 2008 from Mr. Kanagasabapathy, Secretary to the Committee on Financial Sector Assessment.

I. Introduction

The Draft Report does an excellent job of laying out how the laws related to insolvency in India have evolved in recent years. Clearly, insolvency has received close and careful attention in the work of the Eradi Committee, the Mitra Committee and the Irani Committee. It is also apparent that these Committees have received the full attention of the Parliament, which has enacted substantial legislative changes in recent years. These changes have modernised its bankruptcy regime, and on a comparative law basis, India's insolvency laws seem well crafted and current.

The Draft Report observes that the Companies (Second Amendment) Act, 2002, made several, positive changes in India's bankruptcy laws. These changes have not been implemented, however, because of a High Court ruling to the effect that some of the tribunals created in the new law are defective and in breach of India's Constitution. This ruling is currently on appeal to the Supreme Court of India, and it appears that the Supreme Court's determination of the appeal could have a significant impact.

My comments concerning the Draft Report are divided into three parts. In the first part, I comment on those aspects of the insolvency laws of India that, through the prism of the World Bank principles, seem to be well conceived and carefully incorporated into statutory law. In the second part, I comment on issues that are raised in the Draft Report and stimulated questions. In the third part, I pick up on a theme that I detected in the Draft Report, and address what I will

[34] The views expressed by the author are his personal views, and do not necessarily represent the views of the Federal Reserve Bank of New York, of any other part of the Federal Reserve System. The author expresses special thanks to his colleague at the Federal Reserve, Joseph Sommer, for editing this peer review and providing critical analysis of its content.

loosely characterise as India's Insolvency Enigma – why a jurisdiction with such well conceived insolvency laws should have a comparatively poor showing in the World Bank's 'Doing Business Report'.

Stance of the Panel: No specific comments. These are general observations

II. The Insolvency Laws of India Appear to Be Carefully Considered and Well-Developed.

One prominent feature of the insolvency laws of India is a separate legal regime for bank insolvency. In legal cultures where the bank charter is considered to be 'special', one sometimes finds a unique regime for winding-up banks. In this regard, a special insolvency regime is seen to complement access to the credit facilities of the central bank and deposit insurance, as features unique to the bank charter. I found it noteworthy that this subject has received the close attention of the Mitra and Irani Committees, both of which apparently determined that a special regime for bank insolvency is appropriate for India. I note that this particular topic is receiving close attention of the British Parliament as it studies the lessons of the recent failure of a British bank, Northern Rock. It appears that the United Kingdom may well be moving to create a separate insolvency regime for banks. If this happens, and my sources advise me that it is likely, the United Kingdom insolvency regime will become like the regimes found in India and the United States.

Stance of the Panel: No specific comments. These are general observations.

Another area where the laws of India appear to be robust and modern is with respect to security interests in movable property. The Draft Report's description of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act ('SARFAESI Act') reveal a law that is current in design and function, and compares favorably with the law that exists in Europe and the United States. The Draft Report observes that the implementation of the SARFAESI Act has been troubled in certain ways, most notably the Central Registry of security interests, which is yet to be established. I also wondered whether the SARFAESI Act satisfies all of the World Bank's criteria for securities entitlements. Finally, the basic distinction between what the law says and how the law is implemented seems to be an overriding problem with India's implementation of SARFAESI.

Stance of the Panel: The SARFAESI Act only provides* inter alia *for registration of security interests and a special procedure for enforcement of such security interest. An area of concern pointing to a distinction between the law as laid down and as implemented is the passing of* ex-parte *orders by DRTs, staying the enforcement proceedings initiated by banks/FIs under the SARFAESI Act. The SARFAESI Act empowers the secured creditors to approach the District Magistrate/ Chief Judicial Magistrate of the concerned jurisdiction for assistance in taking over the secured assets. Since these officials are unable to pay adequate attention to such demands, a suitable amendment may have to be made to the SARFAESI Act to enable the District Magistrate/CJMs to delegate their powers.

These aspects have been incorporated in comments portion of A5.2 of the Report.

The laws of India also appear to be modern and well-crafted with respect to payment systems. The Payment and Settlement Systems Act, 2007 does what the World Bank Principles expect. One example is statutory authorisation for payments netting. The Draft Report points this out very well. At the same time, the Draft Report observes, correctly in my view, that the law only provides

assurance with respect to payment systems. It leaves unaddressed the subject of netting, both bilateral and multilateral, with respect to financial contracts that are done outside of a payment system. In the G-7 countries, these 'over the counter' markets can be highly material to the functioning of the economy; repurchase agreements and derivative transactions are two forms of money market instruments that are material to economies in the US and Europe, and where netting is important. In these jurisdictions, the ability to liquidate and net these types of contracts and seize, set-off, and apply collateral securing the contracts in the event of the counterparty's insolvency has been expressly recognised in relevant insolvency legislation. While I do not know if these contracts are now important in India, they are likely to be in the future.

Stance of the Panel: Mutual set-off is allowed under the general law. Therefore, in India bilateral netting is recognised. In case any system is engaged in settling transactions on a multilateral netting basis, then it could fall under the definition of a 'payment system' as per the Payment and Settlement Systems Act, 2007.

This aspect has been incorporated by making certain modifications/additions to comments of C 10.2 of the Report. Further, it has already been covered under comments of C 10.4 of the Report.

The law in India with respect to credit agencies also seems from the Draft Report to be well developed and functioning without problem. This too is integral to the functioning of the financial system.

Stance of the Panel: No specific comments. These are general observations.

With respect to the basic insolvency laws, the Draft Report paints a picture of a legal infrastructure that is on the edge of significant reform. The Draft Report observes that the Companies (Second Amendment) Act, 2002 is designed to harmonise a number of older insolvency laws that are somewhat disparate. At the same time, the Draft Report notes that this important law reform hangs in the balance as the Supreme Court considers the Constitutional issues that caused the High Court to set the Act aside.

Stance of the Panel: No specific comments. These are general observations.

India's judiciary, particularly in the High Court and the Supreme Court, appears from the Draft Report to be of exceptional quality. The problem is not the quality of the judges of those Courts, in the Draft Report's view, but in their focus and docket. The Draft Report suggests that the absence of a specialised bankruptcy court takes a toll with respect to the efficiency of the bankruptcy process. The conclusion appears to be well supported and correct. A prestigious bankruptcy court staffed with specialist judges can provide rapid and knowledgeable administration of this specialised law.

Stance of the Panel: No specific comments. These are general observations.

III. Issues that are Raised in the Draft Report and Perhaps Warrant Elaboration

The Draft Report points out well that India has a special insolvency regime for banks. It does not discuss the often difficult question of definition – how does the law identify those institutions that are banks, and distinguish them from those institutions that are not. In the United States, the distinction is not always easy. And, as the recent experience in the United States with Bear Stearns illustrates, there are times when investment banks need to be treated as if they were banks.

Stance of the Panel: Accepted. This aspect has been incorporated in section 5.2 Legal Framework for Bank Insolvency in India in the Report.

The Draft Report also discusses the nationalisation of banks, and the problem of co-operative banks. I was hoping for details about the costs associated with a legal regime where banks are not permitted to fail, and wonder whether the Draft Report might raise issues with respect to this controversial subject. The World Bank's Bank Insolvency project was concerned with issues such as moral hazard. If no bank ever fails, then creditors and depositors have no reason to be disciplined in their selection of a bank. Furthermore, without a balance sheet to protect, the management of a bank is more susceptible to improper outside pressures. The result is that the cost of mistakes made by the insolvent bank's management is socialised to the Government.

Stance of the Panel: Of late, private sector banks are showing keen interest in taking over weak banks on various business considerations. Even in the case of compulsory amalgamation, a failed private sector bank may be taken over by another private sector bank. In such cases cost being socialised to government does not arise.

Even though, generally the interests of the depositors and creditors are fully protected under a scheme of compulsory amalgamation, enabling provisions do exist whereby the Reserve Bank can provide for reduction of their interest or rights. Therefore, the depositors and creditors cannot remain complacent.

It is also in the interest of the shareholders of a bank to see to it that bank functions normally, because they would be the ultimate losers in any scheme of amalgamation.

These aspects have been incorporated in section 5.2.2 of the Report. Further, a paragraph on social cost with a table has also been incorporated as section 5.3 and Table 1 of the Report.

A related but different problem arises with respect to banks that are state owned. In a few places, the Draft Report indicates that insolvency rules are different for corporations that are state owned. This seems to diverge from what the World Bank suggests as a better practice. It certainly differs from what is now considered a better practice in the European Union and the United States. I wondered whether the bank insolvency laws of India create a distinction between banks that are state owned and those that are not. The Draft Report does not appear to dwell on any such distinction. I wondered whether some attention should be paid to state ownership.

Stance of the Panel: The insolvency of banking companies is dealt with under the provisions of the BR Act – where there is a special regime initiated by the Reserve Bank/Central Government and administered by the High Court. The provisions of the BR Act do not give any special dispensation to State-owned banking companies.

As regards the Government's commitment to protect the public sector banks from failure, there could be several social and economic justifications. One such justification could be the

fact that public sector banks, bank in areas which are remote and rural parts of the country, where no private or foreign bank is ever willing to open shop.

This aspect has been already covered in section 5.2.2 of the Report.

The Draft Report suggests that the priority for the deposit insurer needs to be clarified in the statutory law. I take this to mean that there should be a depositor preference incorporated into the statutory law, and that the Deposit Insurance Corporation should be able to 'stand in the shoes' of any insured depositor that receives a payout, and benefit from the depositor preference. Depositor preferences are not unusual in legal regimes that treat bank insolvencies as special, and the United States is one such jurisdiction. In considering this issue there is more than one policy approach. Some jurisdictions apply depositor preference to insured deposits or the portion of the deposit that is insured. Others like the United States give preference to all depositors. This decision affects whether uninsured depositors are ahead of or share pro-rata with other general creditors in priority. I note that depositor preference schemes are a special topic with respect to internationally active banking organisations. If India did enact a depositor preference, one issue associated with that act would be the potential effect on depositors in branch offices of Indian banks that are outside of India. Would the depositor preference have effect outside of the territory of India?

Stance of the Panel: The DICGC Act, 1961 extends only to the territory of India. Further, in terms of Section 2(g) of the said Act, it would not be applicable to depositors of branches of Indian banks outside India.

Under section 43A of the BR Act (which deals with preferential payments to depositors, including depositors not having insurance cover) the payment to be made by liquidator in preference is not expressly restricted to depositors in India. Therefore, it is possible to take a view that depositors of branches of Indian banks outside India are also covered by that provision. Consequently, such depositors may also be entitled to preferential payment. However, the sum payable in preference under section 43 A to such uninsured depositor is very meagre.

Further, the treatment of assets of the Indian banks' outside branch during liquidation would also be subject to the laws of the country in which it is situated.

This aspect has been incorporated in section 5.3 of the Report

The Draft Report, and several of the study Committees that are referenced within it, suggest that India adopt the UNCITRAL Model Law on Cross-border Insolvency. While I also believe adoption of the Model Law is a step forward, there are three important subsidiary issues that need to be analysed. First, as the footnote in the Model Law contemplates, the adopting jurisdiction needs to consider whether the Model Law is suitable for banks. The footnote in the UNCITRAL Model Law was inserted at the request of the U.S. delegation, because the United States was concerned about its special regime for bank insolvency. Second, if a law fashioned on the UNCITRAL model is enacted in India, the Parliament will need to consider how it expects to liquidate overseas branches

of Indian banks. In the event that an Indian bank is liquidated, rather than nationalised, how would creditors of the offshore branches be treated? Would they be compelled to participate as claimants in the Indian insolvency proceeding (where they would receive the preference), or would they be addressed in satellite insolvency proceedings in the jurisdictions that 'host' a branch (where the preference might be ignored)? Finally, how should India address the liquidation of a foreign bank with an Indian presence? These issues have received extensive consideration in other jurisdictions; the situation in the United States is addressed in a publication co-authored by this reviewer.[35]

Stance of the Panel: The draft Report refers to the adoption of the UNCITRAL Model Law on Cross-border Insolvency only in respect of the general corporate insolvency and it would not be applicable to the special bank insolvency regime. If necessary, clarificatory provisions can be inserted in the statute to make this point clear.

This aspect has been incorporated in section 5.3 of the Report.

IV. India's Insolvency Enigma

The Draft Report nicely discusses the fact that India 'lags' other jurisdictions when measured by the World Bank's Doing 'Business Report'. This reviewer thinks this 'lag' deserves considerable attention, especially if India is arrayed against the United States, the United Kingdom, and its former 'colonies', which inherited the British common law and much of its jurisprudence. India is distinguished in two particular characteristics, the length of time for insolvency proceedings and the percentage of recovery for creditors. Consider the following table:

Table PR: India's Insolvency Enigma

Region or Economy	Time (years)	Cost (Per cent of estate)	Recovery rate (cents on the dollar)
United Kingdom	1.0	6	84.6
United States	1.5	7	75.9
Canada	0.8	4	88.8
Hong Kong, China	1.1	9	79.0
Pakistan	2.8	4	39.1
Singapore	0.8	1	91.3
Malaysia	2.3	15	38.3
Australia	1.0	8	79.2
India	10.0	9	11.6
What can account for this?			

I characterise India's showing as an 'enigma' because the Draft Report documents in a highly persuasive manner that India has a robust legal regime for insolvency. The Draft Report also is persuasive in describing the High Court and the Supreme Court as highly capable, and staffed by professionals. While it is true that there have been some setbacks to the law reform agenda, such as the injunction for the Companies (Second Amendment) Act, 2002 this in itself does not seem sufficient to explain India's low marks in the table.

[35] Thomas C. Baxter, Jr., Joyce M. Hansen & Joseph Sommer, *Two Cheers for Territoriality: An Essay on International Bank Insolvency Law*, 78 Am.Bankr. L.J. 57 (2004).

I suspect that the length of insolvency proceedings likely correlates with the low recovery rate. This is intuitive given the penchant of most liquidators to invest proceeds in highly conservative investments, and the costs associated with winding-up a bankrupt's estate. That said, the data on the cost of the proceeding seems within a normal range. Why are the recovery rates in India so abysmal? Is there some easy explanation? My sense is that there must be something other than the length of proceedings that is working mischief here.

Stance of the Panel: Accepted. This aspect has been incorporated in assessment under head legal framework – C.1 of the Report

It is particularly noteworthy that India ranks last in the table in two important categories. The first category is the length of time for proceedings. In India, the average time for a bankruptcy proceeding, again using the Doing Business Survey, is 10 years. In the United Kingdom, Australia, Singapore, and Canada, it is one year or even less. In the United States and Hong Kong SAR, the average time is between 1 and 2 years. In Pakistan and Malaysia, the average proceeding takes between 2 and 3 years. The Draft Report characterises India as 'lagging', but the difference seems so much more than that. In Pakistan, which ranks the lowest next to India, the average bankruptcy proceeding takes 2.8 years. Then, there is India at 10. India's bankruptcy proceedings move at a glacial pace.

The Draft Report suggests that a specialised bankruptcy court could accelerate the slow pace. I concur, but wonder why some of the other specialised Tribunals (the Board of Industrial and Financial Reconstruction and the Debt Recovery Tribunal) mentioned in the Draft Report have not been very useful in speeding the duration of proceedings. Is there something else making India's process of resolution so slow?

Stance of the Panel: Accepted. This aspect has been incorporated in assessment under head legal framework – C.1 of the Report.

Interestingly, India compares rather favorably among those listed in the Table with respect to the cost of the resolution. The average cost in India is 9 percent, which is like the United Kingdom, the United States, and Australia. India is identical to Hong Kong, SAR, a bit higher than Pakistan and Canada, but considerably lower than Malaysia.

Stance of the Panel: No specific comments. These are general observations.

The most astonishing statistic, however, relates to the recovery rate. Having acted as a liquidator, I am very sensitive to the recovery rate, and consider it to be a quantitative method to assess the success of a liquidation. Like the time it takes for bankruptcy proceedings to run their course, India ranks last among those countries shown in the Table. But its final placement is only one dimension of a problem – India falls below Malaysia (38.3) and Pakistan (39.1) by more than 25 percent. Would accelerating the time of proceeding improve the recovery rate in India? This seems likely to this reviewer, but probably not enough. Another area worthy of exploration is

whether insolvent companies are not being placed into bankruptcy soon enough. This is a difficult concept to measure, but most insolvency professionals (particularly in the financial area) believe that it is important to wind a company down as soon as its liabilities exceed its assets. If the company is somehow carried on a form of life support after it has become insolvent, the size of the loss tends to grow, sometimes exponentially. Does this account for India's poor recovery rate? I do not know the answer to this question, but it does seem worth further exploration.

Stance of the Panel: No comments.

To conclude, I found the Draft Report to be exceptionally well done. It provides a treatment of the insolvency laws of India that is both comprehensive and careful, and that notes some areas where improvement is needed. The Draft Report was also very effective in raising issues worthy of further study. Finally, I found the presentation of the World Bank's 'Doing Business Survey' to raise truly provocative issues about India's comparative standing, and look forward to seeing how India's Insolvency Enigma is addressed in the years ahead. Thank you for this opportunity.

General Counsel and Executive Vice President
Federal Reserve Bank of New York
New York, New York
June 6, 2008

Chapter VII

Summary of Recommendations

7.1 Accounting Standards

Convergence with IFRSs

ICAI should make its best efforts to achieve convergence with IFRSs by April 1, 2011 as far as listed entities and other public interest entities are concerned. Apart from seeking the co-operation of regulatory and other authorities, ICAI should create awareness about the requirements of IFRSs amongst preparers, auditors and others, particularly, to ensure that entities get sufficient time to put in place the systems and procedures to be able to comply with IFRSs. At the same time, ICAI should continue with its efforts to issue new as well as revised standards to bridge the existing gap between the two sets of standards. This will smoothen the process of transition to IFRSs and also ensure that Indian standards are largely IFRS-compliant even if full convergence with IFRSs cannot be achieved due to any reason by April 1, 2011.

Greater Participation in the International Standard-setting process

If, as proposed by the Council of the ICAI, there is to be total convergence with IFRSs in India by April 1, 2011 it is essential that India should have a more significant influence, both in the agenda-setting of IASB as also in its technical output. ICAI, therefore, needs to identify individuals within the country who can play a more active role in various organisations of IASB. ICAI also needs to constitute a group of academicians and professionals which would be more pro-active in suggesting items for the agenda of IASB and IFRIC as also for consideration of exposure drafts issued by these bodies.

Development of Accounting Standards

Currently, the Standards issued by ICAI are anchored in the standards issued by IASB. Its work programme, therefore, follows the work programme of IASB. But situations may arise when India finds that there is no international standard on a subject of importance for the country and there is imminent need to have one, *e.g.*, emission rights. ASB ought to consider the development of a standard on such subjects if the work programme of IASB does not permit taking up development of standard on that subject. If and when ICAI commences work of development of a new standard, it ought to keep IASB informed and seek their comments on the basic principles being enunciated in the standard. Such standard(s) ought to be replaced by the standard on the subject, as and when issued by IASB.

Sector-specific Application Guidance

Accounting Standards issued by ICAI and IASB are general purpose Accounting Standards and the principles enunciated in the standards

apply across the board to all industries alike. Typical issues, specific to an industry, do arise in application of these standards, *e.g.,* the insurance sector or the banking sector. ICAI needs to consider providing sector-specific guidance in application of these standards. Such guidance, in a sense, is rule-based guidance in the application of principle-based standard(s). Such an approach will lead to uniformity in application of standards in specific, complex and typical issues relating to a sector/industry segment. Care and caution must, however, be exercised in issuing such a guidance to ensure that the guidance does not travel beyond the principles set out in standards. It should not lead to establishment of new principles.

Interpretations

Current Indian Standards are based on international standards and, therefore, in an ideal scenario, all issues relating to interpretation ought to be referred to IFRIC. This is necessary since, if each country which has adopted or adapted international standards starts issuing interpretations, it could frustrate the very objective of convergence and global adoption of common set of Accounting Standards. Having said that, one should also bear in mind that IFRIC may not be able to provide a timely response to each of the issues referred to it for interpretation.

ICAI will need, therefore, as an interim measure, an institution for providing interpretation/address issues relating to interpretations on need basis. The issues requiring interpretation ought to be brought to the notice of IFRIC and the interpretations that are issued also ought to be brought to the attention of IFRIC. The interpretations issued by India may need to be modified if interpretations, as and when issued by IFRIC, are different from the ones issued by the ICAI. It is, therefore, necessary that an independent 'Interpretation Committee' be constituted by ICAI and that the same 'due process' be followed before an 'interpretation' is issued. Interpretations issued by IFRIC or its predecessor, Standing Interpretations Committee (SIC), may be adopted by the 'Interpretations Committee' of the ICAI where the issue relates to a matter on which Indian Accounting Standard is identical or substantively similar to corresponding IFRS.

Authority for Issuance of Standards

The ASB is a committee of ICAI and the standards are issued by the Council of ICAI and not by the ASB. Though it has representation from outside, it is not truly autonomous. It is true that insofar as companies are concerned, the Standards issued by the Council of ICAI are only recommendatory and have to be prescribed by the Central Government in consultation with NACAS. This lends some degree of outside review. Nonetheless, the autonomy of the ASB would be greatly enhanced if it is given the authority to issue the standards and if the Council of ICAI confines itself to administrative, but not the functional, control of ASB. Also, codifying the constitution of ASB, total number of members, number of members to be nominated by ICAI, representatives of regulators, trade, industry, academics as also independent professionals will add to the transparency of the process adopted by ICAI.

Accounting Standards for Government

The Government Accounting Standards Advisory Board (GASAB), set up by the C&AG, should accelerate its activities and have a time-bound programme to:

(a) have research conducted to identify and articulate reforms in government accounting in countries like the US, the UK, Canada, New Zealand, Australia, *etc.*

(b) lay down a time-bound programme for reforms in the existing system such as:

- Sharper distinction between revenue and capital receipts and disbursements in the existing cash-based system.
- Accounting for indirect subsidies.
- Transition towards modified accrual-based or full accrual-based accounting system. Depending upon the experience of other countries, the extent and the manner in which elements of accrual-based system can be introduced in India should be determined and introduced.
- Issue standards that improve the usefulness of financial reports based on the needs of financial report users. The attempt should be to enhance the primary characteristics of understandability, relevance and reliability and the qualities of comparability and consistency.
- Keep standards current to reflect changes in governmental environment.
- Provide guidance on implementation of standards.
- Consider significant areas of accounting and financial reporting that can be improved through the standard-setting process.
- Improve the common understanding of the nature and the purposes of information contained in government financial reports.

Co-operative Banks

There is need for scheduled co-operative banks to adopt the same principles as applicable to commercial banks. Similarly, even large non-scheduled co-operative banks also need to adopt the same accounting principles as applicable to commercial banks.

Smaller co-operative banks may, however, be given some concessions in the application of accounting principles just as concessions are given to medium and small-sized enterprises. The government, in consultation with the Reserve Bank, should consider taking steps that require scheduled co-operative banks to immediately adopt the accounting principles being adopted by commercial banks.

The same may be required of the large non-scheduled co-operative banks gradually and a time-bound programme should be drawn up. More time may be given to smaller co-operative banks to apply duly modified accounting principles, but a time-bound implementation programme should be drawn up at the earliest.

Harmonisation of Legal and Regulatory Positions with Accounting Standards

ICAI should also continuously hold dialogues with regulatory bodies and take early action for formulation or implementation of standards in developing areas and work with such agencies to bring about change in policy or legal provisions leading to robust accounting, disclosure and presentation norms and to remove disparities, if any, between legal provisions, policies and recommended accounting treatment. These agencies should

also provide early responses and facilitation in this direction.

Compliance Monitoring Programme

The Financial Reporting Review Board established by ICAI has commenced the process of monitoring compliance by reporting entities. It has recommended action to the authorities who need to initiate action where gross non-compliances are brought to their notice by the FRRB.

Monitoring of compliance with Accounting Standards by the Reserve Bank in respect of banks and financial institutions regulated by it and IRDA in respect of insurance companies regulated by it would be useful and needs to be continued. Where there are interpretational issues in respect of any standard or in matters where there are no standards, the regulator should take up such issues with the ICAI on an on-going basis.

Compliance Guidance/Training Programmes

ICAI has been conducting training programmes for its members and also for accountants in the industry. It should continue to do so and take steps to enhance and broaden the scope, possibly, together with regulators, to impart more formalised training to preparers of financial statements.

As the standards become more complex, the need will arise for guidance, both for the preparers of financial statements as also for those who audit them, on the application of the standards. It is, therefore, necessary that ICAI increases the scope and frequency of its training programmes on the implementation of Accounting Standards.

ICAI should consider focussing more on the practical aspects of applying standards. Some of the standards are of recent origin and may require more guidance in implementation. ICAI should establish a mechanism where members who implement standards can approach for advice. ICAI has different mechanisms to address issues like Expert Advisory Committee, but a more informal approach ought to be encouraged, ICAI should also conduct special programmes for educating members on IFRSs and their applications as also US GAAPs to provide broader outlook to its members.

7.2 Auditing Standards

Convergence with ISAs

Notwithstanding the efforts being made by AASB to achieve full convergence with the international standards at the earliest, the road to convergence is difficult. Whereas the extensive requirements of the new Standards could have implications in terms of escalation in the costs of audit, some firms might find it difficult to persuade their clients for increasing the audit fees. Further, a big effort would also be required both at the level of the Institute as well as at the level of these individual firms to not only equip the latter with the requirements of the new Standards, but also give up their old methodologies and fall in line with the new audit techniques. This is also aggravated by the fact that at the international level also, the auditing standards are undergoing changes very frequently. The difficulties notwithstanding, convergence with the international standards has to be pushed forward and in future, EDs must be issued co-terminus with the EDs issued by IAASB.

The omission of a specific reference to 'Public Sector' in Standards on Auditing issued by AASB under the Clarity format needs reconsideration, particularly in view of the significant development that the INTOSAI is using ISAs as a basis for its Financial Audit Guidelines. Though generic guidance regarding specific aspects of public sector has been incorporated in the standard itself, but explicit reference to public sector would go a long way because ultimately these standards would also form the basis for auditing public sector by C&AG of India in the larger context.

Implementation of Auditing Standards

The Indian auditing scene is marked by the presence of a large number of small and medium practitioners. Given their limited resources and need to provide service in multiple aspects of the practice, these practitioners are bound to face difficulties in keeping pace with the fast-changing auditing literature and the resultant changes to the audit methodology. A seamless integration of these small and medium practitioners in the Institute's efforts to make the auditing profession in India truly benchmarked with international practices is, therefore, quintessential for success of these efforts. For this purpose, the Institute needs to adopt a three-pronged strategy. The first part of the strategy being bringing out more technical guidance and other literature to help the practitioners not only understand the new auditing standards and aspects relating to their practical implementation but also appropriately appreciate the need for these changes. AASB has already initiated projects on bringing out implementation guides for its proposed Standards on risk-based audits and quality control in audit firms. The second part would be organising training programmes, conferences and such other programmes on the new auditing literature and methodology, which would help practitioners not only unlearn the old concepts and learn new ones, but also provide a platform for the Institute and the members to interact and understand the problems, apprehensions and expectations from each other and possible solutions thereto. However, with the Institute being the second largest accountancy body in the world with a membership of nearly 1,50,000 spread out over an extensive geographical area, reaching out to them and overcoming their professional, social, cultural and age prejudices and pre-conceptions, would require concerted, well-planned and, above all, patient efforts on the part of the Institute. The third and the final part would be to send a strong message among the practitioners that there is no option but to comply with the new requirements if they really want to contribute to as also share the fruits of the economic growth of the country. It should be clearly demonstrated that the delinquents and the errant would not be let off lightly. This can be ensured by strengthening the quality review and the disciplinary process.

Strengthening Peer Review

The peer review process is aimed at encouraging compliance with the auditing standards. A closer look at the data available with the Institute makes it clear that even for a significant proportion of Stage I and Stage II Practice Units, the actual peer review remains to be completed. ICAI needs to examine the causes of these delays to ensure the continuous efficacy of the process.

The Institute should not also lose sight of the Stage III Practice Units, which comprise auditors of small and medium enterprises. The importance of the Stage III auditors and their clientele in economic development of the country should not be underrated. The small and medium enterprises can also be said to involve public interest given the fact that they also use public funds and other resources in the form of loans from banks, *etc.* Further, gaps in

their accounting concepts and systems, existence of a large number of related parties in the form of individuals, weaker internal control systems, and above all, a fairly free operating environment, without much legal and regulatory oversight, *etc.*, make it all the more important that their audits are done carefully. Another reason for keeping a close watch on the quality of audits of small and medium enterprises is the fact that their audits are done mainly by small and medium audit firms (SMPs), a segment of auditors which is typically plagued by issues such as inability to keep up with the technical pronouncements of the Institute on a regular basis, inadequate staff and failure to provide them proper training and mentor them, over-familiarity with/financial over-dependence on a few clients leading to potential independence threats, *etc.* Moreover, attestation services performed by a chartered accountant holding certificate of practice ought to be a subject matter of review in the larger public interest. While these are valid considerations, until the resources of ICAI are significantly enhanced, it may be desirable to give priority to stage I and stage II Practice Units where large public interest is involved.

There is a feeling that in some cases because of restrictions on cost, the time devoted to the peer review is inadequate. Some alternative method of financing the cost has to be examined so that the adequacy of the peer review is not compromised.

An Independent Oversight Mechanism

The Chartered Accountants Act, 1949 has recently been amended to set up the Quality Review Board (QRB) with the Central Government having a majority (six out of eleven members including the Chairman to the Board) representation thereon and the representation of the Council of the ICAI being lesser than that. Such a constitution of the QRB has definitely sent positive signals all across as to the Board's commitment to a fair and transparent quality review process of audit firms. It is, therefore, essential that the Government and the Institute ensure that the Board starts functioning at the earliest.

The main issue in the above context is clarifying the exact role of the QRB, whether it would be advisory or regulatory in nature. It is felt that to be really effective, it would be essential for the QRB to play a more pro-active role as an independent oversight body for the auditing profession in India, as has become the norm in most of the developed countries. Such an independent oversight body would increase the credibility of the work done by the Indian audit firms, at the global level.

The Board of Discipline and the Disciplinary Committee

With a two-layer disciplinary process, and with the Disciplinary Committee (having Government nominees on board in terms of the provisions of the Chartered Accountants Act, 1949) being bestowed more powers than the Board of Discipline, it is believed that the process of reining in errant members would be more rigorous and strict and would also cut down on the time factor. Since the nominations to the Board of Discipline and the Disciplinary Committee have already been made by the

Institute and the Government, they should now accelerate the process of making the Board and the Committee functional. It is also suggested that until the current backlog of disciplinary cases is eliminated, complaints received from regulatory authorities and government entities like banks, where greater public interest is involved, be dealt with on a fast-track basis.

Enforcing Stricter Reporting Requirements for Listed Companies

The Listing Agreement of the SEBI has been instrumental in improving and strengthening the reporting and disclosure practices among the listed entities. It requires the companies to furnish details regarding audit qualifications, *viz.*, the reason for the audit qualification in their accounts, the reason for the company failing to publish accounts without audit qualifications, and the time within which the company will remove the qualification and publish accounts without qualification. Further, SCODA, in August 2002 also recommended three things. First, that the stock exchanges should be required to inform SEBI in cases where companies fail to remove audit qualifications; second, that SEBI may constitute an Advisory Committee to examine the cases reported by the stock exchanges where the companies have failed to remove audit qualifications, and, third, that SEBI may refer the matter to the Department of Company Affairs (now the Ministry of Corporate Affairs) to initiate necessary action under the Companies Act, 1956 and also to the ICAI in cases where actions are required against the auditors of the company. With this kind of a requirement in the Listing Agreement, SEBI has tried to build in a regulatory framework akin to the SEC in the US, wherein the SEC does not accept qualified audit reports of companies.

The path of 'no qualified audit reports' approach is, however, like a double-edged sword and, therefore, needs to be tread cautiously. Whereas, on the one hand, it would act as a strong deterrent to the companies indulging in what is called 'earnings management' and 'creative accounting', on the other hand, the inability of the auditor to issue qualified audit reports can lead to deadlocks with managements in case of genuine differences of opinion, which normally results in resignation of the auditors without the issuance of the audit report. In the extreme cases, such inability may also lead to impairment of auditor's independence. It may also be noted despite SEC's refusal to accept qualified reports, there has been a slew of re-statements in the last five years or so by the listed companies in the USA, indicating need for some checks and balances in the SEC's policy.

Incidentally, SCODA had, at its December 2006 meeting, recommended that the auditors of the listed companies may be required to submit to SEBI financial statements containing audit qualifications and that, to this effect, SEBI may write to the ICAI requesting them to advise its members suitably. This recommendation needs to be implemented in the right earnest.

Further, SCODA's suggestion made at its meeting held in January 2007 'to amend Clause 41 of the listing agreement to make it mandatory for listed companies to ensure that their auditors submit the Annual Financial Statements to SEBI, along with the Auditor's Report wherever the same are qualified by the auditors' needs closer examination as to the actual follow-up of such a requirement. Guidelines may be prepared for determination of materiality of audit qualification having regard to following major areas:

(i) Where financial statements do not give a true and fair picture of the financial position of the company;

(ii) Non-observance of statutory provisions which may lead to imposition of penalties; and

(iii) Absence of information due to which auditors were unable to express an opinion or instances where auditors have been misled.

Access to Working Papers

Keeping in view the global environment and emergence of large corporate entities in India, the Panel endorses the recommendation of SEBI that, where a company has a material subsidiary whose audit has not been done by the principal auditor, the principal auditor should have the obligation to review the working papers of the other auditors who have audited the financial statements of such subsidiaries.

Functional Independence to the Auditing and Assurance Standards Board

To maintain the credibility and continuing relevance of the profession to the society, it is essential that a message is sent to the stakeholders that the Institute exists to serve the public interest. It is also, similarly, important to demonstrate that the auditing standards that are used by the auditors in carrying out audits of financial statements are to protect and serve the public interest and not to protect the auditors or help them shirk their responsibilities. As of date, though the standards are formulated by the AASB, the same are finally subject to the approval of the Council of the ICAI, which is the supreme body in the Institute, with a majority representation from practicing chartered accountants. It is, therefore, essential that, as is the world-wide phenomenon today, functional independence is given to the Auditing and Assurance Standards Board *vis-à-vis* the Council of the Institute by making it the final authority for drafting and issuance of the Standards and the Council confining itself to the administrative, but not functional, control of the AASB.

Rationalising and Strengthening Auditor Independence

The Companies Act, 1956 contains stringent provisions to protect the financial/personal independence of the auditors. The Institute, too, in addition to the fundamental requirements in a number of clauses in the two Schedules to the Chartered Accountants Act, 1949 which again are explicitly or implicitly aimed at protecting the independence of the auditors, has issued a number of self-regulatory measures for its members. One such measure is restricting the fees from one client to 40 per cent of the total revenues of the firm. Having regard to the growth of the auditing profession and changes in the economics of audit firms and operating environment of the clients, it is felt that the limit of 40 per cent is too large. The independence of the auditor may actually, or apparently, be jeopardised by the time the limit of 40 per cent is reached. It is, therefore, suggested that the limit be reduced to 25 per cent.

Free Flow of Information Among Different Players in the Regulatory Framework

Business enterprises today are functioning in an expanded regulatory regime, especially, those functioning in the corporate form and/or those which involve large public interest, for example, banking companies, insurance companies, or *per se* companies listed

on stock exchanges. The Ministry of Corporate Affairs, through its Registrar of Companies, calls for a number of documents to be submitted by the companies, including their financial statements and the related audit report. Similarly, the Reserve Bank as well as the IRDA also require a number of returns, containing vast amount of information, to be filed by the entities falling under their regulatory regime. In the same way, the SEBI, through means of the various requirements in the Listing Agreement, requires all listed companies, to submit financial and other information periodically.

In addition to the filing requirements, certain regulators, for example, the Reserve Bank undertakes inspections of banks. It would be beneficial if there is a free exchange of information between the different players in the legal and regulatory framework, especially, in relation to financial irregularities found by them.

7.3 Corporate Governance

(i) Investor education can play a key role in spreading awareness about exercise of their rights and impact on board governance. Work in this direction is already being done by the various concerned authorities, which needs to be taken up on a larger scale and reach. A co-ordinated approach amongst authorities can further enhance effectiveness of efforts in this direction. (refer Principle IIC, IIIA).

(ii) It has been observed that presently the participation by shareholders in decision-making is somewhat constrained due to their inability to be present for the AGM/EGMs, lack of understanding about issues, absence of co-ordination amongst themselves due to their dispersed geographical spread (refer Principle IIC). Certain steps like introduction of postal ballot for voting for some decisions, provision for proxy voting, *etc.*, have already been taken to obviate the need for physical presence of the shareholders. Following measures can also be considered to ensure greater shareholder participation:

a. holding of AGM at a place where majority of shareholders are resident;

b. explore alternate methods for voting which are convenient to shareholders (refer Principle IIC);

c. Investor associations can play an active role in providing a platform for co-ordination amongst investors. There is a need to have a larger number of credible investor associations and encourage interaction amongst them. At the same time, there should be checks in place to avoid misuse of such forums.

(iii) Institutional Investors need to be encouraged to declare their voting policy and to effectively participate in the corporate decision-making. Institutional Investors are expected to have better knowledge and understanding of affairs of the company. There is a need to initiate dialogue with the industry to develop the awareness about the contribution that institutional investors can make in the corporate governance of a portfolio company. Possibility of stipulating specific requirements either as good practice or mandatory requirements may be explored (refer Principle IIF, IIG).

(iv) The present corporate governance framework for the listed companies attaches a lot of importance to the role of

independent directors. However, there are no mandatory requirement pertaining to the tenure of their directorship. It is felt that to ensure the independence of independent directors is maintained in spirit, an upper limit on the tenure of independent directors should be provided for in the law. Further, the definition of independent directors could be included in corporate law in due course (refer Principle VIE).

(v) Credible institutional mechanism for the training of directors including the independent directors needs to be created on a priority basis. It is noted that steps have already been initiated in this regard by Ministry of Corporate Affairs as well as SEBI. ICAI and ICSI are also playing a crucial role in addressing this requirement (refer Principle VID).

(vi) To address concerns regarding ownership through cross-holding and opaque, non-transparent structures (refer Principle IID), there is a need for strengthening disclosure norms to bring about greater transparency in ownership structures. Further, stringent penal action needs to be enforced whenever such undesirable practices are unearthed.

(vii) There is a need for strengthening the enforcement mechanism by focusing on the efforts for tracking of defaulters or non-compliance by the corporate. These would act as deterrent for future non-compliance and also boost the confidence of the investors in the system.

(viii) Various provisions have been incorporated both under the Companies Act and the Listing Agreement to address conflict of interest issue in related party transactions. Information pertaining to material related party transactions is required to be in public domain. As a further step, appropriate penalties may be provided for in the law for non-compliance pertaining to related party transactions (refer Principle VID).

(ix) Penal provisions for fraudsters may be strengthened in corporate law by providing for the disgorgement of gains and confiscation of assets.

(x) India today boasts of a robust regulatory framework. There are, however, bottlenecks due to delays in the judicial process. The liquidation process is time-consuming and lengthy, thereby, hardly leaving any effective remedy for the stakeholders other than secured creditors. It has been observed that setting up of dedicated courts for certain areas has led to expeditious disposal of cases. Therefore, an effective institutional mechanism for time-bound resolution of cases needs to be created urgently (refer Principle IVB).

(xi) There is a need for evolving a corporate governance code for unlisted companies. This can take two forms:

- Unlisted companies can voluntarily evolve and adopt a code of corporate governance. Trade Associations like CII, FICCI and

ASSOCHAM can play an important role in this report.

- A separate Corporate Governance Code for unlisted companies may be brought out under the Companies Act, by the Ministry of Corporate Affairs which takes into account the interest of stakeholders in such companies. The Ministry can also consider mandating, in respect of unlisted companies of above a particular size, compliance with applicable provisions of Clause 49 of the Listing Agreement. Companies Act would need amendment in this regard (refer Principle IA).

(xii) In the case of mergers and amalgamations, role and responsibility of Ministry of Corporate Affairs *vis-à-vis* courts may be reviewed, particularly with reference to valuation and interest of minority shareholders.

(xiii) In terms of the recommendations made by the Narayana Murthy Committee, certain requirements of Clause 49 of the Listing Agreement were non-mandatory. It was probably hoped that many companies would move, over time, towards complying with the non-mandatory requirements. Four years have lapsed since the recommendations of the Committee were implemented. At present, the listed companies are required to disclose the extent to which the non-mandatory requirements have been adopted. It is recommended that the listed companies may be required to also disclose the reasons for non-compliance of non-mandatory requirements (refer Principle VID).

(xiv) Presently, in terms of Clause 49 of the Listing Agreement, the requirement to establish whistle-blower mechanism is not mandatory and depends on discretion of the companies. Four years have passed since this non-mandatory requirement was introduced. It may, therefore, be worthwhile to gather information on the experience of the companies which chose to implement this mechanism so far and consider further course of policy change, if any, in this area (refer Principle IVE).

(xv) Recent developments in the derivatives market have brought to the forefront the importance of risk management. There is a need for strengthening the existing framework with regard to risk management in the listed companies. Introducing the requirement of having Risk Committees in the Listing Agreement can be specifically explored in this regard (refer Principle VID).

(xvi) There is a need for greater disclosure and publicity of CSR (corporate social responsibility) initiatives by the corporate sector. This would put peer pressure on companies inactive in this area. Industry groups and chambers of commerce like FICCI and CII can play an important role in this regard (refer Principle IVA).

(xvii) Impact of the new Competition Act on the markets for corporate control needs to be studied and suitable action taken to ensure that such markets function in an efficient and transparent manner (refer Principle IIE).

(xviii) While international practices and developments have apparently been factored into the evolution of corporate governance framework in India, it is essential that learning from the experience of other countries should be a dynamic process and not a static one. The corporate governance code should be constantly reviewed in light of the ever-changing global scenario.

7.4 Payment and Settlement Systems

Systemically Important Payment Systems

Settlement in Central Bank Money

At present, High Value clearing takes place at 27 places. At 17 centres where the Reserve Bank manages the clearing, the settlement of High Value clearing takes place in the current accounts maintained by the participant banks with the Reserve Bank. At other centres, the settlement banks are commercial banks managing the clearing houses. The settlement banks in these cases are major public sector banks. In respect of the settlement which takes place in the commercial bank money, the risk management measures need further review.

Completion of Daily Settlements in the Event of an Inability to Settle by the Participant with the Largest Single Settlement Obligation

The High Value clearing which settles on a multilateral net settlement basis does not have any arrangement to ensure completion in the event of an inability to settle by the participant with the largest single settlement obligation. Settlement risk in this system is addressed through a mechanism of partial unwind. The Reserve Bank should consider migrating all high value transactions to secure electronic channels like RTGS and NEFT.

Security and Operational Reliability of the SIPS

In the case of RTGS system, the on-city hot back-up site is in place. BCP and DR arrangements are in the process of implementation. Data centre of Tier IV standard of Uptime Institute is being set up at three different sites. The RTGS system currently does not have a dedicated off-site DR site. Once implemented, the site would provide high degree of security and operational reliability.

Efficient Use of SIPS

Though the Reserve Bank is not charging any processing fees, the RTGS system charges are still priced relatively higher by banks for customer transactions as compared to charges for clearing paper-based instruments. The level of utilisation of the electronic payments infrastructure has been sub-optimal. The service charges being levied by banks from general public are relatively high. The Reserve Bank has initiated steps to collect the details of charges from banks and place them on the website to bring transparency and encourage competition among banks. It has issued a directive under the Payment and Settlement Systems Act, 2007 indicating the maximum charges which could be levied on the customers by banks for electronic payments and collection of outstation cheques. Steps may be taken to optimise the utilisation of electronic payments infrastructure and reduce the charges for the same.

Governance Arrangements for SIPS

The Reserve Bank has published a document highlighting its vision of payment and settlement system, but is yet to clearly disclose publicly its role with respect to SIPS. A document on this may be published by the Reserve Bank.

The decisions taken at the Standing Committees of various SIPS should be communicated to the members more promptly.

Retail Payment Systems

The current low utilisation of the electronic payments infrastructure can be increased with the use of technology to make the facilities more accessible to the customers. Enabling usage of these facilities on mobile devices, which have very high penetration levels, could result in a large portion of the population gaining access to these facilities. Mobile devices are used for small value money transfers. Development of fund transfer or payment system through mobile phones would not only allow reduction in the transaction costs, but would potentially also allow use of these facilities by a large unbanked segment. The solution will be to expand the network connectivity of branches in rural and semi-urban areas so that customers in these areas can utilise the electronic payment infrastructure. This would allow the benefits of technology to trickle down the pyramid and allow the banking community to develop products which currently might be unfeasible or un-profitable. The Panel notes that the Reserve Bank has issued operating guidelines on mobile payments in India in October 2008.

Central Counterparties (CCIL)

Measurement and Management of Credit Exposures

There is no provision for re-computation of margin requirement for outstanding trades by intra-day valuation of outstanding trades for the CBLO and forex segments. CCIL may endeavour to develop capacity to measure intra-day exposure and margin requirement (based on intra-day exposures) for government securities, CBLO and Forex segments.

Margin Requirements

Under the Recommendation 4, CCPs need to validate that the models and parameters used to determine the margin levels are consistent with the intended coverage and that the same should be reviewed and validated frequently. Back-testing for CBLO is a must to assess the associated risks as well as adequacy of margins. However, back-testing model is not in place for CBLO segment. In the CBLO segment, CCIL needs to develop a model for back-testing for margining to ascertain the adequacy of margins collected.

Adequacy of Financial Resources

On occasion, the largest exposure in the government securities, CBLO and forex settlements exceed the liquid financial resources at the command of CCIL. Hence, there is a need for the CCIL to have adequate financial resources. The Panel recommends that the:

1. CCIL can arrange for additional liquidity, *i.e.,* additional lines of credit.
2. A debit cap already exists in the US dollar leg of US dollar-INR segment of CCIL. A similar cap can be fixed for the exposure of CCIL in government securities and CBLO segments. The amounts exceeding the debit cap can be settled by CCIL on a DVP I basis, directly on RTGS. However, in view of the quantum increase in the volume of trades in the government securities markets and the fact that banks are mandated to operate through CCIL, the implementation of this recommendation should duly consider that the debit cap does not hamper smooth trade and settlement operations in the government securities market.
3. CCIL can settle through continuous settlement on the RTGS. This would require that CCIL is granted full membership of RTGS with IDL support.
4. CCIL may be granted a Limited Purpose Banking license, so that they would be able to approach the Reserve Bank or the market for liquidity by repo arrangements.

CCIL needs to develop stress-testing models for the CBLO segment. Further, in the forex segment, CCIL may evolve a clear and transparent policy to ensure prompt actions (like calling for additional resources, time and manner of collection, *etc.*) are taken in cases when stress-test indicates that resources are inadequate.

Default Procedures

Though default procedures are clearly laid out in CCIL's bye-laws, rules and regulations and the intended actions in this regard are well-supported by the bilateral contract between the members and CCIL which is legally enforceable, the default procedures are required to be supported by a policy. Further, there is a lack of clarity on the eventuality of liquidating US dollar assets or other securities in case the need arises. The Panel recommends that CCIL may evolve an objective policy on the modalities of liquidating the default position to reinforce the established default procedure for both CBLO and forex segments.

Money Settlements

The detailed processes for monitoring exposures are not in place. CCIL may develop processes for monitoring of settlement bank risk for CBLO and forex segments.

Transparency

Stress-test methodology and the results of stress-tests done by the CCIL are not disclosed to the members/public. CCIL may consider making public stress-test methodology and, if feasible, also the results. Further, they may endeavour to provide public information apart from English, in local languages also.

Equities Market

Legality of Netting and Settlement Finality – need for amendment in Securities Contracts (Regulation) Act, 1956

SCRA is a special statute for regulating contract in securities in the Recognised Stock Exchange (RSE). Section 9 of SCRA empowers the RSE (with the approval of SEBI) to make bye-laws for the regulations and control of contracts in securities. Section 9(2)(b), (k) and (n) of SCRA empowers RSE to make bye-laws for settlement of contracts, the delivery of and payment for securities, the consequences of default or insolvency on the part of a seller or buyer or intermediary and procedure for the settlement of claims or disputes.

Section 8A(1) of SCRA empowers RSE with the prior approval of SEBI to transfer the duties and functions of a clearing house to a clearing corporation for the purpose of periodical settlement of contracts and differences thereunder and the delivery of, and payment for securities. The bye-laws and rules of the RSE made under SCRA are required to be published in the Official Gazette. To that extent, in a way, they acquire the statutory flavour as held by the Supreme Court in Bombay Stock Exchange Vs Jaya I. Shah and another (2004) 1 Supreme Court Cases 160. The bye-laws and rules of the RSE or its clearing corporation provide under their framework, various operating rules of governing the transactions that are taken up for settlement such as settlement on netted basis, rules regarding close-out of the transactions, default handling procedure, *etc.* Every contract note issued to a constituent contains a specific provision that 'the contract is made subject to

the rules, bye-laws and regulations and usages of the RSE'. Thus, the contract in securities in RSE are governed by provisions of SCRA or bye-laws made thereunder, except the cases where the SCRA or bye-laws are silent, in such eventuality, the general law of contract will be applicable.

In the event of a winding-up of a stock-broking company, these rules of RSE in respect of settlement obligations are applied and collaterals of the failed entity, deposited with RSE towards its dues, are appropriated in terms of the provisions of the bye-laws of RSE and settled as against the claims of the liquidator. Since these transactions are netted, any unwinding of these transactions could lead to catastrophic situation in the RSE. There is no express bar on liquidator under the extant insolvency laws or income tax authorities to avoid such contracts and it is debatable whether the bye-laws of RSE could preclude the applicability of insolvency or priority provisions or provisions which bars fraudulent transfers under substantive laws, such as provisions of Companies Act, Income Tax Act, *etc.* This issue has become more pronounced, especially in the light of the recently passed legislation, the Payment and Settlement Systems Act, 2007 which specifically provide for legal recognition to the netting procedure and settlement finality by provisions made in the parent Act instead of leaving it to be made through sub-ordinate legislations such as bye-laws and regulations of RSE. However, there is hardly any case where the netting or finality of settlement in RSE has been successfully challenged. To put the matter beyond any doubt, it is felt that it may be desirable to incorporate specific clarificatory provisions in the SCRA to provide for the following:

i) The payment obligations and settlement instructions in respect of securities transactions in RSE/Clearing Corporation among the members or clients may be determined in accordance with netting (or gross) procedure as may be approved by SEBI;

ii) Such netting procedure shall have affect notwithstanding anything to the contrary contained in any other law;

iii) A settlement affected under such procedure shall be final and irrevocable;

iv) Where a member of RSE or Clearing Corporation is declared as insolvent or is dissolved or wound-up, then notwithstanding anything contained in any other law, the order of adjudication or dissolution or winding-up, shall not affect any settlement that has become final and irrevocable and the right of the RSE or Clearing Corporation to appropriate any collaterals or deposits or margins contributed by the member or client towards its settlement or other obligations in accordance with bye-laws of RSE/Clearing Corporation; and

v) Settlement, whether net (or gross), shall be final and irrevocable as soon as the money, securities, or derivatives or other transactions payable as a result of such settlement is determined, whether or not such money, securities, or derivatives or other transactions is actually paid.

Funds Settlement – Need for Promoting Electronic Funds Transfer Mechanisms

Settlement for transactions is effected on T+2 basis. Most of the securities traded in stock exchanges are settled in demat form through electronic book entry. Funds settlement takes place though multiple clearing banks. Payment through cheques has been the conventional and more prevalent mode of transfer of funds. The efficiency of the existing settlement system can be further enhanced by greater use of electronic funds transfer mechanisms like RTGS, NEFT,

etc. Lack of knowledge, cost of operations and lesser access and availablity appear to be the major reasons restricting larger use of electronic funds transfer mechanisms. There is a need for spreading awareness and encouraging use of high speed methods for movement of funds through the banking system. Incentivising the usage of the said methods as well as enhancing the reach and availability of these mechanisms (*e.g.,* enabling more branches, extending the availability of service window at existing branches beyond 3 p.m. to facilitate timely pay-in, *etc.*) also need to be considered.

7.5 Effective Insolvency and Creditor Rights Systems

Legal Framework for Creditor Rights

- The law should provide that the priority of charge for State dues should not operate in respect of prior mortgages created in favour of the secured creditors.
- Since there is no comprehensive credit guarantee scheme in the market, it would be worthwhile to improve the scheme notified under the DICGC Act, 1961.
- Though Competition Act requires reference by the Competition Commission to relevant authorities with regulatory powers, the concerned authorities' opinion will not be binding. Hence, the present status of the Reserve Bank and other regulators on matters of insolvency of banks and financial institutions is likely to be severely diluted raising concerns about stability. Under the provisions of Competition Act, every person or enterprise proposing to enter into a combination is required to give notice to the Commission before entering into a combination and wait for 210 days. This, apart from delaying the whole process, is likely to raise regulatory conflicts. This is applicable to all categories of banks including SBI, its associates and nationalised banks. Considering the gravity of the matter and the repercussions, it is necessary to have a serious look into the whole issue and if considered necessary, Central Government should give exemption to banks under Section 54 of Competition Act.

Security (Immovable Property)/(Movable Property)

- All States should take steps to remove restrictions on the creation of security interests in favour of banks and financial institutions in respect of lands belonging to specified categories by rescinding the revenue orders or by way of legislation, as the case may be.
- All States should enact legislation similar to the Himachal Pradesh Agricultural Credit Operations and Miscellaneous Provisions (Banks) Act, 1972 to facilitate an adequate flow of credit for agricultural production and development through banks and other institutional credit agencies.
- SARFAESI Act may be extended to cover the security interest in agricultural land beyond a specified holding (for example,

five acres, which would be exempt from the provisions of the SARFAESI Act).

- Stamp duties charged by the States should be nominal so that they do not hamper the transfer of immovable properties and interests therein. State Governments should look at property taxes as the main source of revenue, which they do not do at present.
- There should be a common legislation dealing with the creation and registration of security interests (collaterals) irrespective of the nature of the security and its location. However, such a move would require amendments to several legislations as well as the Constitution.
- There is a need to amend Section 14 of the SARFAESI Act for providing an enabling provision for district magistrates to delegate powers under the SARFAESI Act to other executive magistrates in the district, so that the delay in taking possession/control of the secured asset may be obviated.

Registry Systems

- The Central Registry envisaged under the provisions of the SARFAESI Act should be constituted to provide a good database on the creation of security interests/charges under the SARFAESI Act. This would also be an authentic source of public notice.
- The Central Registry should also be allowed to register all transactions creating the security interest (both in movable as well as immovable property) by entities/individuals other than banks/financial institutions. For this purpose, it would be appropriate to bring in a separate legislation in respect of the Central Registry. In course of time, the Central Registry (with adequate number of branches all over the country) should become the sole registry for the registration of all security interests relating to all kinds of interests over properties. Registries under the various statutes should be wound-up with suitable amendments to the respective Acts dealing with registration of security interest.
- There is an urgent need to computerise the record of Registrar of Assurances, to link them to the Central Registrar and provide an online search facility. Measures should be taken by all the State Governments in this regard.
- The online search facility has to be provided to verify the existence of a security interest over a patent, trademark or design after making payments online.
- There should be express provision for the registration of charges over trade marks under the Trade Marks Act, 1999.

Jurisdiction of Recovery Tribunals

- The number of DRT benches should be increased and a separate bench should be formed to deal with cases of large unpaid debts involving Rs. one crore and above.
- DRTs granting *ex parte* stay orders against the sale of securities by banks/financial institutions under section 13(4) of the SARFAESI Act are a matter of serious concern. A suitable provision to safeguard the interest of the lenders needs to be inserted into the SARFAESI Act.

Risk Management and Corporate Workout

- There is a need to grant priority (by statute) to the claim of banks or financial institutions in respect of the financial assistance given to rehabilitate a sick/weak company in financial distress. Such priority of claim should also extend while disbursing the assets in liquidation.

- NCLT, envisaged under the provisions of the Companies Act, should be made functional for significant improvement in the restructuring process.

Legal Framework for Insolvency

- In order to achieve a more transparent, predictable and sound insolvency system, ideally, there is a need to consolidate all the separate laws dealing with insolvencies into a single, uniform and comprehensive bankruptcy code with a common forum, irrespective of the entity involved in such insolvency. This would require amendments to the Constitution and various other laws.
- There is a need to provide for priority to the financial assistance given at the time of rehabilitation while disbursing the assets in liquidation, by inserting a special provision in the Companies Act. The law should provide for an extension of financial aid during the rescue process only to such an entity as would have suffered losses as a result of matters beyond its control and not to those entities who have suffered losses due to maladministration and recklessness.
- It is advisable to keep insolvency procedures of entities with systemic risk like the banks/insurance companies separate from the insolvency relating to ordinary companies.
- The law should provide for time-frame to conclude liquidation proceedings.
- The UNCITRAL Model Law on Cross-border Insolvency with suitable modifications should be adopted.
- The Companies (Second Amendment) Act 2002 provides for the formation of a rehabilitation and revival fund, the appointment of professionals as liquidators and the setting of NCLT with powers to deal with liquidation as well as rehabilitation/re-organisation of a company. So its operationalisation must be expedited.
- A separate bench of NCLT should be set up to deal with cases involving rehabilitation with loan amounts of Rs.10 crore and above.
- Companies often use the SICA to prevent creditors from proceeding against them. This is on account of statutory stay on initiation/continuance of suits or other legal proceeding once a reference is made to the BIFR. The Companies (Second Amendment) Act 2002 should be brought into operation to remedy this situation.

Provisional Measures and Effects of Commencement

- The Companies (Second Amendment) Act, 2002 should be quickly brought into operation as it seeks to expressly empower the court/liquidator to take relevant measures to protect the properties of the company during the proceedings.
- The law should provide for an automatic stay on creation of further liabilities on

or alienation of the company's assets, camouflaged as in the ordinary course of business, after the presentation of winding-up petition and service of its notice on the company. As a safeguard against abuse of such proceedings, the law should also provide for severe penalties against applicants for vexatious and mala fide petitions.

- Because of delay, the actual realisation of assets in liquidation is very low and there is a need to provide for an expeditious disposal mechanism for better valuation.

Creditors and the Creditors' Committee

- The law should provide for a Creditors' Committee at the initial stage of insolvency proceedings to consider the re-organisation of the company.
- There should be provision for an exclusive Creditors' Committee/assembly in insolvency laws, when the liquidator is not a creditor-nominated liquidator. Such committees should be empowered to participate in the decisions along with the liquidator and to file a report independently to the court/tribunal for improving liquidation proceedings.
- The law should provide for nominating unsecured creditors in the Creditors' Committee to ensure their participation, and for safeguarding their interest.

Administration

- The Companies (Second Amendment) Act, 2002 should be brought into operation quickly to empower the liquidator/court to protect the assets of the company and to even sell the undertaking as a going concern.

Treatment of Contractual Obligations

- There should be express provisions dealing with the treatment of set-off rights, netting and close-out contracts, personal contracts and labour contracts during re-organisation and winding-up.
- A limited extent of certainty has been introduced by way of the Payment and Settlement Systems Act, 2007 in respect of contracts in a payment system. However, the position regarding treatment of the OTC transactions in derivatives settled outside the 'payment systems' regulated under the Payment and Settlement Systems Act, 2007 especially the closing-out provisions in such contracts, is not yet clear. Appropriate provisions should be inserted in the Securities Contracts (Regulation) Act, 1956 to provide protection to the contracts entered on recognised stock exchanges because the provisions of the Payment and Settlement Systems Act, 2007 are not applicable to stock exchanges and clearing corporations of such stock exchanges regulated by SEBI and, therefore, the protection afforded to netting and close-out conducted on such stock exchanges.

Claims Resolution Procedures

- The implementation of the provisions relating to the receipt of claims and their process in liquidation needs to be improved to reduce delay.

Reorganisation Proceedings

- The Companies (Second Amendment) Act, 2002 should be operationalised to improve the rehabilitation mechanism available to sick industrial companies.
- The law should provide for setting time-limits for the approval of a rehabilitation plan. It would be necessary for the legal provisions to limit the number of plans that can be submitted for sanction before the court or provide for the automatic

lapse of a scheme if the same is not approved within a specified period, say within three months or six months from the date of submission.

- In rehabilitation proceedings under SICA, there should be a provision for the appointment of a creditor-nominated representative/committee.
- There is a necessity for incorporating provisions that would compel companies to report the implementation of their plan periodically to the Regional Director/ Department of Corporate Affairs (similar to the banks reporting to the Reserve Bank) till all the terms and conditions of the plan are substantially complied with and the court passes final orders to that effect.

International Considerations

- It is necessary to adopt the UNCITRAL Model Law on Cross-border Insolvency as suggested by various committees.

Implementation: Institutional and Regulatory Frameworks

Judicial Decision-making and Enforcement of Orders

- Certified copies of court orders should be made available online to improve the efficiency and utility of the system.
- The lack of judicial time, lack of expertise and consequent lack of proper appreciation of issues pertaining to insolvency, is causing delay in deciding the court cases. This can, to a large extent, be solved if the NCLT and the NCLAT are set up.