

# Handbook on adoption of governance enhancing and non-legislative elements of the draft Indian Financial Code

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# Chapter 1

## Background

The *Report of the Financial Sector Legislative Reforms Commission*, was submitted to the Central Government in March 2013. This report has recommended transformation of the legal foundations for Indian finance, through the enactment of the *IFC*. The *IFC*, establishes sound public administration and rule of law, and focuses financial agencies towards addressing market failures in the financial sector.

In its Eighth Meeting, the **Financial Stability and Development Council (FSDC)** decided, *inter alia* that,

*“all the financial sector regulators (including FMC) will finalise an action plan for implementation of all the FSLRC principles relating to regulatory governance, transparency and improved operational efficiency that do not require legislative action.”<sup>1</sup>*

The **FSDC** accordingly approved twelve steps (and one item on the early implementation of these steps) that each regulator will take for the implementation of the recommendations of the *Report of the Financial Sector Legislative Reforms Commission*, that would enhance governance, and not require legislative action at present.

At present, regulators implement many of these measures in sectoral silos with wide divergences in practices and minimum standards. Definitions of key terms and regulatory approaches vary across regulators and sectors. The absence of clearly articulated principles, and the excessive reliance on narrowly specified rules reduces predictability and consistency in rulemaking and enforcement. This in turn weakens the rule of law, and increases the likelihood and severity of market failures. An efficient financial regulatory framework should aim to harmonise processes and standards across sectors. This reduces problems of regulatory arbitrage, and also creates more robust mechanisms of governance.

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<sup>1</sup>Financial Stability and Development Council, Government of India, ed., *FSDC Meeting dated October 24, 2013, ANNEXURE B (Implementation of Non-Legislative Recommendations of FSLRC)*, Oct. 24, 2013.

The governance enhancing measures that flow from the **FSDC** and *Report of the Financial Sector Legislative Reforms Commission* resolution will increase the legitimacy of regulatory intervention. Regulators will clearly and transparently communicate their intervention to prevent or rectify market failures. Relying on this, regulated entities can provide valuable feedback while also planning for compliance costs. This in turn will make the task of regulation easier. There will be greater consistency in regulation and supervision across the Indian financial system, thus reducing the costs to the economy that are induced by the present financial regulatory architecture.

This Handbook is a guidance document on the implementation of the twelve steps. For each of these steps, this Handbook:

1. Provides an explanation of the measures to be taken, along with the rationale for implementing the measure;
2. Provides examples of best practices from India and other advanced jurisdictions which are already implementing such measures; and
3. Provides a brief checklist of specific actions that may be taken to ensure the full implementation of the step.

The bibliography of this Handbook contains a number of online references which are representative of best practices of good governance in other jurisdictions. They may be considered as standards which the Indian financial regulatory regime should also try to achieve.

# Chapter 2

## Consumer Protection

### 2.1 Introduction

The regulators, as per their *FSDC Resolution dated October 24, 2013*, decided that

*“There is a general need to improve the standards of protection available to consumers in the financial sector. With this view, the regulator should review its existing regulations, guidelines, circulars and other instruments pertaining to consumer protection and ensure that the following basic rights and protections are made available to all financial consumers:*

- 1. Financial service providers must exercise professional diligence while dealing with consumers, which implies a standard of skill and care that is commensurate with honest market practice, good faith and the different profiles of consumers.*
- 2. Unfair terms in contracts between financial service providers and consumers are void unless the provider can exhibit that the terms were expressly negotiated between the parties. A term can be deemed to be unfair if it causes significant imbalance in the rights of parties in the contract, to the detriment of the consumer, and is not needed to protect the legitimate interests of the financial service provider. The regulator may publish an indicative list of terms deemed to be unfair in certain contexts.*
- 3. Financial service providers are prohibited from indulging in unfair conduct, which includes conduct that is misleading or abusive, while dealing with consumers. The unfairness of any conduct would be gauged based on whether it interferes with the ability of the consumer to make an informed transactional decision.*
- 4. Personal information of consumers must be protected and held confidential. A financial service provider would not be permitted to disclose such information unless the prior written informed consent of the consumer has been obtained, or the disclosure is required under*

*law or in other identified circumstances.*

*5. Consumers must be provided with fair disclosure of information that is required to make an informed transactional decision. Appropriate disclosures need to be made both before the consumer enters into a financial contract and on a continuing basis.*

*6. Financial service providers must have in place appropriate internal mechanisms to redress consumer complaints and consumers should be adequately informed of such mechanisms.”<sup>1</sup>*

In short, the **FSDC** has agreed to harmonised standards of treatment with respect to all consumers in the following ways:

1. Requirement of professional diligence;
2. Protection from unfair terms in financial contracts;
3. Protection from unfair conduct, which includes misleading conduct and abusive conduct;
4. Protection of personal information and confidentiality;
5. Requirement of fair disclosure, both at the initial stage and on continuing basis; and
6. Requirement for each financial service provider to have an effective grievance redress mechanism, which is accessible to all its consumers.

The *FSLRC Analysis and Recommendations*, recommends giving certain *rights and protections* to all consumers. Existing markets for services follow varying standards of the *buyer beware* principle. This is insufficient protection for consumers of financial products and services. Empowering consumers with rights and protections is a higher standard of protection than what we see in these other markets.

The existence of *market failures* such as information asymmetries, market externalities and differences in the bargaining power of consumers and service providers create the need for regulatory intervention in markets. Specifically, protection of financial consumers is justified because of information asymmetries and differences in bargaining power.

Differences between the information available to consumers and financial services providers often allows the latter to take undue advantage of consumers. They could induce consumers to take decisions that are not in their own best interests. Similarly, financial service providers may use the differences in bargaining powers between them and consumers to create situations wherein they can impose unfair conditions on consumers.

The vulnerability of consumers reflects a major gap in Indian financial regulation. The **Financial Sector Legislative Reforms Commission (FSLRC)** has recommended

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<sup>1</sup>Financial Stability and Development Council, Government of India, see n. 1.



the adoption of a consolidated consumer protection framework for the entire financial system that will empower and require regulators to pursue consumer protection for the financial activities under their jurisdiction. It has recommended legislative action on two fronts: prevention and cure.

Prevention requires regulation-making and enforcement across the entire financial system from the viewpoint of consumer interests. For example, regulation may prohibit use of certain unfair terms of contract, which unreasonably favor the financial service provider at the expense of consumers.

Cure requires providing consumers access to effective grievance redress mechanisms. The *Report of the Financial Sector Legislative Reforms Commission*, has recommended a two-tiered system of grievance redress. First, there should be a mandated grievance redress mechanism within each financial service provider. Second, it has recommended an Ombudsman-like mechanism to redress consumer grievances.

These rights and protections for consumers can be voluntarily ensured by regulators by exercising the powers given under their respective statutes.

## 2.2 Requirement of professional diligence

### 2.2.1 Provisions

Section 85 of the *IFC*, (Requirement of professional diligence) places an obligation on all financial service providers to exercise professional diligence while entering into a financial contract or discharging any obligations under it.

This section defines *professional diligence* as the standard of skill and care that a financial service provider would be reasonably expected to exercise towards a consumer. This standard has to be commensurate with:

1. Honest market practice;
2. The principle of good faith;
3. The level of knowledge, experience and expertise of the consumer;
4. The nature and degree of risk embodied in the financial product or financial service being availed by the consumer; and
5. The extent of dependence of the consumer on the financial service provider.

### 2.2.2 Rationale

Consumers rely on financial service providers (a) to guide them through their transactional decisions, (b) to help them exercise their rights, and (c) to access promised benefits as per the contracts they enter into. The relationship between

a consumer and a financial service provider is a fiduciary relationship based on trust. Consumers typically do not have the ability to evaluate the practices of a financial service provider and enforce professional conduct.

Based on these considerations, *FSLRC Analysis and Recommendations*, states

“Consumers should be assured that any interaction that they have with a financial service provider will be carried out in good faith and in line with honest market practices. The level of diligence expected from a provider will vary depending on the honest practices followed in that line of business, the consumer’s knowledge and expertise level and the nature of risk involved in the financial service.”<sup>2</sup>

Though the present regulations in different financial sectors in India deal with the issue of treating consumers with diligence, there is no consistency in these regulations. Using the provision in *IFC*, to create a harmonised regulatory provision on professional diligence could minimise opportunities for regulatory arbitrage. This would help to ensure that consumers are treated with utmost diligence across all sectors.

### 2.2.3 International examples

#### Australia

Different countries enforce standards of professional diligence differently. Section 12ED of the *Australian Securities and Investments Commission Act 2001*, provides certain warranties in relation to the provision of financial services:<sup>3</sup>

1. In every contract for the supply of financial services by a person to a consumer in the course of a business, there is an implied warranty that:
  - (a) the services will be rendered with due care and skill; and
  - (b) any materials supplied in connection with those services will be reasonably fit for the purpose for which they are supplied.
2. If:
  - (a) a person supplies financial services to a consumer in the course of a business; and
  - (b) the consumer expressly or by implication, makes known to the person:
    - i. any particular purpose for which the services are required; or

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<sup>2</sup>Section 5.4 of the Financial Sector Legislative Reforms Commission, *FSLRC Analysis and Recommendations*, Mar. 2013, URL: [http://finmin.nic.in/fslrc/fslrc\\_report\\_vol1.pdf](http://finmin.nic.in/fslrc/fslrc_report_vol1.pdf), at p. 47.

<sup>3</sup>Australia, *Australian Securities and Investments Commission Act 2001*, 2001, URL: [http://www.comlaw.gov.au/Details/C2013C00438/Html/Text#\\_Toc364688227](http://www.comlaw.gov.au/Details/C2013C00438/Html/Text#_Toc364688227) (visited on Dec. 19, 2013).

- ii. the result that he or she desires the services to achieve;

there is an implied warranty that:

- (a) the services supplied under the contract for the supply of the services;  
and
- (b) any materials supplied in connection with those services;

will be reasonably fit for that purpose or are of such a nature and quality that they might reasonably be expected to achieve that result, except if the circumstances show that the consumer does not rely, or that it is unreasonable for him or her to rely, on the person's skill or judgment.

## United Kingdom

Section 3(3)(a) of *The Consumer Protection from Unfair Trading Regulations 2008*, defines a commercial practice that contravenes the requirements of *professional diligence* as an unfair commercial practice, which is prohibited. Section 2(1) of *The Consumer Protection from Unfair Trading Regulations 2008*, defines *professional diligence* as the standard of special skill and care which a trader may reasonably be expected to exercise towards consumers which is commensurate with either:<sup>4</sup>

1. honest market practice in the traders field of activity, or
2. the general principle of good faith in the traders field of activity;

### 2.2.4 Implementation

Every regulator should take the following steps to ensure their regulations require professional diligence in dealings with consumers:

1. Document the existing regulations that deal with the standards of diligence that the financial service providers in different sectors must ensure in their dealings with consumers.
2. Use the text of section 85 (Requirement of professional diligence) of *IFC*, to issue regulations requiring all financial service providers regulated by the respective regulator to follow professional diligence in their dealings with consumers.
3. Create and publish a statement on the consistency between the requirement of professional diligence enshrined in section 85 of *IFC*, and the existing regulations governing interaction between financial service providers and consumers. Based on this statement, make amendments to sector-specific

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<sup>4</sup>United Kingdom, *The Consumer Protection from Unfair Trading Regulations 2008*, 2008, URL: <http://www.legislation.gov.uk/ukxi/2008/1277/contents/made> (visited on Dec. 2, 2013).

regulations to ensure consistency of regulations with the overarching regulation requiring professional diligence in dealing with consumers.

## 2.3 Protection from unfair terms in financial contracts

### 2.3.1 Provisions

Section 86 of the *IFC*, (Unfair terms in financial contracts) states that an *unfair term* found in a *non-negotiated financial contract* will be void. This section provides definitions of *unfair term* and *non-negotiated contracts*. It also provides guidance on factors to be considered while determining whether a term is unfair.

1. This section defines an *unfair term* as a term that causes a significant imbalance in the rights and obligations of parties under a financial contract to the detriment of the consumer, and is not reasonably necessary to protect the legitimate interests of the financial service provider.
2. As per section 86, the following factors are to be taken into account while determining whether a term is unfair:
  - (a) the nature of the financial product or financial service dealt with under the financial contract;
  - (b) the extent of transparency of the term, which is determined on the basis of whether the term
    - i. is expressed in reasonably plain language that is likely to be understood by the consumer;
    - ii. is legible and presented clearly; and
    - iii. is readily available to the consumer affected by the term.
  - (c) the extent to which the term allows a consumer to compare it with other financial contracts for similar financial products or financial services; and
  - (d) the financial contract as a whole and the terms of any other contract on which it is dependent.
3. Section 86 of the *IFC*, empowers the Regulator to specify an illustrative list of terms that are considered to be unfair terms.
4. Section 87 of the *IFC*, (Non-negotiated contracts) defines a *non-negotiated contract* as a contract whose terms are not negotiated between the parties to the financial contract and includes a financial contract in which, relative to the consumer, the financial service provider has a substantially greater

bargaining power in determining the terms of the financial contract; and a standard form contract.

- (a) Section 87 of the *IFC*, defines a *standard form contract* as a financial contract that is substantially not negotiable for the consumer.
  - (b) As per section 87 of the *IFC*, even if some terms of a financial contract are negotiated, the financial contract may be regarded as a non-negotiated contract if this is indicated by:
    - i. an overall and substantial assessment of the financial contract; and
    - ii. the substantial circumstances surrounding the financial contract.
  - (c) In a claim that a financial contract is a non-negotiated contract, the onus of demonstrating otherwise will be on the financial service provider.
5. Section 86 of *IFC*, states that if a term of a financial contract is determined to be unfair, the parties will continue to be bound by the remaining terms of the financial contract to the extent that the financial contract is capable of enforcement without the unfair term.

### 2.3.2 Rationale

Financial service providers and their intermediaries often have significantly higher bargaining powers than consumers. As a result, consumers often have to accept contractual terms presented to them by financial service providers. As the understanding of many contractual terms requires specialised knowledge, consumers are often not able to understand the implications of contractual terms. They also do not have the opportunity to fully discuss and negotiate such terms. Consumers may therefore end up accepting unreasonable contractual terms that are not in their best interests. To prevent such abuse, *FSLRC Analysis and Recommendations*, states that unfair terms in financial contracts that have not been explicitly negotiated between the parties must be declared void.<sup>5</sup>

In India, a comprehensive, internally consistent approach to dealing with such terms is missing from legislations and regulations. The provisions of the *IFC*, provide a comprehensive approach to provide to consumers regulatory protection from unfair contract terms

### 2.3.3 International examples

#### Australia

Section 12BF of the *Australian Securities and Investments Commission Act 2001*, renders a term of a consumer contract void if the term is unfair, and the contract

<sup>5</sup>FSLRC, *FSLRC Analysis and Recommendations*, see n. 2, Table of Recommendations 5.6, p. 13.

is a standard form contract.<sup>6</sup>

Section 12BG of the *Australian Securities and Investments Commission Act 2001*, defines an *unfair term* as one (a) that would cause a significant imbalance in the parties' rights and obligations arising under the contract; (b) is not reasonably necessary in order to protect the legitimate interests of the party who would be advantaged by the term; and (c) would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on.

Section 12 BH of the *Australian Securities and Investments Commission Act 2001*, lists certain examples of unfair terms:

1. A term that permits, or has the effect of permitting, one party (but not another party) to avoid or limit performance of the contract;
2. A term that permits, or has the effect of permitting, one party (but not another party) to terminate the contract;
3. A term that penalises, or has the effect of penalising, one party (but not another party) for a breach or termination of the contract;
4. A term that permits, or has the effect of permitting, one party (but not another party) to vary the terms of the contract;
5. A term that permits, or has the effect of permitting, one party (but not another party) to renew or not renew the contract;
6. A term that permits, or has the effect of permitting, one party to vary the upfront price payable under the contract without the right of another party to terminate the contract;
7. A term that permits, or has the effect of permitting, one party unilaterally to vary financial services to be supplied under the contract;
8. A term that permits, or has the effect of permitting, one party unilaterally to determine whether the contract has been breached or to interpret its meaning;
9. A term that limits, or has the effect of limiting, one party's vicarious liability for its agents;
10. A term that permits, or has the effect of permitting, one party to assign the contract to the detriment of another party without that other party's consent;
11. A term that limits, or has the effect of limiting, one party's right to sue another party;

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<sup>6</sup>A consumer contract is a contract at least one of the parties to which is an individual whose acquisition of what is supplied under the contract is wholly or predominantly an acquisition for personal, domestic or household use or consumption. Australia, *Australian Securities and Investments Commission Act 2001*, 2001, URL: [http://www.comlaw.gov.au/Details/C2013C00438/Html/Text#\\_Toc364688227](http://www.comlaw.gov.au/Details/C2013C00438/Html/Text#_Toc364688227) (visited on Dec. 19, 2013)

12. A term that limits, or has the effect of limiting, the evidence one party can adduce in proceedings relating to the contract;
13. A term that imposes, or has the effect of imposing, the evidential burden on one party in proceedings relating to the contract;
14. A term of a kind, or a term that has an effect of a kind, prescribed by the regulations.

## United Kingdom

Section 5(1) of the *Unfair Terms in Consumer Contracts Regulations 1999*, defines the principles of deeming a term of unfair:<sup>7</sup>

1. If a contractual term has not been individually negotiated and
2. contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer.

Section 5(1) of the *Unfair Terms in Consumer Contracts Regulations 1999*, also provides definition of the phrase *has not been individually negotiated*:

1. A term is always to be regarded as not having been individually negotiated where it has been drafted in advance and the consumer has therefore not been able to influence the substance of the term.
2. Notwithstanding that a specific term or certain aspects of it in a contract has been individually negotiated, the regulations apply to the rest of a contract if an overall assessment of it indicates that it is a pre-formulated standard contract.
3. It is for any seller or supplier who claims that a term was individually negotiated to show that it was.

Schedule 2 of the *Unfair Terms in Consumer Contracts Regulations 1999*, sets out an indicative list of terms that would be unfair.

### 2.3.4 Implementation

Every regulator should take the following steps to ensure there are regulations against unfair terms of contract:

1. Document the existing regulations that deal with unfair terms of contract in the sectors regulated by the respective regulators.

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<sup>7</sup>United Kingdom, *Unfair Terms in Consumer Contracts Regulations 1999*, 1999, URL: [http://www.legislation.gov.uk/ukxi/1999/2083/pdfs/ukxi\\_19992083\\_en.pdf](http://www.legislation.gov.uk/ukxi/1999/2083/pdfs/ukxi_19992083_en.pdf) (visited on Dec. 2, 2013).

2. Use the text of sections 86 (Unfair terms in financial contracts) and 87 (Non-negotiated contracts) of the *IFC*, to issue a regulation prohibiting unfair terms contract in non-negotiated financial contracts. Every term in the regulation should be the same as that in these sections.
3. Specify by regulation, an illustrative list of terms that would be considered to be unfair terms. This list must be based on the observations and case laws in the regulated sector for each respective regulator, and application of the tests provided in section 86 of the *IFC*.
4. Create and publish a statement on the consistency between the protection against unfair terms of contract envisaged in section 86 of the *IFC*, and the existing regulations governing such terms in various sectors. Based on this statement, make amendments to sectoral regulations to ensure consistency of regulations with the overarching regulation protecting consumers from unfair terms of contract.

## 2.4 Protection from unfair conduct

### 2.4.1 Provisions

Section 89 of the *IFC*, (Unfair conduct prohibited) prohibits *unfair conduct* in relation to financial products or financial services.

1. This section defines *unfair conduct* as an act or omission by a financial service provider or its financial representative that significantly impairs, or is likely to significantly impair, the ability of a consumer to make an informed transactional decision. This conduct includes misleading conduct and abusive conduct.
  - (a) Section 90 of the *IFC*, (Misleading Conduct) defines *misleading conduct* as conduct of a financial service provider or its financial representative that is likely to cause the consumer to take a transactional decision that the consumer would not have taken otherwise, and involves providing the consumer with inaccurate information or information that the financial service provider or financial representative does not believe to be true; or providing accurate information to the consumer in a manner that is deceptive.
  - (b) Section 91 of the *IFC*, (Abusive conduct) defines *abusive conduct* as the “conduct of a financial service provider or its financial representative in relation to a financial product or financial service” that “involves the use of coercion or undue influence; and causes or is likely to cause the consumer to take a transactional decision that the consumer would not have taken otherwise.”



### 2.4.2 Rationale

Two factors should inform a consumer's decision to enter into a financial contract, or to exercise rights and avail benefits under a financial contract. First, such decisions should be fully informed. Second, such decisions should be free of undue influence. Financial service providers may take advantage of the information asymmetries and difference in bargaining power to indulge in conduct that forces the consumers into decisions they would otherwise not have taken. For example, since financial service providers almost always know more than the consumer about the financial product or service, it is easy for them to mislead consumers. As the *FSLRC Analysis and Recommendations*, states, consumers must be protected from such conduct.<sup>8</sup>

The *IFC*, provides protections to the consumer from any unfair conduct that is intended to unfairly influence the consumer's transactional decisions. This includes situations where a consumer's transactional decision is affected by:

1. **Misleading conduct:** Knowingly providing consumers with false information or information that is correct but is provided in a deceptive manner. Any failure to correct an evident and important misapprehension on the part of the consumer will also be covered under the law.
2. **Abusive conduct:** Use of coercion or undue influence to influence a consumer's transactional decisions.

### 2.4.3 International examples

Several jurisdictions across the world give protections against conduct that can be categorised as unfair conduct.

#### United Kingdom

Regulation 3 of *The Consumer Protection from Unfair Trading Regulations 2008*, prohibits unfair commercial practices. These include misleading actions and omissions, as well as aggressive commercial practices.<sup>9</sup>

Regulation 5 of *The Consumer Protection from Unfair Trading Regulations 2008*, defines *misleading action* as a commercial practice that:<sup>1011</sup>

1. Contains false information and is therefore untruthful in relation to certain matters related to the service, or if it or its overall presentation in any way

<sup>8</sup>See Financial Sector Legislative Reforms Commission, *Report of the Financial Sector Legislative Reforms Commission*, Mar. 2013, URL: [http://finmin.nic.in/fslrc/fslrc\\_index.asp](http://finmin.nic.in/fslrc/fslrc_index.asp), Table of Recommendations 5.5, p. 46.

<sup>9</sup>See United Kingdom, *The Consumer Protection from Unfair Trading Regulations 2008*, see n. 4.

<sup>10</sup>*Ibid.*

<sup>11</sup>*Ibid.*, The contents of Regulation 5 have been para-phrased in this Handbook.

deceives or is likely to deceive the average consumer in relation to any of the matters in that paragraph, even if the information is factually correct;

2. Causes or is likely to cause the average consumer to take a transactional decision he would not have taken otherwise;
3. Concerns any marketing of a product which creates confusion with any products, trade marks, trade names or other distinguishing marks of a competitor;
4. Concerns any failure by a trader to comply with a commitment contained in a code of conduct which the trader has undertaken to comply with, if the trader indicates in a commercial practice that he is bound by that code of conduct, and the commitment is firm and capable of being verified and is not aspirational.

Regulation 6 of *The Consumer Protection from Unfair Trading Regulations 2008*, defines *misleading omission* as commercial practices that:<sup>12</sup>

1. Omit material information,
2. Hide material information,
3. Provide material information in a manner which is unclear, unintelligible, ambiguous or untimely, or
4. Fail to identify its commercial intent, unless this is already apparent from the context.

Regulation 7 of *The Consumer Protection from Unfair Trading Regulations 2008*, defines *aggressive commercial practice* as a commercial practice that, taking account of all of its features and circumstances:<sup>13</sup>

1. Significantly impairs or is likely significantly to impair the average consumers freedom of choice or conduct in relation to the product concerned through the use of harassment, coercion or undue influence; and
2. Thereby causes or is likely to cause him to take a transactional decision he would not have taken otherwise.

*Coercion* includes the use of physical force. *Undue influence* means exploiting a position of power in relation to the consumer so as to apply pressure, even without using or threatening to use physical force, in a way which significantly limits the consumers ability to make an informed decision.

In UK, the *Financial Services and Markets Act 2000*, also protects consumers of financial products and financial services from *misleading statements and practices*.<sup>14</sup>

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<sup>12</sup>United Kingdom, *The Consumer Protection from Unfair Trading Regulations 2008*, see n. 4.

<sup>13</sup>*Ibid.*

<sup>14</sup>United Kingdom, *Financial Services and Markets Act 2000*, URL: <http://www.legislation.gov.uk/ukpga/2000/8/contents>.

## South Africa

The *Consumer Protection Act 2008*, prohibits *unconscionable conduct* and *false, misleading and deceptive representations*.<sup>15</sup>

1. Section 40 defines *unconscionable conduct* as use of physical force against a consumer, coercion, undue influence, pressure, duress or harassment, unfair tactics or any other similar conduct.
2. It is also unconscionable conduct for a supplier to knowingly to take advantage of the fact that a consumer was substantially unable to protect the consumers own interests because of physical or mental disability, illiteracy, ignorance, inability to understand the language of an agreement, or any other similar factor.
3. Section 41 prohibits directly or indirectly expressing or implying a false, misleading or deceptive representation concerning a material fact to a consumer; use of exaggeration, innuendo or ambiguity as to a material fact, or failure to disclose a material fact if that failure amounts to a deception; and failure to correct an apparent misapprehension on the part of a consumer, amounting to a false, misleading or deceptive representation, or permitting or requiring any other person to do so on behalf of the supplier. The section also lists a number of types of representations that may be false, misleading or deceptive.

### 2.4.4 Implementation

Every regulator should take the following steps to ensure there are regulations to protect consumers against unfair conduct:

1. Document the existing regulations that deal with unfair conduct in the sectors regulated by the respective regulators.
2. Use the text of sections 89, 90 and 91 of the *IFC*, to issue a regulation prohibiting unfair conduct by financial service providers or their representatives. Every term in the regulation should be defined in the same way as it is defined in these sections.
3. Create a statement on the consistency between the prohibition of unfair conduct envisaged in sections 89, 90 and 91 of the *IFC*, and the existing regulations governing such conduct in various sectors. Based on this statement, make amendments to sectoral regulations to ensure consistency of regulations with the overarching regulation prohibiting unfair conduct.

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<sup>15</sup>South Africa, *Consumer Protection Act 2008*, Mar. 29, 2009, URL: <http://www.info.gov.za/view/DownloadFileAction?id=99961> (visited on Dec. 2, 2013).

## 2.5 Protection of personal information

### 2.5.1 Provisions

Section 92 of *IFC*, (Meaning of personal information) defines *personal information* as any information that relates to a consumer or allows a consumer's identity to be inferred, directly or indirectly, and includes:<sup>16</sup>

1. Name and contact information;
2. Biometric information, in case of individuals;
3. Information relating to transactions in, or holdings of, financial products;
4. Information relating to the use of financial services; or
5. Such other information as may be specified by regulation.

Section 93 of *IFC*, (Principles governing use of personal information) requires a financial service provider to

1. Collect only relevant personal information relating to a consumer for the provision of a financial product or financial service;
2. Maintain the confidentiality of personal information relating to consumers and not disclose it to a third party, except if
  - (a) It has obtained prior written informed consent of the consumer for the disclosure, after giving the consumer an effective opportunity to refuse consent;
  - (b) The consumer has directed the disclosure to be made;
  - (c) The Regulator has approved or ordered the disclosure, and unless prohibited by the relevant law or regulations, the consumer is given an opportunity to represent under such law or regulations against such disclosure;
  - (d) The disclosure is required under any law or regulations, and unless prohibited by such law or regulations, the consumer is given an opportunity to represent under such law or regulations against such disclosure;
  - (e) The disclosure is directly related to the provision of a financial product or financial service to the consumer, if the financial service provider –
    - i. Informs the consumer in advance that the personal information may be shared with a third party; and
    - ii. Makes arrangements to ensure that the third party maintains the confidentiality of the personal information in the same manner as required under this Part; or

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<sup>16</sup>Financial Sector Legislative Reforms Commission, *FSLRC Draft Indian Financial Code*, Draft Law, Mar. 2013, URL: [http://finmin.nic.in/fslrc/fslrc\\_report\\_vol2.pdf](http://finmin.nic.in/fslrc/fslrc_report_vol2.pdf).

- (f) The disclosure is made to protect against or prevent actual or potential fraud, unauthorised transactions or claims, if the financial service provider arranges with the third party to maintain the confidentiality of the personal information in the manner required under this Part.
- 3. Make best efforts to ensure that any personal information relating to a consumer that it holds is accurate, up to date and complete;
- 4. Ensure that consumers can obtain reasonable access to their personal information, subject to any exceptions that the Regulator may specify; and
- 5. Allow consumers an effective opportunity to seek modifications to their personal information to ensure that the personal information held by the financial service provider is accurate, up to date and complete.

### 2.5.2 Rationale

Any information relating to *an identifiable person* belongs to that person and should be protected from unauthorised use. Financial service providers should therefore be restrained from collecting, using or disclosing any personal information belonging to consumers, except to the extent required for the purposes of carrying out their business or expressly permitted under a law. Consumers should also be able to access their personal information held by service providers and ensure that the information is accurate and complete. In the absence of such protections for personal information, some financial service providers may misuse this information by (a) selling it to third parties, (b) making it available to third parties who may want to use this information to cause harm to the consumer, or (c) just by violating the privacy of the consumer by making such information public.

India needs a consistent regulatory framework for protecting personal information across the financial system. The existing regulatory regimes may be brought together under the principles enunciated by the **FSLRC**. Such a consistent approach to protecting personal information would minimise regulatory arbitrage and give greater certainty to consumers in their interactions with the financial system.

### 2.5.3 International examples

Protection of personal information is ensured in most advanced jurisdictions. There are general privacy laws that protect such information, and there are also some sector-specific laws and regulations protecting personal information.

## United States

The *Gramm-Leach-Bliley Act*, addresses concerns relating to consumer financial privacy.<sup>17</sup> The Act requires financial sector regulators to frame regulations to carry out the Act's financial privacy provisions. The Act requires that financial institutions protect information collected about consumers.

Section 502 of *Gramm-Leach-Bliley Act*, states that, except otherwise provided, a financial institution may not, directly or through any affiliate, disclose to a non-affiliated third party any non-public personal information, unless such financial institution provides or has provided to the consumer a notice.

The section allows a financial institution to provide non-public personal information to a non-affiliated third party. This information can be given to perform services for or functions on behalf of the financial institution, including marketing of the financial institution's own products or services, or financial products or services offered pursuant to joint agreements between two or more financial institutions, if the financial institution fully discloses the providing of such information and enters into a contractual agreement with the third party that requires the third party to maintain the confidentiality of such information.

The section also allows certain general exceptions, such as

1. To effect, administer, or enforce a transaction requested or authorized by the consumer, or in connection with:
  - (a) servicing or processing a financial product or service requested or authorized by the consumer;
  - (b) maintaining or servicing the consumers account with the financial institution, or with another entity as part of a private label credit card program or other extension of credit on behalf of such entity; or
  - (c) a proposed or actual securitization, secondary market sale (including sales of servicing rights), or similar transaction related to a transaction of the consumer.
2. With the consent or at the direction of the consumer;
3. To protect the confidentiality or security of the financial institutions records pertaining to the consumer, the service or product, or the transaction therein;
4. To protect against or prevent actual or potential fraud, unauthorized transactions, claims, or other liability;
5. For required institutional risk control, or for resolving customer disputes or inquiries;
6. To persons holding a legal or beneficial interest relating to the consumer;

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<sup>17</sup>United States, *Gramm-Leach-Bliley Act*, 1999, URL: <http://www.gpo.gov/fdsys/pkg/PLAW-106publ102/html/PLAW-106publ102.htm> (visited on Dec. 20, 2013), Also known as the Financial Modernization Act of 1999.

7. To persons acting in a fiduciary or representative capacity on behalf of the consumer; or
8. To comply with Federal, State, or local laws, rules, and other applicable legal requirements; to comply with a properly authorized civil, criminal, or regulatory investigation or subpoena or summons by Federal, State, or local authorities; or to respond to judicial process or government regulatory authorities having jurisdiction over the financial institution for examination, compliance, or other purposes as authorized by law.

### 2.5.4 Implementation

Every regulator should take the following steps to ensure there are regulations to protect personal information of consumers of financial products or services:

1. Use the text of sections 92 and 93 of *IFC*, to issue a regulation protecting personal information of all consumers interacting with the financial sector regulated by the respective regulator. Every definition and obligation in the regulation should be the same as it is in these sections.
2. Document the existing regulations that deal with protection of personal information of financial consumers.
3. Create a statement on the consistency between the protection of personal information envisaged in sections 92 and 93 of *IFC*, and the existing regulations governing such information in various sectors. Based on this statement, regulators should make amendments to sectoral regulations to ensure consistency of regulations with the overarching regulation protecting personal information.

## 2.6 Requirement of fair disclosure

### 2.6.1 Provisions

The *IFC*, provides for initial disclosures as well as continuing disclosures.

1. Section 95 of *IFC*, (Initial disclosures) requires a financial service provider to ensure fair disclosure of information that is likely to be required by a consumer to make an informed transactional decision. Fair disclosure is when the information is provided:
  - (a) Sufficiently before the consumer enters into a financial contract, so as to allow the consumer reasonable time to understand the information;
  - (b) In writing and in a manner that is likely to be understood by a consumer belonging to a particular category; and

- (c) In a manner that enables the consumer to make reasonable comparison of the financial product or financial service with other similar financial products or financial services.
2. Section 96 of *IFC*, (Continuing disclosures) requires a financial service provider to provide a consumer that is availing a financial product or financial service provided by it. Such continuing disclosures should be provided within a reasonable time-period and in writing and in a manner that is likely to be understood by the consumer. The continuing disclosure should pertain to:
- (a) Any material change to the information that was required to be disclosed under section at the time when the consumer initially availed the financial product or financial service;
  - (b) Information relating to the status or performance of a financial product held by the consumer, as may be required to assess the rights or interests in the financial product or financial service; and
  - (c) Any other information that the regulator specifies by regulation.

### 2.6.2 Rationale

Information asymmetry between consumers and financial firms affects the quality of financial decisions made by consumers. Information asymmetry also increases with complexity, and as financial services become more complex, the dependence of consumers on the financial firm increases. One way to protect consumers is to ensure that they get the information they need to take good decisions in a form and manner they can understand and use.

A positive obligation imposed on financial service providers to provide consumers with all relevant information is beneficial to consumers. Consumers will receive all information that could be helpful in making an informed decision. This is an important way to protect consumers from the problem of information asymmetry. This should include disclosures required to be made prior to entering a financial contract. It should also include continuing disclosures regarding material changes to previously provided information or the status or performance of a financial product.

Disclosure requirements already exist in financial regulation in India. All regulators have fairly detailed disclosure requirements imposed on the financial services providers they regulate. What is missing is a comprehensive and consistent framework that defines the obligations for making disclosures. Primary laws do not contain such requirements, and there are various regulations requiring disclosures. Following the approach proposed in *IFC*, would help bring greater consistency and completeness in the disclosure regulations in financial regulation. It would ensure all financial service providers are bound by the same set of principles for making disclosures.



### 2.6.3 International examples

Disclosure requirements exist in many jurisdictions. Some examples are presented below:

#### Australia

Section 1013D of *Corporations Act 2001*, mandates the following statements in a Product Disclosure Statement, which is required as initial disclosure:<sup>18</sup>

1. a statement setting out the name and contact details of:
  - (a) The issuer of the financial product; and
  - (b) If the Statement is a sale Statement, the seller.
2. Information about any significant benefits to which a holder of the product will or may become entitled, the circumstances in which and times at which those benefits will or may be provided, and the way in which those benefits will or may be provided;
3. Information about any significant risks associated with holding the product;
4. Information about:
  - (a) The cost of the product;
  - (b) Any amounts that will or may be payable by a holder of the product in respect of the product after its acquisition, and the times at which those amounts will or may be payable; and
  - (c) If the amounts paid in respect of the financial product and the amounts paid in respect of other financial products are paid into a common fund any amounts that will or may be deducted from the fund by way of fees, expenses or charges;
5. If the product will or may generate a return to a holder of the product information about any commission, or other similar payments, that will or may impact on the amount of such a return;
6. Information about any other significant characteristics or features of the product or of the rights, terms, conditions and obligations attaching to the product;
7. Information about the dispute resolution system that covers complaints by holders of the product and about how that system may be accessed;
8. General information about any significant taxation implications of financial products of that kind;

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<sup>18</sup>Australia, *Corporations Act 2001*, 2001, URL: [http://www.austlii.edu.au/au/legis/cth/consol\\_act/ca2001172/](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/) (visited on Dec. 2, 2013).

9. Information about any coolingoff regime that applies in respect of acquisitions of the product (whether the regime is provided for by a law or otherwise);
10. If the product issuer (in the case of an issue Statement) or the seller (in the case of a sale Statement) makes other information relating to the product available to holders or prospective holders of the product, or to people more generally a statement of how that information may be accessed;
11. Any other statements or information required by the regulations;
12. If the product has an investment component the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment; and
13. Unless in accordance with the regulations, for information to be disclosed in accordance with paragraphs (2), (4) and (5), any amounts are to be stated in dollars.

This provision also empowers the regulator to create exemptions, to provide that particular information is not required either in a particular situation or generally, and to provide a more detailed statement of the information that is required either in a particular situation or generally.

Section 1013E of *Corporations Act 2001*, requires a Product Disclosure Statement to also contain any other information that might reasonably be expected to have a material influence on the decision of a reasonable person whether to acquire the product.<sup>19</sup>

## South Africa

Section 22 of *Consumer Protection Act 2008*, provides a right to information in plain and understandable language.<sup>20</sup> Plain language is deemed to have been used “if it is reasonable to conclude that an ordinary consumer of the class of persons for whom the representation is intended, with average literacy skills and minimal experience as a consumer of the relevant goods or services, could be expected to understand the content, significance and import of the notice, document or visual representation without undue effort.”<sup>21</sup> This determination is to be made with regard to (a) the context, comprehensiveness and consistency of the representation; (b) the organisation, form and style of the representation; (c) the vocabulary, usage and sentence structure of the representation; and (d) the use of any illustrations, examples, headings or other aids to reading and understanding.

<sup>19</sup>Australia, *Corporations Act 2001*, see n. 18.

<sup>20</sup>South Africa, see n. 15.

<sup>21</sup>See *ibid.*, Section 22.

## United Kingdom

The *Financial Conduct Authority Handbook*, Conduct of Business Sourcebook, regulation 4.5.2 requires firms to ensure that information given to consumers:<sup>22</sup>

1. Includes the name of the firm;
2. Is accurate and in particular does not emphasise any potential benefits of relevant business or a relevant investment without also giving a fair and prominent indication of any relevant risks;
3. Is sufficient for, and presented in a way that is likely to be understood by, the average member of the group to whom it is directed, or by whom it is likely to be received; and
4. Does not disguise, diminish or obscure important items, statements or warnings.

### 2.6.4 Implementation

Every regulator should take the following steps to ensure there are regulations requiring initial disclosures and continuing disclosures:

1. Document the existing disclosure regulations in the sectors regulated by the respective regulators.
2. Use the text of sections 95 and 96 of the *IFC*, to issue a regulation requiring initial disclosures and continuing disclosures by financial service providers and their representatives. Every definition and obligation in the regulation should be the same as that in these sections.
3. Create a statement on the consistency between the disclosure requirements envisaged in sections 95 and 96 of the *IFC*, and the existing regulations governing disclosures in various sectors. Based on this statement, regulators should make amendments to sectoral regulations to ensure consistency of regulations with the overarching regulation requiring initial disclosures and continuing disclosures.

## 2.7 Redress of complaints

### 2.7.1 Provisions

Section 98 of *IFC*, (Responsibility of financial service providers) requires each financial service provider to have in place an effective mechanism to receive and redress complaints from its consumers in relation to financial products or financial

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<sup>22</sup>Financial Conduct Authority, *Financial Conduct Authority Handbook*, URL: <http://www.fshandbook.info/FS/html/FCA> (visited on Dec. 1, 2013).

services provided by it or on its behalf in a prompt and fair manner. This section also requires a financial service provider to inform a consumer of the following at the commencement of relationship with the consumer and at such other time when the information is likely to be required by the consumer:

1. The consumer's right to seek redress for any complaints, including through the Redress Agency; and
2. The processes followed by the financial service provider to receive and redress complaints from its consumers.

Section 99 of *IFC*, (Regulations regarding redress of complaints) requires regulators to make regulations on the processes to be followed by a financial service provider to receive and redress complaints from its consumers. The regulations should provide for the process to be followed by a consumer to (a) file a complaint with a financial service provider, (b) the time-period within which the complaint must be filed, (c) the process to be followed by a financial service provider to receive and redress complaints, and (d) the time limits for each step of the process.

### 2.7.2 Rationale

Regulation should focus not only on preventing consumer abuse, but also providing redress to consumers once abuse has occurred. If a consumer is dissatisfied with a product or service, the first recourse should be to take this grievance to the financial service provider and seek redress. For this, it is necessary that each financial service provider has an effective grievance redress mechanism in place. Such a mechanism need not be in-house. It can also be a shared arrangement with other financial service providers.

### 2.7.3 International examples

#### United Kingdom

Regulation 1.3 of the Dispute Resolution Sourcebook of *Financial Conduct Authority Handbook*, mandates a wide range of financial service providers to establish, implement and maintain effective and transparent procedures for the reasonable and prompt handling of complaints.<sup>23</sup> The procedures should be such that a complaint can be made free of cost.

Regulation 1.4 of the Dispute Resolution Sourcebook of *Financial Conduct Authority Handbook*, provides complaint resolution rules.<sup>24</sup> It requires that once a complaint has been received by a financial service provider, it must:

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<sup>23</sup>FCA, *Financial Conduct Authority Handbook*, see n. 22.

<sup>24</sup>*Ibid.*

1. Investigate the complaint competently, diligently and impartially, obtaining additional information as necessary;
2. Assess fairly, consistently and promptly:
  - (a) the subject matter of the complaint;
  - (b) whether the complaint should be upheld;
  - (c) what remedial action or redress (or both) may be appropriate; and
  - (d) if appropriate, whether it has reasonable grounds to be satisfied that another respondent may be solely or jointly responsible for the matter alleged in the complaint;
3. Taking into account all relevant factors:
  - (a) Offer redress or remedial action when it decides this is appropriate;
  - (b) Explain to the complainant promptly and, in a way that is fair, clear and not misleading, its assessment of the complaint, its decision on it, and any offer of remedial action or redress; and
  - (c) Comply promptly with any offer of remedial action or redress accepted by the complainant.

#### 2.7.4 Implementation

Every regulator should make regulations requiring all financial service providers to have in place effective mechanisms of redress for consumers. The regulators may take into account the issues in their respective regulated sectors, and specify, by regulations, the processes to be followed in providing redress to consumer grievances in the respective sectors.

Every regulator should take the following steps to ensure there are regulations requiring internal mechanisms to redress consumers grievances and to keep consumer informed of such mechanisms:

1. Document the existing regulations requiring internal mechanisms to redress consumer grievances in the sectors regulated by the respective regulators.
2. Use the text of section 98 of the *IFC*, to issue a regulation requiring each financial service provider to develop and maintain an internal mechanism for grievance redress.
3. Use the text of section 99 of the *IFC*, relevant information about the respective sectors, and international best practices, to issue regulations governing the systems and processes for handling consumer grievances through the internal mechanism for grievance redress.
4. Create a statement on the consistency between the requirements envisaged in section 98 of the *IFC*, and the existing regulations governing internal re-

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dress of consumer grievances in various sectors. Based on this statement, regulators should make amendments to sectoral regulations to ensure consistency of regulations with the overarching regulation requiring internal mechanisms to redress consumer grievances.

## Chapter 3

# Consumer Protection for Retail Consumers

### 3.1 Introduction

The regulators, as per their *FSDC Resolution dated October 24, 2013*, decided that:<sup>1</sup>

*“In addition to the above basic rights available to all consumers, the regulator should identify a separate category of retail consumers consisting of individuals and small and medium enterprises that obtain financial products or services below a specified value and provide them with the following additional protections:*

- 1. Right to receive advice that is suitable taking into account the relevant personal circumstances of the consumer, such as the consumers financial circumstances and needs. This obligation would apply to persons who render advice to retail consumers and the regulator may specify categories of financial products and service that necessarily require such advice to be given.*
- 2. In case of any conflict between the interests of a retail consumer and that of the advisor or the financial service provider that the advisor represents, preference must be given to the consumers interests.*
- 3. Access to a grievance redressal mechanism for expeditious settlement of complaints.”*

The *Report of the Financial Sector Legislative Reforms Commission*, report recommends giving certain *rights and protections* to retail consumers.<sup>2</sup> Retail consumers are individuals and small organisations. The *market failures* resulting from information asymmetries and bargaining power differences are accentuated for such consumers. Moreover, such consumers also face enormous *coordination*

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<sup>1</sup>Financial Stability and Development Council, Government of India, see n. 1.

<sup>2</sup>See FSLRC, *Report of the Financial Sector Legislative Reforms Commission*, see n. 8, Section 5.5 of the report, p. 48.

*challenges*, because it is usually very difficult for a large number of small value consumers to influence a financial service provider to do the right thing in their interest. For example, it is easier for partners of a venture capital fund to influence the fund, than for small value consumers of a typical bank. Individuals and small businesses that are not involved in the business of financial services are also likely to lack the knowledge to take sophisticated financial decisions. Based on these considerations, certain advanced rights and protections are required for retail consumers.

The first step towards implementation of these recommendations is to define *retail consumers* as a separate category. The *IFC*, envisages a significant role for the regulators in defining who would be considered retail consumers. Section 2(140) of the *IFC*, (Definition of “retail consumer”) defines a retail consumer as a consumer who is an individual or an eligible enterprise where the value of the financial product or of the financial service rendered, does not exceed such amount as may be specified by regulations.

Section 2(61) of the *IFC*, (Definition of “eligible enterprise”) defines *eligible enterprise* as a person, “other than an individual, which at the relevant time has a net asset value of not more than a specified amount or has a turnover of not more than a specified amount, but excludes a financial service provider who is a consumer of a financial product or financial service that is identical to, or substantially similar to, the financial product or financial service that such person provides.”

It is envisaged that the regulators will specify by regulation:

1. A cap on the value of the financial product or financial service, below which a consumer is considered a retail consumer; and
2. A cap on the net asset value or turnover for organisations, below which such organisations may be considered retail consumers, as long as the value of the financial product or financial service they are availing or looking to avail is less than the cap specified above.

Every regulator should specify these caps to create a category of *retail consumers* in the specific sector(s) it is regulating. It should also extend the rights and protections discussed in the following sections of this chapter to such consumers.

## 3.2 Suitability of advice for retail consumers

### Provisions

Section 100 (Assessment of suitability) of *IFC*, requires any retail advisor to

1. make all efforts to obtain correct and adequate information about the relevant personal circumstances of a retail consumer; and
2. ensure that the advice given is suitable for the retail consumer after due consideration of the relevant personal circumstances of the retail consumer.



“Retail advisor” means a financial service provider or financial representative that gives advice to a retail consumer, as per section 2.(139) (Definition of “retail advisor”) of *IFC*. Section 2(4) of *IFC*, (Definition of “advice”) defines *advice* as a recommendation, opinion, statement or any other form of personal communication directed at a consumer that is intended, or could reasonably be regarded as being intended, to influence the consumer in making a transactional decision.

Section 100 (Assessment of suitability) of the *IFC*, also requires that if it is reasonably apparent to the retail advisor that the available information regarding the relevant personal circumstances of a retail consumer is incomplete or inaccurate, such an advisor must warn the retail consumer of the consequences of proceeding on the basis of incomplete or inaccurate information.

Section 101 (Regulations regarding suitability of advice) of the *IFC* requires and empowers the regulators to specify the financial products or financial services which may be provided to retail consumers or a class of retail consumers, only after advice has been given to them as per section 100 (Assessment of suitability). This section requires that the Regulator must take into account the consequences for inclusion and the sufficiency of disclosures before mandating the requirement of suitability advice for any financial service.

### 3.2.1 Rationale

Retail consumers may often be in a situation where they are not able to fully appreciate the features or implications of a financial product, even with full disclosure of information to them. This makes a strong case for a thorough suitability assessment of the products being sold to them. The *IFC*, provides this protection by requiring that any person who advises a retail consumer in relation to the purchase of a financial product or service must obtain relevant information about the needs and circumstances of the consumer before making a recommendation to the consumer.

### 3.2.2 International examples

#### Australia

Till July 1, 2013, section 945A of *Corporations Act 2001*, required the advice to be given any consumer to be appropriate for the consumer, taking into consideration the consumer’s relevant personal circumstances.<sup>3</sup> *Relevant personal circumstances*, in relation to advice provided or to be provided to a person in relation to a matter, are such of the person’s objectives, financial situation and needs as would reasonably be considered to be relevant to the advice.

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<sup>3</sup>Australia, *Corporations Act 2001*, see n. 18.

From July 1, 2013, this obligation was replaced by a *best interest* obligation, under which the provider is expected to always act in the best interest of the consumer. This obligation is as follows:

1. The provider must act in the best interests of the client in relation to the advice, which means that the provider must have done each of the following:
  - (a) identified the objectives, financial situation and needs of the client that were disclosed to the provider by the client through instructions;
  - (b) identified:
    - i. the subject matter of the advice that has been sought by the client (whether explicitly or implicitly); and
    - ii. the objectives, financial situation and needs of the client that would reasonably be considered as relevant to advice sought on that subject matter (the client's relevant circumstances);
  - (c) where it was reasonably apparent that information relating to the client's relevant circumstances was incomplete or inaccurate, made reasonable inquiries to obtain complete and accurate information;
  - (d) assessed whether the provider has the expertise required to provide the client advice on the subject matter sought and, if not, declined to provide the advice;
  - (e) if, in considering the subject matter of the advice sought, it would be reasonable to consider recommending a financial product:
    - i. conducted a reasonable investigation into the financial products that might achieve those of the objectives and meet those of the needs of the client that would reasonably be considered as relevant to advice on that subject matter; and
    - ii. assessed the information gathered in the investigation;
  - (f) based all judgments in advising the client on the client's relevant circumstances; and
  - (g) taken any other step that, at the time the advice is provided, would reasonably be regarded as being in the best interests of the client, given the client's relevant circumstances.

### 3.2.3 Implementation

Every regulator should take the following steps to ensure there are regulations requiring suitability of advice:

1. Use the text of Section 100 of the *IFC*, to issue a regulation requiring suitability assessment to be done by any retail advisor or its representative

before giving advice to a retail consumer. The definitions and obligations in the regulations must be the same as those in the section.

2. Specify, by regulation, a list of financial products and financial services that must not be provided to retail consumers without being accompanied by advice as per section 100 of *IFC*. This list must be based on the tests given in Section 101 of the *IFC*.
3. Document the existing regulations that deal with suitability requirements in the sectors regulated by the respective regulators.
4. Create a statement on the consistency between the suitability requirement envisaged in sections 100 and 101 of the *IFC*, and the existing regulations governing advisors in various sectors. Based on this statement, make amendments to sectoral regulations to ensure consistency of regulations with the overarching regulation requiring suitability assessment.

### 3.3 Dealing with conflict of interests

#### 3.3.1 Provisions

Section 102 (Dealing with conflict of interests) of the *IFC*, requires any advisor giving advice to a retail consumer to:

1. Provide the consumer with information regarding any conflict of interests, including any conflicted remuneration that the retail advisor has received or expects to receive for making the advice to the retail consumer; and
2. Give priority to the interests of the retail consumer if the advisor knows, or reasonably ought to know, of a conflict between its own interests and the interests of the retail consumer; or the interests of the concerned financial service provider and interests of the retail consumer, in cases where the advisor is a financial representative.

*Conflicted remuneration*<sup>4</sup> is defined as any benefit, whether monetary or non-monetary, derived by a retail advisor from persons other than retail consumers, that could, under the circumstances, reasonably be expected to influence the advice given by the retail advisor to a retail consumer.

This section also empowers the Regulator to specify, by regulations, the circumstances in which a benefit received by a retail advisor would, or would not, be considered to be a conflicted remuneration; or the nature, type and structure of benefits permitted to be received by a retail advisor for a financial product or financial service.

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<sup>4</sup>See Section 102(4) FSLRC, *IFC*, see n. 16.

### 3.3.2 Rationale

One of the best ways to ensure good consumer protection is to align the incentives of financial service providers with those of consumers and ensure that in case of a conflict, the interests of consumers take precedence. The interests of retail consumers must be prioritised over those of the provider. Advisors must also inform consumers about any conflicted remuneration they stand to receive, which may influence the advice being given to the retail consumer.

### 3.3.3 International examples

#### Australia

Divisions 4 and 5 of Part 7.7A of *Corporations Act 2001*, define and restrict conflicted remunerations and other banned remunerations<sup>5</sup> Section 963A of *Corporations Act 2001*, defines *conflicted remuneration* as any benefit, whether monetary or non-monetary, given to a financial services licensee, or a representative of a financial services licensee, who provides financial product advice to persons as retail clients that, because of the nature of the benefit or the circumstances in which it is given:

1. could reasonably be expected to influence the choice of financial product recommended by the licensee or representative to retail clients; or
2. could reasonably be expected to influence the financial product advice given to retail clients by the licensee or representative.

This broad definition includes commissions and volume based payments in relation to the distribution of and advice to retail clients. It also includes non-monetary benefits. Section 963E of the *Corporations Act 2001*, bans acceptance of conflicted remunerations. The Act also carries other prohibitions and disclosure requirements with respect to conflicts of interest of financial service providers.

### 3.3.4 Implementation

Every regulator should make regulations requiring all financial service providers to ensure that in their and their representatives' dealings with consumers, consumers are informed about the conflicts of interest of the consumer-facing person. The regulators may also specify regulations requiring the financial service provider or its representative to give priority to the consumer's interest if there is a conflict between their interest and the consumer's interest. These regulations must be consistent with the principles laid down in the *IFC*.

Every regulator should take the following steps to ensure there are regulations dealing with conflicts of interest of retail advisors:

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<sup>5</sup>Australia, *Corporations Act 2001*, see n. 18.

1. Use the text of section 102 (Dealing with conflict of interests) of the *IFC*, to issue a regulation requiring disclosure of conflicts of interest and the duty to give precedence to consumer's interest over other interests while giving advice to a retail consumer. The definitions and obligations in the regulations must be the same as those in the section.
2. Document the existing regulations that deal with conflicts of interest in the sectors regulated by the respective regulators.
3. Create a statement on the consistency between the regulation envisaged in section 102 (Dealing with conflict of interests) of the *IFC*, and the existing regulations governing conflicts of interest. Based on this statement, make amendments to sectoral regulations to ensure consistency of regulations with the overarching regulation requiring suitability assessment.

### 3.4 Access to a grievance redress mechanism

The *IFC*, envisages a hi-tech financial redress agency to redress grievances of consumers with a presence across the country. This agency, when it comes into being, will redress consumer grievances from all sectors in the financial systems. Till the agency comes into existence, the following five-part strategy will help give consumers access to an effective grievance redress mechanism for expeditious settlement of complaints:

1. *Document the grievance redress systems:* The systems and processes of the existing *de jure* grievance redress systems – combining laws, regulations and internal policies – should be documented by each respective regulator. Each regulator should also create and publish a database of consumer grievances collected over the years.
2. *Identify gaps in de jure and de facto grievance redress systems:* Identify gaps, if any, between the *de facto* and *de jure* arrangements on grievance redress.
3. *Close the gap between de facto and de jure:* If there are gaps between the *de facto* and the *de jure*, they need to be closed. As an example, if there are positions which are vacant, then those posts need to be filled.
4. *Implement process and information systems as per FSLRC Draft Indian Financial Code:* Chapters 24, 25, 26 and 27 of *IFC*, provide a detailed framework for a comprehensive two-tiered redress system. This system has two steps in the redress process: mediation and adjudication. It also envisages use of modern technology to keep the proceedings efficient, and minimise costs for the consumers. The bulk of these practices can be implemented in consumer grievance redress systems operated by all financial agencies.
5. *Consolidate infrastructure:* The existing grievance redress systems under various financial sector regulators can make efficiency gains if they start us-

ing common infrastructure. This would also reduce the cognitive complexity faced by consumers, who should see a single point where grievances can be taken. Eventually when the Financial Redress Agency comes into existence, there will be one common set of facilities for consumer grievance redress in the financial system. Progress in this direction can be made by the existing systems of grievance redress if they plan and start sharing infrastructure.

# Chapter 4

## Framing Regulations

### 4.1 Introduction

<sup>4</sup> The regulators, as per their *FSDC Resolution dated October 24, 2013*, decided that

- “ 1. All regulations after Oct. 31, 2013 and all other subordinate legislations (including circulars, notices, guidelines, letters, etc.) issued after Dec. 31, 2014 must comply with the following requirements:
  2. No subordinate legislation may be published without a Board resolution determining the need for such subordinate legislation.
  3. All draft subordinate legislation should be published with statement of objectives, the problem it seeks to solve, and a cost-benefit analysis (using best practices).
  4. Comments should be invited from the public and all comments should be published on the web site of the regulator.
- Regulations will become effective after the Board approves them. Board approval should take into account all comments received.<sup>1</sup> ”*

All regulators have legal processes for regulation-framing. The current processes however suffer from a few lacunae:

1. Boards of regulators do not initiate regulation-making, or approve final regulations through an explicit vote;
2. Not all regulations go through a public consultation process, and there is no standardised way for inviting and considering public comments;
3. Draft regulations, when received do not usually contained detailed statements on the objectives of the regulation, the problem it attempts to solve, and costs and benefits of the proposed regulation.

The *FSLRC Analysis and Recommendations*, states:

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<sup>1</sup>Financial Stability and Development Council, Government of India, see n. <sup>1</sup>.

*In a system governed by the rule of law, no action should be judged against unknown standards. Therefore, before the regulator can carry out any supervision or adjudication functions it has the responsibility to lay down in clear and unambiguous terms, the behaviour that it expects from regulated entities. While doing so, the regulator needs to follow a structured process that allows all stake-holders to be fully informed of and participate in the regulation-making process.*<sup>2</sup>

This chapter provides a step forward for the implementation of a harmonised, governance enhancing legal process in regulation-making common to all regulators. The *FSLRC Analysis and Recommendations*, lays down the key features of the desired regulation making system, which are:<sup>3</sup>

1. The regulator will have to publish the following documents in the process of formulating new regulations:
  - (a) Draft regulations;
  - (b) Jurisdiction clause to identify the legal provision under which the proposed regulations are being made, and the manner in which the regulation is consistent with the principles in the concerned legislation(s). If the parent legislation does not specifically refer to the subject matter of regulations, the regulator will have to establish a logical connection between the subject matter and the empowering provision in the law;
  - (c) A statement of the problem or market failure that the regulator seeks to address through the proposed regulations, which will be used to test the effectiveness with which the regulations address the stated problem. The statement must contain: (a) The principles governing the proposed regulations; and (b) The outcome the regulator seeks to achieve through the regulation; and
  - (d) An analysis of the costs and benefits of the proposed regulation. This is required because every regulatory intervention imposes certain costs on regulated entities and the system as a whole.
2. The Commission recommends that regulations be drafted in a manner that minimises these compliance costs. In some cases where a pure numerical value based cost-benefit analysis is not possible, the regulator should provide the best possible analysis and reasoning for its choice of intervention.
3. After publishing the above documents, the regulator will specify a designated time for receiving comments from the public on the regulations and the accompanying documents.
4. The draft Code will ensure that the time period and the mode of participation specified by the regulator is appropriate to allow for widespread public

<sup>2</sup>See FSLRC, *FSLRC Analysis and Recommendations*, see n. 2, section 4.1. Issuing regulations and guidelines, p. 29.

<sup>3</sup>Table of Recommendations 4.1 stating the Issuance of documents for public consultation. *ibid.*, at page 31.



participation.

The *FSLRC Analysis and Recommendations*, therefore identified detailed requirements to define the process that regulators should follow while making regulations.

## 4.2 Initiating Regulation

### 4.2.1 Provisions

The provisions governing the initiation of the regulation making process are given in Section 52 of the *IFC*.<sup>4</sup> Section 52 requires that the board of a regulator should approve all draft and final regulations.<sup>5</sup>

### 4.2.2 Rationale

The primary function of any regulator is to set down standards of behaviour expected from regulated activities. This encompasses how the regulated entities interact with the regulator, consumers, markets, other regulated entities, etc.

Laws that establish regulators delegate powers to frame regulations to the board of the regulator. To balance this discretion given to regulators, the laws that delegate regulation-making powers to the regulator also require the regulator to be accountable to the legislature in their exercise of such powers. Since the board of the regulator is the apex body of the agency and is accountable to the legislature, regulation-making processes should originate from the board. This will ensure that the issues requiring regulation are discussed at an appropriate level.

### 4.2.3 International examples

#### United States of America

The **U.S. Securities and Exchange Commission (SEC)** publishes the records and agenda of all its meetings. Figure 4.1 is a public notice stating that the **SEC** will consider proposals for rule-making (See *Open Meeting Agenda, Wednesday, September 18, 2013*):<sup>6</sup>

This agenda paper highlights the fact the **SEC** will consider and examine proposals for making rules (subordinate legislation framed by regulators in the USA are





<sup>4</sup>See FSLRC, *IFC*, see n. 16, S.52 (Process of making regulations).

<sup>5</sup>*Ibid.*, S.52 (Process of making regulations).

<sup>6</sup>Securities and Exchange Commission, *Open Meeting Agenda, Wednesday, September 18, 2013*, Sept. 18, 2013, URL: <http://www.sec.gov/news/openmeetings/2013/agenda091713.htm> (visited on Nov. 23, 2013), page 1.

Figure 4.1: Example of SEC Agenda stating SEC will consider proposals for rule-making

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## Open Meeting Agenda Wednesday, September 18, 2013

**Item 1:** Registration of Municipal Advisors  
**Office:** Office of Municipal Securities  
**Staff:** Jessica Kane, Rebecca Olsen, Mary Simpkins

The Commission will consider whether to adopt new rules and forms under the Securities Exchange Act of 1934 relating to the registration of municipal advisors.

For further information, please contact Jessica Kane, Office of Municipal Securities, at (202) 551-3235.

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**Item 2:** Pay Ratio Disclosure  
**Office:** Division of Corporation Finance  
**Staff:** Felicia Kung, Christina Padden

The Commission will consider whether to propose rules to require companies to disclose the median annual total compensation of all employees and the ratio of that median to the annual total compensation of the company's chief executive officer as mandated by Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

For further information, please contact Christina L. Padden, Division of Corporation Finance, at (202) 551-3430.

<http://www.sec.gov/news/openmeetings/2013/agenda091713.htm>

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www.sec.gov/news/openmeetings/2013/agenda091813.htm
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**Source:** Securities and Exchange Commission, *Open Meeting Agenda, Wednesday, September 18, 2013*, Sept. 18, 2013, URL: <http://www.sec.gov/news/openmeetings/2013/agenda091713.htm> (visited on Nov. 23, 2013)

called “rules”, not regulations). The SEC’s decision to make rules is then followed by the release of the draft rules for public consultation.

## United Kingdom

Figure 4.2 from a detailed summary of the Financial Services Authority (FSA)’s (now Financial Conduct Authority (FCA)) March 20, 2013 meeting highlights a similar practice to that of the SEC (See *Summary minutes of a meeting of the Board of the Financial Services Authority held on 20 March 2013 at 25 The North Colonnade, Canary Wharf, London, E14 5HS*).<sup>7</sup>

Item 2.5 of the minutes given in Figure 4.2 states that the FSA Board received a report for consideration, and noted and discussed the proposed fees to be charged by the FCA in 2013/14. It then gives details of the related issues considered by the Board, and the items to be released for public consultation.

A similar process should be followed by regulators in India as well.

### 4.2.4 Implementation

#### Changes

All regulation making should therefore commence with the approval of the board of the regulator and comply with the following process:

1. Before initiating the regulation making process, the board should first consider whether a regulation should be drafted. The board has to consider what the requirement for the regulation is, whether a regulation is the best method to solve the problem at hand, and then direct its agency to commence the process of writing a regulation. Board discussion at this early stage would improve the quality of regulation, rather than placing of draft regulations to the board of the regulator at a later stage. Only after a resolution reflecting a decision on this issue has been made by the board should the staff of the regulator be empowered to start the process of making regulations.
2. After the process of drafting a regulation is complete, it should be approved by the board before being released for public comments.
3. After public comments have been considered, the final regulation should be approved by the Board by a resolution.

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<sup>7</sup>Financial Services Authority, *Summary minutes of a meeting of the Board of the Financial Services Authority held on 20 March 2013 at 25 The North Colonnade, Canary Wharf, London, E14 5HS*, Mar. 20, 2013, URL: <http://www.betterregulation.com/external/March%20Board%20summary%20minutes%20-%2020%20March%202013.pdf> (visited on Nov. 23, 2013).

Figure 4.2: Selected portions from Minutes of **FCA** Board meetings

*20 March 2013  
FSA Board Meeting*

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**2.4 Approval of external spend for Consumer Credit Programme**

The Board received the report, and noted and discussed the proposal for the external spend element of the Consumer Credit Programme budget. The programme objective was to deliver the transfer of regulation of consumer credit from the OFT to the FCA by April 2014. The Board challenged the value for money of the IS spend which was a significant proportion of the cost - it noted that a full procurement exercise had been conducted to find the provider and the project work had been interrogated by the IS senior leadership team.

After due consideration, the Board approved the external spend element of the Consumer Credit Programme budget of £13-21 million.

**2.5 Regulatory Fees & Levies 2013/14**

The Board received the report, and noted and discussed: the proposed fees for 2013/14 for the FCA; the Financial Ombudsman Service budget and general levy allocation to industry blocks; and the Money Advice Service method of allocating money advice costs following consultation.

The Board noted the facts provided and the proposals for specific issues, such as the Financial Penalty Scheme, the minimum regulatory fee and the above average increases in the fee blocks.

The Board noted that there was likely to be an underspend of £40 million and the proposals for dealing with that underspend, considering in particular the fairness to the industry and the requirements for funding the pension scheme and its deficit.

After due consideration of the issues, the Board stressed the need to be transparent about the calculation of fees and approved for consultation:

- the proposed approach to setting FCA fees for 2013/14;
- the allocation of the £23 million FOS general levy across industry blocks as set out in the supporting paper; and
- the revised MAS money advice service allocation basis.

The Board also approved the FOS final budget for 2013/14 of £283.6 million.

The Board agreed that £22m should be paid into the defined pension scheme to help service the deficit, prior to the financial year end.

**3. REPORTS FROM THE CHAIRMAN AND MANAGING DIRECTORS**

**3.1 Executive Chairman's report**

The Board received the report, and noted and discussed the following key points:

- the reports that had been published since the last meeting and actions taken; following the publication of the findings of the Independent Complaints Commissioner relating to a recent complaint, the Board noted the lessons learned by the Executive and supported the

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**Source:** Financial Services Authority, *Summary minutes of a meeting of the Board of the Financial Services Authority held on 20 March 2013 at 25 The North Colonnade, Canary Wharf, London, E14 5HS*, Mar. 20, 2013, URL: <http://www.betterregulation.com/external/March%20Board%20summary%20minutes%20-%2020%20March%202013.pdf> (visited on Nov. 23, 2013)

## Instruments

The board of every regulator may pass a resolution stating:

1. Every proposal to frame regulations should be approved by the board before further work on it is initiated;
2. The proposal to the board should have a clear statement explaining the need for the regulation, and what the regulation will do;
3. Once the board approves the proposal and the draft regulations have been prepared by the staff, the draft regulations and other related documents such as the cost-benefit analysis should be approved by the board;
4. Once the draft regulations and related documents are approved, the regulator should release the documents for public comments. The documentation packet that goes out should satisfy the requirements of the regulation-making process of the *IFC*.
5. The board should approve the final regulations after considering comments from the public and modifications of the regulation consequent to the comments (if any).

## 4.3 Contents of draft Regulations

### 4.3.1 Statement of objectives - Provisions

Section 52(2) of the *IFC*, requires that all regulators should first publish a draft of the regulations to be made. This draft should be accompanied by a statement of objectives, and other documents.

### 4.3.2 Statement of objectives - Rationale

The statement of objectives must clearly state the purpose of the regulation. The purpose may be the obligation to frame regulations under a new law or legal provision. It may also be in furtherance of the need to regulate a previously unregulated area under the regulator's jurisdiction that the regulator has a statutory duty to regulate.

Setting out the objectives of the proposed regulation has many benefits for regulators, regulated entities, and consumers:

1. It gives clear information on the reasons that motivated the proposed regulations to both regulated entities and consumers, and also clearly crystalizes these objectives for the regulator.

2. As can be seen in the examples in section ??, in cases where regulations pertain to complicated and technical issues, understanding the objectives of the regulator helps the affected market participants deliberate better on these issues.
3. By ensuring greater deliberation on the reason for the regulations, the regulator benefits by getting better feedback on how best to frame effective regulations and also minimise compliance costs.
4. Market participants also benefit as they have a clear expectation of regulatory interventions, and can start factoring in the costs of compliance that the proposed regulations may impose.

### 4.3.3 Statement of objectives - International Examples

#### Singapore - Monetary Authority of Singapore

The draft regulations pursuant to the Securities and Futures Act for Reporting of Derivatives Contracts<sup>8</sup>, published by the **Monetary Authority of Singapore (MAS)** mentions the objective of the regulation clearly.

As can be seen in Figure 4.3, the portions titled “Introduction” and “(A) Specified Derivative Contracts” clearly explain the context in which the draft regulations are being proposed i.e. the changes to the Singapore Securities and Futures Act. It mentions clearly the legal requirement for MAS to frame these regulations, it explains what obligations the changes to the Act now imposes on regulated persons, and how MAS has to ensure these persons report to it. Paragraph “(A)” also explains how the reporting requirements help regulators in performing their regulatory functions.

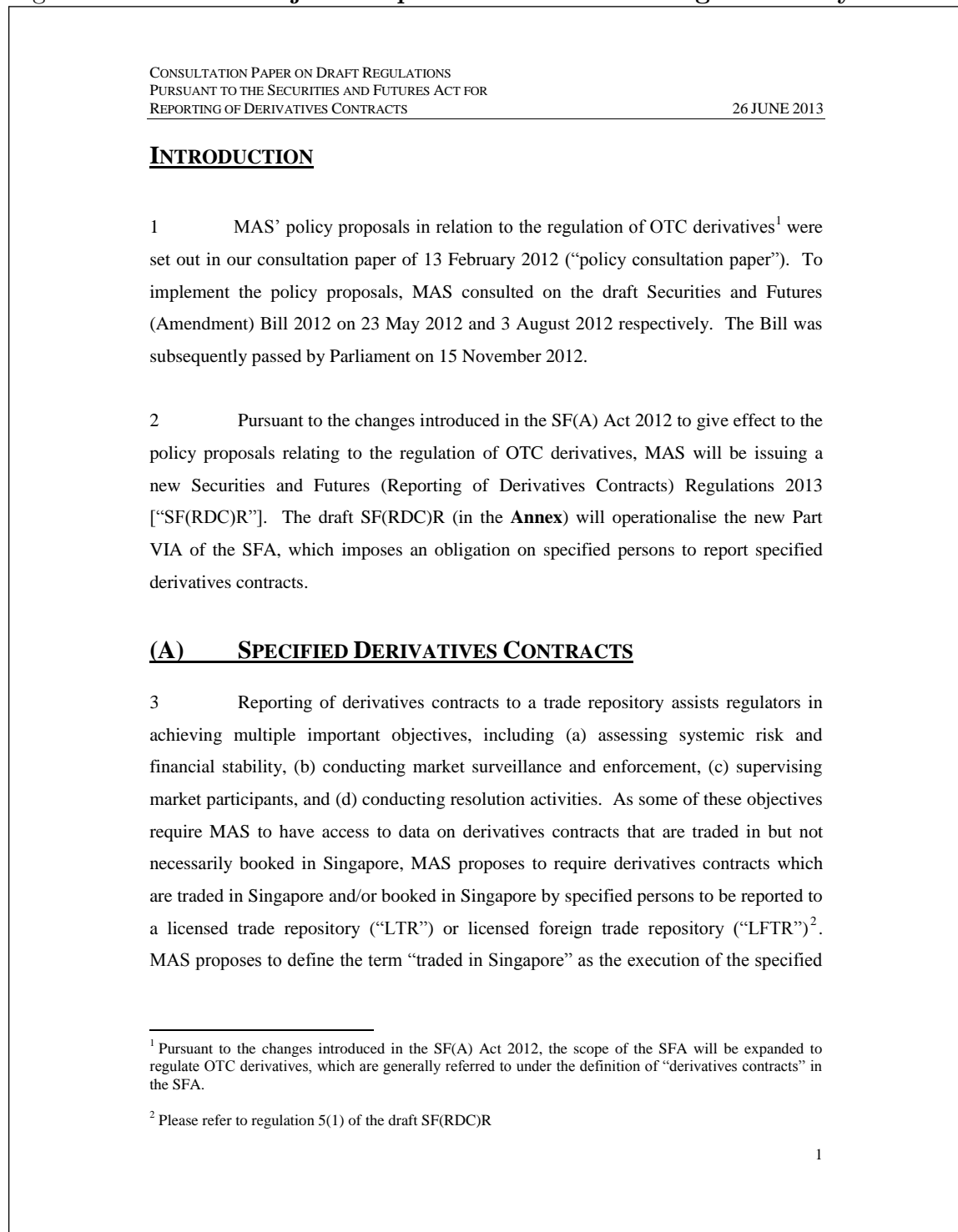
#### United States

The extract in Annexure A is from the **SEC**’s proposed rules amending certain existing rules to bring them in line with the *Dodd–Frank Wall Street Reform and Consumer Protection Act (Proposed Rule on Pay Ratio Disclosure)*. As is well-known, the *Dodd–Frank Wall Street Reform and Consumer Protection Act*, was a comprehensive, complicated, and technical reform of financial sector regulation that required regulators to frame hundreds of new regulations. As can be seen, the proposed extract from the introduction to the proposed rules does the following:

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<sup>8</sup>See Monetary Authority of Singapore, *Consultation Paper on Draft Regulations Pursuant to the Securities and Futures Act for Reporting of Derivatives Contracts*, Monetary Authority of Singapore, June 26, 2013, URL: <http://www.mas.gov.sg/~media/MAS/News%20and%20Publications/Consultation%20Papers/CPReportingRegs.pdf> (visited on Nov. 23, 2013), page 1.

Figure 4.3: Detailed objectives published with draft regulations by MAS



**Source:** Monetary Authority of Singapore, *Consultation Paper on Draft Regulations Pursuant to the Securities and Futures Act for Reporting of Derivatives Contracts*, Monetary Authority of Singapore, June 26, 2013, URL: <http://www.mas.gov.sg/~media/MAS/News%20and%20Publications/Consultation%20Papers/CPReportingRegs.pdf> (visited on Nov. 23, 2013)

1. It explains the effect of the proposed rule, i.e. amendments to Item 402 of Regulation S-K, to implement a particular provision of the US Dodd-Frank Act;
2. It explains in plain and simple English what regulatory requirements are proposed to be imposed;
3. It clearly mentions what the Dodd-Frank Act requires of the SEC on this particular subject; and
4. It clearly explains categories of financial firms who would be exempt from the regulations.

The pro-active sharing of the type of information highlighted above are governance enhancing practices which may be adopted by regulators.

### 4.3.4 Statement of Objectives - Implementation

#### Changes

Implementing the provisions of Section 52(2) of the *IFC*, will require correctly identifying the objective of the regulation. The *FSLRC Analysis and Recommendations*, clearly states:<sup>9</sup>

*“If the parent legislation does not specifically refer to the subject matter of regulations, the regulator will have to establish a logical connection between the subject matter and the empowering provision in the law. The document must contain explanation on how the regulation stands vis-a-vis each of the relevant principles in the part(s) of the draft Code from which the powers are being drawn.”*

Therefore, the following changes will have to be implemented:

1. The statement should clearly state the objective(s) of framing the regulations. The objective of the regulation may be to prevent/rectify market failure, or to improve the collection of regulatory information by requiring reporting of additional information, or to improve the investigative process by standardising notice requirements. Market failures should be clearly stated in the cost-benefit analysis and a statement explaining the problem to be addressed published along with the draft regulations;
2. The statement should state what provision(s) of the existing law the regulator is complying with/ensuring compliance with, while framing the regulations; and
3. The statement should identify how the proposed regulations would help achieve the stated objective.

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<sup>9</sup>See FSLRC, *FSLRC Analysis and Recommendations*, see n. 2, Table of Recommendations 4.1: Issuance of documents for public consultation at p.31.



## Instruments

The board of every regulator should pass a bye-law/resolution stating that every draft regulation will contain a statement of objectives of the regulation explaining:

1. What the regulatory objectives are;
2. What legal provision(s) empower/obligate the regulator to pursue those objectives;
3. How the regulations will help the regulator in achieving the stated objective; and
4. The context in which the regulation is proposed.

### 4.3.5 Problem the regulation seeks to solve - Provisions

Section 52(2)(b) of the *IFC*, requires that every draft regulation be published along with a statement on the problem that the proposed regulations seeks to address.

### 4.3.6 Problem the regulation seeks to solve - Rationale

The draft regulations and the attached information must clearly identify the existing problems within the regulated market that requires an intervention by the regulator.

Stating the problem to be addressed goes hand in hand with a statement of the objectives of the regulation. This requirement ensures that regulators communicate both- the problem, and the objective of regulations. Including this requirement ensures greater transparency in regulation-making as:

1. Others can assess whether the regulator has identified the problem correctly, and therefore provide valuable feedback on the same; and
2. One can assess whether the proposed regulations would actually solve the problem to be addressed.

The problem to be solved may range from the compliance of regulators with the obligation to frame regulations under a new law, to a situation where regulators discover market abuse. In either case, it is essential for the regulator to disclose the motivation for its intervention in the market.

### 4.3.7 Problem the regulation seeks to solve - Implementation

1. The board of every regulator should pass a bye-law/resolution stating that every draft regulation will contain a statement explaining the problem that the regulation seeks to solve.
2. The board of the regulator should ensure that its staff writes a detailed manual on how such a statement should be framed in line with Section 52(2) of the *IFC*.

### 4.3.8 Cost Benefit Analysis - Provisions

1. Section 52(2) of the *IFC*, requires a **Cost Benefit Analysis (CBA)** to be published along with the draft regulations.
2. Section 54 (Standard of analysis of costs and analysis of benefits) details the costs and benefits that, at the minimum, must be considered. These are:
  - (a) Costs borne by:
    - i. regulated entities in complying with the regulations;
    - ii. consumers, both directly and indirectly;
    - iii. the regulator, in enforcing the regulations; and
    - iv. any other person affected by the regulations.
  - (b) Benefits that will accrue to consumers and other persons as a result of the regulations.
3. It also requires regulators to use the best scientific data and the best scientific methods available for conducting **CBAs**.

### 4.3.9 Cost-benefit analysis - Rationale

A **CBA** requires that regulators identify market failures/regulatory failures, assess the cost of intervening to rectify these failures and compare them with the benefits of the proposed intervention. New regulations should only be framed if the net benefits exceed the net costs.

A **CBA** measures the total costs of imposing a new regulation on all affected persons compared to the benefits of the regulatory intervention. The motivation is to (1) learn if the benefits of an action are likely to justify the costs, or (2) discover which of various possible alternatives would be the most cost-effective.<sup>10</sup>

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<sup>10</sup>See Office of Management and Budget, *Informing Regulatory Decisions: 2003 Report to Congress on the Costs and Benefits of Federal Regulations and Unfunded Mandates on State, Local, and Tribal Entities*, Office of Management and Budget, 2003, URL: <http://www.>

In essence therefore, CBA measures the efficiency or resource allocation effects of a regulatory change.<sup>11</sup> If the quantified benefits outweigh the quantified costs, the regulation will increase efficiency. Even in cases where costs cannot be clearly quantified, “CBA should aim to quantify all relevant costs and benefits, where necessary making estimates when prices cannot be observed.”<sup>12</sup>

A good CBA should perform the following functions:<sup>13</sup>

1. Provide decision makers with quantitative and qualitative information about the likely effects of a regulatory proposal;
2. Encourage decision makers to take account of all the positive and negative effects of a regulatory proposal, and discourages them from making decisions based only on the impacts of a single group within the community;
3. Assess the impact of regulatory proposals in a standard manner, which promotes comparability, assists in the assessment of relative priorities and encourages consistent decision making;
4. Capture the various linkages between the regulatory proposal and other sectors of the economy (for example, increased safety may reduce health care costs), helping decision makers maximise net benefits to society; and
5. Help identify cost-effective solutions to problems by identifying and measuring all costs.

#### 4.3.10 Cost Benefit Analysis - International Examples

##### Australia

Australia’s Office of Best Practice and Regulation (OBPR) states that a CBA must contain the following nine steps:<sup>14</sup>

1. *Specify a set of 3 options to be considered*: a regulatory option, a light-handed regulatory option, or a “do-nothing” option. The “do-nothing” is the base case scenario.
2. **Decide whose costs and benefits count**: Costs and benefits of all firms and persons residing within the regulator’s jurisdiction should be counted, as far as possible.

[whitehouse.gov/sites/default/files/omb/inforeg/2003\\_cost-ben\\_final\\_rpt.pdf](http://whitehouse.gov/sites/default/files/omb/inforeg/2003_cost-ben_final_rpt.pdf) (visited on Dec. 20, 2013).

<sup>11</sup>See Office of Best Practise and Regulation, *OBPR Guidance Note – Cost Benefit Analysis*, Office of Best Practise and Regulation, July 1, 2013, URL: <http://www.dpmc.gov.au/deregulation/obpr/handbook/index.html> (visited on Dec. 19, 2013).

<sup>12</sup>See Bank of England, *Cost-benefit analysis of monetary and financial statistics*, Bank of England, 2006, URL: <http://www.bankofengland.co.uk/statistics/Documents/about/cba.pdf> (visited on Dec. 19, 2013).

<sup>13</sup>See OPBR, see n. 11.

<sup>14</sup>See *ibid.*

3. *Identify the impacts and select measurement indicators:* The incremental costs of each option should be identified, relative to the base “do-nothing” option. But the base case should not assume that nothing will change over time. All the effects of a proposal that are considered desirable by those affected are benefits all undesirable effects are costs. **CBA** requires the regulator to identify explicitly the ways in which the proposal makes individuals better or worse off.
4. *Predict the impacts over the life of the regulatory proposal:* The impacts should be quantified for each time period over the life of the regulatory proposal. A **CBA** should present the best estimates of expected costs and benefits, along with a description of the major uncertainties and how they were taken into account.
5. *Monetise impacts:* Assigning a net Rupee value of the gains and losses of a regulatory initiative for all people affected is one useful way to measure the effects of a proposed change. Measurement of costs and benefits in this way is sometimes referred to as monetising costs and benefits.

The **CBA** guidance note states:

*The fact that some impacts may be very difficult to quantify in dollar terms does not invalidate the CBA approach. In such cases, a detailed qualitative analysis will often be most appropriate in place of dollar values. Your qualitative analysis should be supported by as much evidence and data as possible to increase the transparency of the report and to assist the decision maker in choosing between alternative options.*<sup>15</sup>

6. *Discount future costs and benefits to obtain present values.*
7. *Compute the net present value for each option:* The net present value (NPV) of an option equals the present value of benefits minus the present value of costs. If the NPV is positive, the proposal improves efficiency. If the NPV is negative, the proposal is inefficient.
8. *Perform sensitivity analysis:* There may be considerable uncertainty about predicted impacts and their appropriate monetary valuation. Sensitivity analysis provides information about how changes in different variables will affect the overall costs and benefits of the regulatory proposal. It shows how sensitive predicted net benefits are to different values of uncertain variables.
9. *Conclusion:* One should summarise the results of the **CBA**. The conclusion should include the time profiles of costs, benefits and net benefits, their net present value, the discount rate used, information on the sensitivity of estimated impacts to alternative assumptions, a list of assumptions made, and how costs and benefits were estimated.

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<sup>15</sup>OPBR, see n. 11.

## United States

The *Follow-Up Review of Cost-Benefit Analyses in Selected SEC Dodd-Frank Act Rulemakings*, mentions a number of binding guidelines CBAs done by the SEC should follow.<sup>16</sup> The most important of these are:

1. The draft regulations “should identify possible direct and indirect costs and benefits for members of the industry, relevant market segments, and types of investors and issuers. It should also discuss any available data and solicit comments and additional data.”
2. When the draft regulations are published, “the cost-benefit analysis should be tentative and should not reach any conclusions. As comments are received, the cost-benefit analysis should be refined.”
3. “The proposing release should include a request for comments soliciting data and views on costs and benefits.”
4. “Estimated compliance costs included in the adopting release must be verified.”
5. “A complete cost-benefit analysis should consider macro costs, such as anticipated changes in market behavior, as well as micro costs, such as paperwork burdens.”
6. “A cost-benefit analysis should consider both direct costs, such as costs incurred by a market participant subject to a rule, and indirect costs, such as costs incurred by customers or clients of the market participant.”
7. “The benefits and costs of a proposed rule should be measured against a baselinethe best assessment of the way the world would look absent the proposed regulation (the as is environment).”
8. “If a regulation includes a number of distinct provisions, the benefits and costs of the different provisions should be evaluated.”
9. The publication of the final regulations should also have an attached document with a “substantive, qualitative discussion of the costs and benefits and the staffs final quantitative analysis of any available data. A strong cost-benefit section should include both quantitative and qualitative analysis.”

## United Kingdom

The U.K. Treasury (the U.K. body corresponding to the Ministry of Finance of India) has a “Greenbook” that mandates and sets the minimum requirement forCBAs for all “new policies, programmes and projects, whether revenue, capital

<sup>16</sup>Office of Inspector General, *Follow-Up Review of Cost-Benefit Analyses in Selected SEC Dodd-Frank Act Rulemakings*, Securities and Exchange Commission, Jan. 27, 2012, URL: <http://www.sec-oig.gov/Reports/AuditsInspections/2012/499.pdf> (visited on Dec. 16, 2013).

or regulatory”.<sup>17</sup> The Greenbook also contains broadly similar requirements for conducting a CBA.

### 4.3.11 Implementation

#### Changes

Regulators at present do not carry out systematic CBAs before framing regulations. The *IFC*, follows international best practices in regulation-making by requiring that regulators publish a detailed CBA along with the draft regulations.

As the examples in section 4.3.10 clearly show, all CBA handbooks recommend broadly similar steps to be performed. They all require:

1. the creation of a base-case;
2. the creation of alternate scenarios/options based on regulatory actions that may be considered;
3. identifying the costs and benefits of each option against the base-case, considering each and every possible cost and benefit that may occur directly or indirectly;
4. monetizing the costs and benefits after adjustment; and
5. presenting a conclusion on the basis of the CBA.

Regulators should compile detailed CBA manuals for framing regulations in line with the best practices mentioned above.

#### Instruments

1. The board of every regulator should pass a resolution stating that every draft regulation will contain a CBA of the regulations; and
2. The regulator will draft internal manuals on CBA complying with the minimum requirements set out in Section 54 of the *IFC*, and in-line with international best practices, some of which have been mentioned as examples in this section.

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<sup>17</sup>H.M. Treasury, *The Green Book, Appraisal and Evaluation in Central Government*, Treasury Guidance, H.M. Treasury, 2003, URL: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/220541/green\\_book\\_complete.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/220541/green_book_complete.pdf) (visited on Dec. 20, 2013).

## 4.4 Comments on draft Regulations

### 4.4.1 Provisions

1. Section 52 of the *IFC*, requires that the draft of the proposed regulations must be released along with information on the process by which any person may make a representation in relation to the proposed regulations.
2. The regulator must consider these representations before making the final regulations.
3. The regulator has to publish all representations received, and at least a general account of the response to the representations while publishing the final regulations.

### 4.4.2 Rationale

The process of soliciting public comments enhances regulatory governance in many ways. Most significantly, it enhances the legitimacy of regulatory intervention by engaging with stakeholders. Additionally, it enables regulators to seek external advice and views in a cost-effective manner. It also vastly increases the transparency of the regulation-making process.

In India, a number of regulators and government departments have started soliciting public comments on draft laws, regulations and policies. The Airport Economic Regulatory Authority, Telecom Regulatory Authority of India, Central Electricity Regulatory Commission are among some regulators who regularly solicit public comments. Some financial regulators also solicit comments occasionally. It is therefore clear that the role of public consultation in framing regulations has already been recognized in India. There are however, certain problems with the existing practice of asking for public comments:

1. Not all regulators solicit comments;
2. Regulators who solicit comments often do not solicit comments for all regulations;
3. There is no consistency in the process of soliciting comments;
4. Comments received are often not made public; and
5. Regulators do not publish information on whether the comments were considered while framing the final regulations.

The *Report of the Financial Sector Legislative Reforms Commission*, requires a common process for all financial regulators and addresses the problems stated above.

### 4.4.3 International Examples

#### United Kingdom

The UK law mandates broadly similar requirements for soliciting and publishing comments as the *IFC*.<sup>18</sup>

The **FSA** (now **FCA**) came out with proposed regulations “Consumer Credit regulation” in March 2013. An extract from their online response form is given in Figure 4.4. The extract contains a number of features which may be considered for adoption by regulators in India:

1. Provision for both electronic and paper representations;
2. Clear declaration that all responses received will be made public;
3. Provision for persons to respond in an individual capacity, or as a representative of some other organization; and
4. Specific questions on each provision of the proposed regulations.

#### United States

The extract provided in Annexure-B displays a list of all comments received on a proposed rule published by the **SEC**.<sup>19</sup> As may be seen, the comments are published by name, and clicking on any of the names opens up the full comment submitted by that person.

### 4.4.4 Implementation

#### Changes

As per the provisions mentioned above, regulators would have to streamline the process by which representations from the public are solicited:

1. Comments/representations should be sought on all regulations;
2. Clear information on the manner of making comments should be provided;
3. All comments received should be considered while framing the final regulations;
4. All comments received should be published; and
5. The regulator should publish a general account of the response to the representations along with the final regulations.

<sup>18</sup>United Kingdom, *Financial Services and Markets Act 2000*, see n. 14.

<sup>19</sup>See Securities and Exchange Commission, *Proposed Rule on Pay Ratio Disclosure*, Sept. 18, 2013, URL: <http://www.sec.gov/rules/proposed/2013/33-9452.pdf> (visited on Dec. 19, 2013).




Figure 4.4: Extract from online response form relating to **FCA** Consumer Credit Regulations

11/26/13
CP13/7: Response form

The FSA has now become two separate regulatory authorities and this site is no longer updated.  
 The Financial Conduct Authority can be found at [www.fca.org.uk](http://www.fca.org.uk) and the Prudential Regulatory Authority at [www.bankofengland.co.uk](http://www.bankofengland.co.uk).  
 Archived versions of the FSA site are available at the National Archives.

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**CP13/7: Response form**

We would like to invite your responses to the following questions. Please ensure that your responses reach us by 1 May 2013 in order to be included in our feedback paper.

You can send your response by electronic submission using the following form or by emailing us at the address shown.

Alternatively, please send comments in writing to:

Anna Wallace  
 Policy Risk & Research Division  
 Financial Services Authority  
 25 The North Colonnade  
 Canary Wharf  
 London E14 5HS  
 Telephone: 020 7066 2000  
 Email: [cp13\\_07@fca.gov.uk](mailto:cp13_07@fca.gov.uk)

It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise.

Note: You can take a printout of your response before clicking the 'Submit to FSA' button at the end of the form, but this will only print the visible text on screen, and you may have given longer answers. After submitting your response, the form will clear, but when we acknowledge receipt of your response by email, we can return to you a copy of your full submission as received. Check this box if you would like to have a copy of your submission returned: ☐

---

**Submission Details**

Name:

Position:

Company:

Address:

Post Code:

Telephone:

Email:

☐ in what capacity are you responding?

☐ as an individual

☐ as a representative of an authorised firm

☐ as a representative of a professional firm

☐ other (please specify):

**Q1**  
Do you agree that our proposals strike the right balance between proportionality and strengthening consumer protection?

**Q2**  
Do you agree that we have included the right activities in the higher and lower risk regimes?

**Q3**  
Do you agree that our proposals minimise any adverse impact on competition within the regulated consumer credit market?

**Q4**  
Do you have any comments regarding our proposals for the interim permission regime?

[www.fsa.gov.uk/library/policy/cp/2013/cp13-07-response.shtml](http://www.fsa.gov.uk/library/policy/cp/2013/cp13-07-response.shtml)
1/4

**Source:** Financial Services Authority, ed., *FSA CP13/7: Changes to the Listing Rules resulting from new regulations being implemented by BIS*, Response Form, Nov. 26, 2013

## Instruments

The board of every regulator should pass a resolution stating:

1. Comments/representations will be sought from the public for all regulations, after the draft regulations have been approved by the board of the regulator;
2. All comments/representations, and responses to the same will be made publicly available on the website of the regulator.
3. While publishing the draft regulations, the regulator will provide information on the manner in which representations should be made, and the time within which representations should be made; and
4. The regulator should allow representations to be made in both paper and electronic formats.
5. The regulator should ensure that its staff drafts manuals to standardise this process and publish such a manual on its website.

## 4.5 Approval of final Regulation

### 4.5.1 Provision

1. Section 52(5) and Section 35 (Decisions of the board of a financial agency) of the *IFC*, read together require that to approve the final regulations, the board must decide through a majority vote, to pass the regulations.
2. In addition, the board must publish all comments received, and at least a general account of the response to the comments.

### 4.5.2 Rationale

In an earlier section (4.2) it was stated that the regulation-making process should commence with the approval of the board of a regulatory agency. All final regulations should also be approved by the board before they become binding. This ensures that the board, which is the body directly accountable for regulating a given sector can review the final regulations with in order to:

1. Check whether the final regulations confirm to the original resolution passed approving the drafting of the regulation;
2. Consider all comments/representations received; and
3. Consider the final regulations in detail and approve/recommend changes/disapprove them.

### 4.5.3 Examples from other countries

#### United States

Figure 4.5 is a press release of the SEC stating that it voted unanimously to approve certain registration rules under the *Dodd–Frank Wall Street Reform and Consumer Protection Act*. As can be seen, along with the approval order, the extract also provides a background of the rule. A detailed perusal of this release also shows the SEC’s consideration of comments received, and an explanation, in plain and clear language, of what the rules would do.

The SEC also conducts open meetings at which the SEC Commissioners discuss the proposed rules, while making reference to public comments, ongoing research conducted by regulatory staff, and monitoring mechanisms for evaluating the effect of rules on the markets. The webcasts of the open meetings are also available on the SEC website. The *SEC Open Meeting Wednesday, July 10, 2013*, provides a good example of the same.

### 4.5.4 Implementation

#### Changes

At present, the role of the board of regulators in the framing and passing of regulations is unclear. Regulations may be drafted and issued by the staff of the regulator without any explicit approval by the board.

As per the *IFC*, provisions mentioned above, the board will have to approve the final regulations by a majority vote. This will require a deliberation on the regulations by the board of the regulator.

#### Instruments

The board of every regulator should pass a resolution stating:

1. The final regulations will be published only after they receive the approval of the board. The board should vote on the regulations to approve them;
2. The board must consider the comments/representations received with regard to the draft regulations; and
3. The response of the regulator to the comments should be made public at the same time as the publication of the final regulations.

Figure 4.5: **SEC Press Release on vote on approval of new rules under the Dodd-Frank Act**

11/27/13
SEC.gov | SEC Approves Registration Rules for Municipal Advisors

**PRESS RELEASE**

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## SEC Approves Registration Rules for Municipal Advisors

**FOR IMMEDIATE RELEASE**  
**2013-185**

*Washington D.C., Sept. 18, 2013* — The Securities and Exchange Commission today voted unanimously to adopt rules establishing a permanent registration regime for municipal advisors as required by the Dodd-Frank Act.

State and local governments that issue municipal bonds frequently rely on advisors to help them decide how and when to issue the securities and how to invest proceeds from the sales. These advisors receive fees for the services they provide. Prior to passage of the Dodd-Frank Act, municipal advisors were not required to register with the SEC like other market intermediaries. This left many municipalities relying on advice from unregulated advisors, and they were often unaware of any conflicts of interest a municipal advisor may have had.

After the Dodd-Frank Act became law, the SEC established a temporary registration regime. More than 1,100 municipal advisors have since registered with the SEC.

The new rule approved by the SEC requires a municipal advisor to permanently register with the SEC if it provides advice on the issuance of municipal securities or about certain "investment strategies" or municipal derivatives.

"In the wake of the financial crisis, many municipalities suffered significant losses from complex derivatives and other financial transactions, and their investors were left largely unprotected from these risks," said SEC Chair Mary Jo White. "These rules set forth clear, workable requirements and guidance for municipal advisors and other market participants, which will provide needed protections for investors in the municipal securities markets."

The new rules become effective 60 days after they are published in the Federal Register.

# # #

**FACT SHEET**

**Municipal Advisor Registration**

**SEC Open Meeting**

**Sept. 18, 2013**

**Background**

*Municipal Securities and Municipal Advisors*

Every year, states and local governments issue municipal securities – most notably municipal bonds – to raise funds for various public projects such as building schools, roads, and hospitals. Those who purchase municipal bonds usually receive interest payments on the principal amount they invest and a return of that principal amount after a period of time, and the municipalities receive needed capital.

Municipalities that issue these securities frequently rely on advisors, who help to decide among other things how and when to issue the securities and how to invest the proceeds from the sales.

[www.sec.gov/News/PressRelease/Detail/PressRelease/1370539817759#.UpV8d2SSCbg](http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539817759#.UpV8d2SSCbg)
1/6

**Source:** Securities and Exchange Commission, *SEC Approves Registration Rules for Municipal Advisors*, Press Release, 2013, URL: <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539817759#.Up2RvWSSCbg> (visited on Dec. 1, 2013)

# Chapter 5

## Notices

### 5.1 Introduction

The regulators, as per their *FSDC Resolution dated October 24, 2013*, decided that<sup>1</sup>

*“All different types of notices issued to individual regulated entities must comply with the following requirements after Oct. 31, 2013:”*

*“1. There will be a finite list of types of notices that may be sent to regulated entities and standard form of notices.”*

*“2. The minimum content of notices that are related to any allegation of any violation of a law must include the regulation alleged to have been violated and the set of facts that allegedly constitute the violation.”*

*“3. Any notice/order imposing a penalty should record the specific regulation violated, the facts that constitute the violation, and the quantum of penalty imposed.”*

One of the steps the *IFC*, takes to ensure transparency and accountability is by requiring the standardisation of notices sent to regulated entities. The serving of a notice fulfills one of the requirements of the principles of natural justice. It seeks to give the recipient necessary information to respond to a regulator effectively, in order to defend his/her actions.

The *FSLRC Analysis and Recommendations*, states:

*“...the overall approach of the draft Code should be to provide for strong executive powers, balanced with greater transparency and accountability, to prevent abuse. Executive functions of regulator do not have standardised statutory checks under present legislations.”<sup>2</sup>*

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<sup>1</sup>Financial Stability and Development Council, Government of India, see n. 1.

<sup>2</sup>Section 4.2, FSLRC, *FSLRC Analysis and Recommendations*, see n. 2, at pg. 32.

It is therefore a governance enhancing measure to standardise the minimum content of all notices that may be sent by regulators to regulated entities.

## 5.2 Provisions

The *IFC*, creates a finite list of notices that may be sent by regulators and explicitly mentions the types of information that must, at a minimum, be contained in the notice.<sup>3</sup> Provisions which define notices/require notices to be sent are:

1. The requirement to issue show-cause notices for all enforcement actions<sup>4</sup>;
2. The minimum contents of show cause notices<sup>5</sup>;
3. The requirement of a written notice before seeking information from regulated entities<sup>6</sup>;
4. The requirement of issuing a decision notice before issuing a decision order disqualifying auditors and actuaries<sup>7</sup>;
5. The requirement of serving compensation notices to those entitled to compensation after the resolution of a covered service provider<sup>8</sup>; and
6. Notice intimating the recipient of a discontinuance of proceedings<sup>9</sup>

For example, all show cause notices, as per Section 400 (Content and standard of show cause notices) of the *IFC*, should contain the following:

1. Be in writing;
2. State the action which the Financial Agency proposes to take;
3. Give causes requiring the proposed action; and
4. Provide a time-period for making representations.

## 5.3 Rationale

Notices should contain some minimum information (depending on the type of notice issued) that discharges the regulator's obligation to comply with principles of natural justice. Under present laws, regulators send notices to regulated entities for various reasons such as:

<sup>3</sup>See, FSLRC, *IFC*, see n. 16, at Chapter 78.

<sup>4</sup>*Ibid.*, Section 399 (Show-cause notice for enforcement action).

<sup>5</sup>*Ibid.*, Section 400 (Content and standard of show cause notices).

<sup>6</sup>*Ibid.*, Section 72 (Power to gather information) and Section 121 (Power to call for information),

<sup>7</sup>*Ibid.*, Section 165(Disqualification).

<sup>8</sup>*Ibid.*, Section 276 (Compensation notice).

<sup>9</sup>*Ibid.*, Section 404 (Conclusion of proceedings through discontinuance notice).

1. Asking for information;
2. Asking for proof of compliance with laws and regulations;
3. Informing the recipient before initiating an investigation/penal action; and
4. Communicating a decision to the recipient with regard to any regulatory action against him.

For each of the above-mentioned purposes, notices should mandatorily contain the following:

1. *Statement of legal power*: Notices often do not contain any mention of what legal power the regulator is using and/or intends to use. This is contrary to the principle of rule of law. Since a regulator derives its powers from a parent law and regulations framed under it, there is a duty to state what law/regulation is being used/proposed to be used. The recipient of the notice similarly has a right to know the provision of law being used against him/her.
2. *Statement of purpose of notice*: Notices should also mention why the notice is being sent to the recipient i.e. whether the notice is just for the purpose of seeking information, or whether the information being asked for is part of a larger inquiry. There may be exceptions to this requirement, but such exceptions should be clearly specified in the internal bye-laws/operating manuals of the regulator.
3. *Statement of proposed action*: Notices that intimate recipients of a regulator's intention to initiate administrative/penal proceedings against them often do not mention the penalty for a legal violation. Nor do they mention the possible action that may be taken against the recipient.
4. *Reasons for the proposed action*: Show-cause and other notices that inform the recipient of an action against him/her being contemplated should also compulsorily mention the reasons for the proposed action. The recipient has a right to know the factual grounds on which the regulator's decision to propose a particular course of action is based.

In addition, notices sent by regulators often suffer from a lack of standardisation. Notices sent for similar reasons often contain varying levels of information.

## 5.4 International Examples

The examples below highlight the minimum contents of different types of notices that are sent by regulators in different jurisdictions. As can be seen, though the types of notices may vary, there is certain minimum content in all notices designed to give the recipient full and complete information.

### 5.4.1 United Kingdom

The *Financial Services and Markets Act 2000*, specifies the limited kinds of notices that may be sent by regulators, and the minimum content for each. “Warning notices” for example, must state (among other requirements):<sup>10</sup>

1. State the action which the Authority proposes to take;
2. Be in writing; and
3. Give reasons for the proposed action.

Similarly, “Decision notices” must:<sup>11</sup>

1. Be in writing;
2. Give the Authority’s reasons for the decision to take the action to which the notice relates; and
3. Give an indication of
  - (a) Any right to have the matter referred to the Tribunal which is given by this Act; and
  - (b) The procedure on such a reference.

While warning notices are confidential, decision notices are available to the public. The *FCA Decision Notice to Bayliss & Co (Financial Services) Limited*, is an example, which shows the minimum content of the decision notice in a standardised form.<sup>12</sup>

A perusal of any of these notices shows that the decision notice clearly mentions (a) the action the **FCA** has decided to take, (b) a summary of reasons for the same, (c) a detailed explanation of the facts, (d) clear statement of the laws and regulations breached, and (e) the regulations and guidances the **FCA** considers while imposing penalties.<sup>13</sup> All these details should also be incorporated by Indian regulators as governance enhancing mechanisms.

### 5.4.2 United States

The *Federal Administrative Procedure Act*, states that when a regulator wishes to withdraw, suspend or revoke a license given to a person, such action cannot take

<sup>10</sup>See United Kingdom, *Financial Services and Markets Act 2000*, see n. 14, Section 387 (Warning Notices).

<sup>11</sup>*Ibid.*, S.388 (Decision Notices).

<sup>12</sup>Financial Conduct Authority, ed., *FCA Decision Notice to Bayliss & Co (Financial Services) Limited*, May 23, 2013, URL: <http://www.fca.org.uk/static/documents/decision-notices/bayliss.pdf>.

<sup>13</sup>All decision notices may be searched and seen at <http://goo.gl/Cx6Awc>



place unless the individual or entity receives a notice by the agency “in writing of the facts or conduct which may warrant the action”.<sup>14</sup>

As an example of fulfilling this requirement, the SEC sends “Wells notices” to individuals and entities. “A *Wells notice* is a communication from the staff to a person involved in an investigation that: (1) informs the person the staff has made a preliminary determination to recommend that the Commission file an action or institute a proceeding against them; (2) identifies the securities law violations that the staff has preliminarily determined to include in the recommendation; and (3) provides notice that the person may make a submission...to the Commission.”<sup>15</sup>

As per the, *SEC Enforcement Manual*, Wells notices should do the following (among other details):<sup>16</sup>

1. Identify the specific charges the staff has made a preliminary determination to recommend to the Commission.
2. Accord the recipient the opportunity to provide a voluntary statement, in writing or on videotape, setting forth the recipients position with respect to the proposed recommendation, which in the recipients discretion may include arguments why the Commission should not bring an action or why proposed charges or remedies should not be pursued, or bring any relevant facts to the Commissions attention in connection with its consideration of the matter.
3. Set reasonable limitations on the length of any submission made by the recipient, as well as the time period allowed for the recipient to submit a voluntary statement in response.
4. Advise the recipient that any submission should be addressed to the appropriate official.
5. Inform the recipient that any Wells submission may be used by the SEC in any action or proceeding that it brings and may be discoverable by third parties in accordance with applicable law.

As reflected in the above-mentioned examples, good regulators across jurisdictions follow a principle of including standard, minimum content in notices sent by them to regulated individuals or entities. Indian regulators may also consider voluntarily adopting this practice in line with the provisions of the *IFC*.

<sup>14</sup>United States, *Federal Administrative Procedure Act*, 1946, URL: <http://www.law.cornell.edu/uscode/text/5/part-I/chapter-5/subchapter-II> (visited on Dec. 20, 2013).

<sup>15</sup>See Office of the Chief Counsel, Division of Enforcement, *Enforcement Manual*, Oct. 9, 2013, URL: <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf> (visited on Nov. 28, 2013).

<sup>16</sup>See *ibid.*, Section 2.4 at pg. 22. These requirements are not exhaustive, and have been para-phrased for this Handbook.

## 5.5 Implementation

### 5.5.1 Changes

To implement the requirements of writing notices and mandating the issuance of notices to regulated entities in a standardised form, regulators will have to write detailed internal manuals on the form and content of notices (as defined in the *IFC*), and mandate that the staff of the regulator follows such manuals. The harmonisation of manuals on notices as per the provisions of the *IFC*, across financial agencies would reduce cost and complexity across the Indian financial system.

### 5.5.2 Instruments

1. The board of the regulator should pass a resolution defining the finite list of notices it will send to regulated entities;
2. The board of the regulator should pass a resolution stating that the regulator will prepare detailed manuals on the minimum content of each type of notice, and the circumstances in which such notice will be issued;
3. The regulators should make manuals governing the standards and minimum content of the notices, upholding best principles of governance; and
4. These manuals must be published.

# Chapter 6

## Transparency

### 6.1 Introduction

Transparency refers to the practice of disclosing appropriate information to the public about the workings of an organisation, including the decision making processes as well as outcomes. The regulators, as per their *FSDC Resolution dated October 24, 2013*, decided that<sup>1</sup>:

*“All regulators must publish all regulations and relevant information on the website within 24 hours of their coming into force in text-searchable format.*

*Global best practices on publication of laws and regulations to be incorporated by Dec. 31, 2013. This will apply with respect to all past rules, regulations, notifications, circulars and other relevant information.”*

The text of the extract above flows from the governance-enhancing recommendations of the *Report of the Financial Sector Legislative Reforms Commission*. Implementing these would greatly enhance the transparency of regulatory processes in the financial sector in India, and would bring regulators in line with contemporary global standards of transparency.

### 6.2 Provisions

The provisions of the *IFC*, regarding transparency are:

1. Definition of the term “publish”<sup>2</sup>;

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<sup>1</sup>Financial Stability and Development Council, Government of India, see n. 1.

<sup>2</sup>FSLRC, *IFC*, see n. 16, Section 2(115).

2. The process of making regulations, and requiring publication of drafts of proposed regulations<sup>3</sup>;
3. Publication of general and special guidance<sup>4</sup>;
4. The requirement that a mandatory review of all regulations take place periodically, and the result of the review be published<sup>5</sup>;
5. The publication of comments received during the rulemaking process<sup>6</sup>; and
6. The minimum standard for publication of information<sup>7</sup>.

## 6.3 Rationale

The *FSLRC Analysis and Recommendations*, puts a focus on enhancing the rule of law in the financial sector, and notes that transparency is critical to legal process. According to the report, transparency provides balance to the strong executive powers that regulators must possess.

The *FSLRC Analysis and Recommendations*, states:

*“The Commission notes that the overall approach of the draft Code should be to provide for strong executive powers, balanced with greater transparency and accountability, to prevent abuse. Executive functions of regulator do not have standardised statutory checks under present legislations. Therefore, the Commission recommends that adequate transparency requirements, checks and judicial oversight be placed on the exercise of executive functions by regulator. This will also reduce allegations of possible bias and arbitrariness to the minimum.”*

Transparency brings major benefits to all stakeholders in the system:

1. When all relevant information is easily available and clearly presented, it becomes easier for regulated entities to understand what they are and are not allowed to do. As a result, they will be able to operate with clarity and confidence.
2. Regulators also benefit from increased transparency. When regulated entities understand the rules that bind them, they will not need to seek additional clarity from the regulator. Consequently, they are also less likely to unintentionally violate rules and laws. This reduces the routine workload of the regulator, and allows the regulator to concentrate its attention on detecting and disciplining wilful violators.

<sup>3</sup>FSLRC, *IFC*, see n. 16, Section 52 (Process of making regulations).

<sup>4</sup>*Ibid.*, Sections 56 (General guidance) and 57 (Special guidance).

<sup>5</sup>*Ibid.*, Section 59 (Review of regulations).

<sup>6</sup>*Ibid.*, Section 63 (Process for making rules).

<sup>7</sup>*Ibid.*, Section 74 (Minimum standard for publication of information).

3. With regard to wilful violations, transparency provides clarity on the exact status of the legal validity of regulatory instruments, and therefore makes it more difficult to dispute whether the violated regulations were valid, in-force, or correctly notified. This again allows the regulator to be more efficient and effective, as violators will be less likely to contest the regulators decisions, and litigation outcomes regarding regulatory decisions will likely improve.
4. Also, in a globally integrated financial system, international co-operation is a critical tool for regulators. Transparency allows foreign regulators to co-operate more effectively with their Indian counterparts, as they are able to access up-to-date information such as watch lists, decisions and changes in policy.

## 6.4 International Examples

### 6.4.1 Australia

*Information Publication Scheme Plan*, of which an extract is given in which is an extract is given in Figure 6.1 is an information sheet published by **Australian Securities & Investments Commission (ASIC)**. It explains the regulator's obligations under the relevant transparency laws.<sup>8</sup>

The document contains the following noteworthy information:

1. Specific reference to the applicable sections of the relevant law;
2. A description of the regulator's obligations under the country's Freedom of Information Act;
3. The regulator's plan for complying with these obligations;
4. A description of how the regulator will ensure that information that is already available, will continue to be available under any new system;
5. A description of the broad features of the information technology system that will be used to publicize information going forward;
6. A specific commitment to execute the plan by a particular date; and
7. Details of a review mechanism for ensuring the regulator's ongoing compliance with its obligations.

In addition to the information content of the document, the following features should be noted:

1. The document uses plain, clear English;

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<sup>8</sup>See Australian Securities & Investments Commission, *Information Publication Scheme Plan*, Apr. 2011, URL: [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC-information-publication-scheme-plan.pdf/\\$file/ASIC-information-publication-scheme-plan.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC-information-publication-scheme-plan.pdf/$file/ASIC-information-publication-scheme-plan.pdf) (visited on Dec. 1, 2013).

2. The document is cleanly laid out, with minimal extraneous information;
3. Key information is presented in bullet points;
4. The document is written so that it can be clearly understood without requiring extensive references to other documents; and
5. Where other documents are referred to, this document provides clear and accurate information about how to access those other documents.

### 6.4.2 United States

*Regulatory Actions Page*, is the webpage on which the SEC publishes all relevant laws and rules.<sup>9</sup> The extract of the webpage shown in figure 6.2 displays the following features:

1. All relevant types of documents have been grouped together according to type;
2. Past rules, regulations, notifications, circulars and other relevant information are available;
3. Proposed rules are accessible; and
4. The webpage contains no extraneous information, uses minimal graphics, and uses a simple table with muted colours and simple formatting, that will display correctly on a variety of modern internet browsers.

### 6.4.3 United Kingdom

A perusal of the *Financial Conduct Authority Handbook* shows that the regulator has maximised the potential of the digital format. The extract from the *Financial Conduct Authority Handbook*, in figure 6.3 displays the following noteworthy features:

1. The page uses simple, muted colours and an uncluttered layout that allows users to quickly identify the various functionalities of the site;
2. The page features a menu on the right which allows the user to navigate quickly between the handbook, the glossary, and key topics;
3. The page prominently lists recent regulatory decisions or changes in chronological order, with the latest item at the top of the list; and
4. The page includes a tool for displaying the state of the handbook today, or as it appeared on any date in the past. This allows users to understand what rules had been notified at what point.

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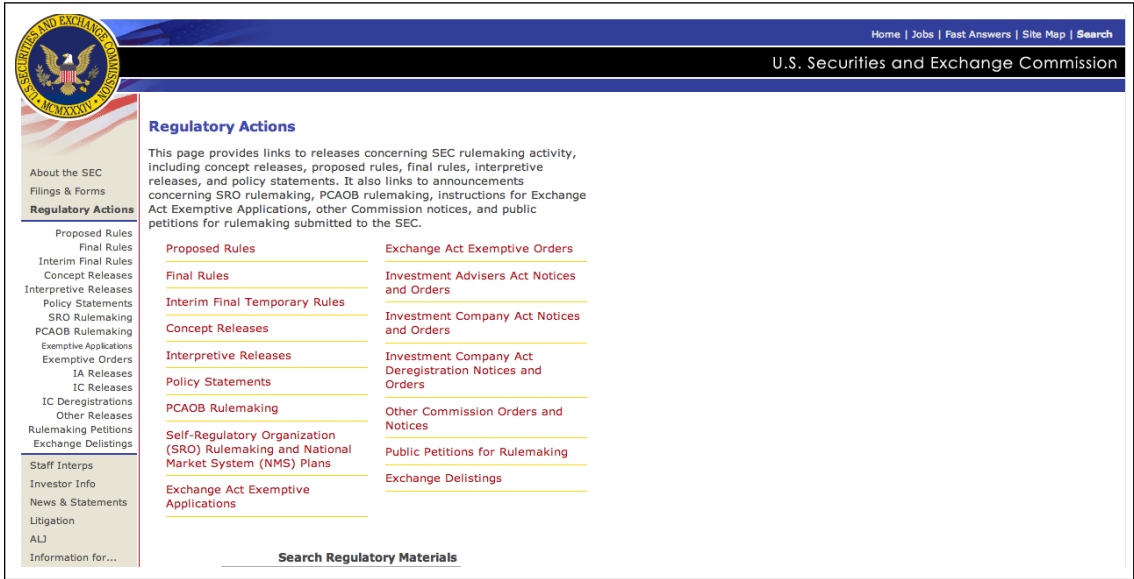
<sup>9</sup>See Securities and Exchange Commission, *Regulatory Actions Page*, May 30, 2013, URL: <http://www.sec.gov/rules.shtml> (visited on Dec. 1, 2013).

Figure 6.1: Explanation of **ASIC**'s obligations to maintain a transparent regulatory framework



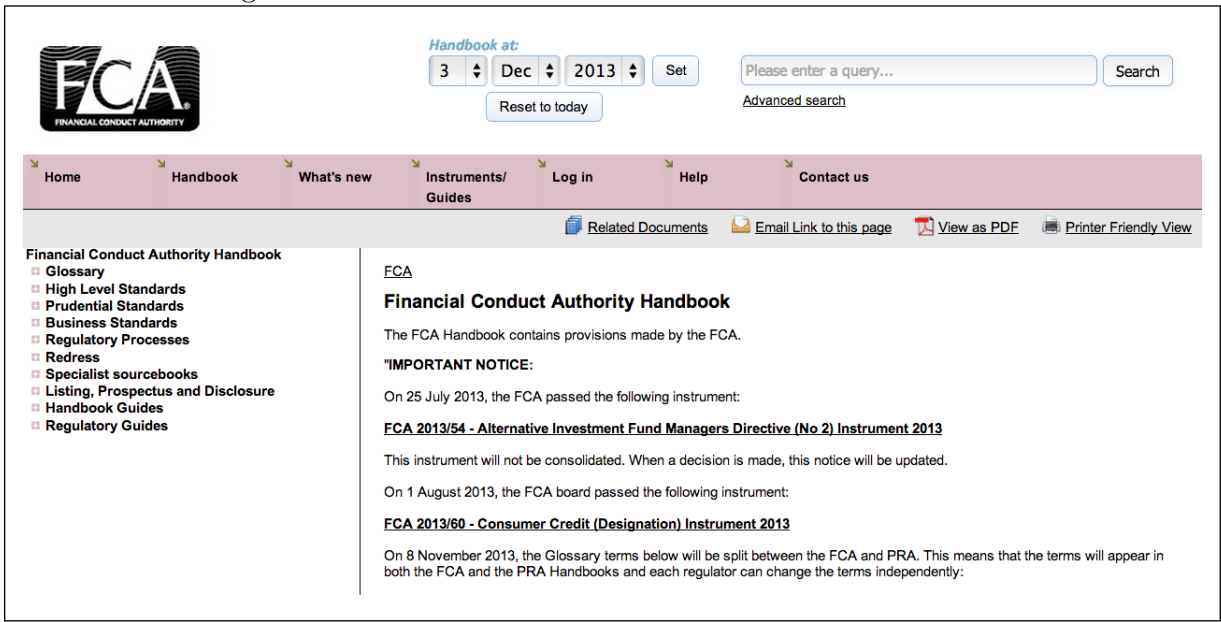
**Source:** Australian Securities & Investments Commission, *Information Publication Scheme Plan*, Apr. 2011, URL: [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC-information-publication-scheme-plan.pdf/\\$file/ASIC-information-publication-scheme-plan.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC-information-publication-scheme-plan.pdf/$file/ASIC-information-publication-scheme-plan.pdf) (visited on Dec. 1, 2013)

Figure 6.2: Extract showing the publication of relevant laws and rules by the SEC



Source:Securities and Exchange Commission, *Regulatory Actions Page*, May 30, 2013, URL: <http://www.sec.gov/rules.shtml> (visited on Dec. 1, 2013)

Figure 6.3: Extract from the FCA Handbook



Source:Financial Conduct Authority, *Financial Conduct Authority Handbook*, URL: <http://www.fshandbook.info/FS/html/FCA> (visited on Dec. 1, 2013)



## 6.5 Implementation

### 6.5.1 Changes

Implementation of the provisions of the *IFC*, will lead to the following outcomes:

1. The process of making regulations, including proposed regulations will become more transparent;
2. General and special guidances will be published;
3. Comments received during the rulemaking process will be published; and
4. Regulators will re-design their websites keeping in mind the global best practices on transparency in financial regulation.

### 6.5.2 Instruments

Implementing the recommendations under the *IFC*, would require all regulators to pass internal resolutions requiring their staff to:

1. Develop rules and processes for capturing the information that is required to be published under the *IFC*;
2. Developing and maintaining appropriate information systems for centralising and storing this information;
3. Developing rules and processes to ensure that all relevant information
4. Developing and maintaining a web site, through which this information can be found in a text-searchable format; and
5. Ensuring that the design of the user interface of the website is clear and accessible as per global best practices.

# Chapter 7

## Transparency in Board Meetings

### 7.1 Introduction

The regulators, as per their *FSDC Resolution dated October 24, 2013*, decided that

*“The secretary of the Board of the regulatory agency will be responsible for keeping records of every meeting, and any votes taken and resolutions passed during the meeting.*

*The records of every meeting, along with the decisions taken, resolutions passed and voting records will be published within three weeks of the meeting.*

*Selected portions of records may not be published if: (i) it is personal information relating to an individual within the regulatory agency, or personal information exempt from the Right to Information Act, 2005, (ii) it involves a particular instance of the violation of any laws, or disclose information about an ongoing investigation, (iii) it discloses a procedure or technique of investigation, (iv) it contains information of a commercial nature with regard to a regulated entity, or (v) contains information that would deprive a person of a right to fair and impartial hearing.*

*Selected portions of records may be delayed if: (i) disclosure would lead to a major instability of the financial system, (ii) disclosure would significantly frustrate any action of the regulatory agency and such action has not been disclosed to the public, (iii) they involve discussion of any ongoing legal proceeding before a court, tribunal or arbitrator. Any decision to not disclose information under the paras ... above will be taken by a vote of the Board, separately for each portion of the selected records.”*

Transparency in board meetings refers to the practice of allowing public scrutiny of the work of the board's crucial functions. The recommendations of the *FSLRC Analysis and Recommendations*, regarding transparency are as follows:

*“The Commission is of the view that very high regard should be given to the need for transparency in the board meetings of the regulator. While there may be some specific decisions or deliberations of the regulator which may have commercial implications and may not be released immediately, this should not be unduly used as a reason to deviate from the general principle of transparency. The draft Code will therefore require the regulators to be transparent about meetings as far as possible and when any information is kept confidential, reasons for doing so must be recorded. For instance, pending investigations and queries about violations by a regulated entity should be kept outside the purview of publication as they have an impact on the reputation on the institution without a finding of violation of laws. However, the decisions of the regulator should be published to provide information to the regulated entities on the standards of conduct expected by the regulator.”<sup>1</sup>*

## 7.2 Provisions

The provisions regarding transparency of board meetings in the *IFC*, are:

1. There is a specified procedure as per which every meeting of the board of a regulator has to be conducted<sup>2</sup>;
2. The Second Schedule - regarding procedure of meetings of the board of the regulator requires:
  - (a) The secretary of the board of the regulatory agency will be responsible for keeping records of every meeting, and any votes taken and resolutions passed during the meeting.
  - (b) The records of every meeting, along with the decisions taken, resolutions passed and voting records will be published within three weeks of the meeting.
  - (c) Selected portions of records may not be published if: (i) it is personal information relating to an individual within the regulatory agency, or personal information exempt from the Right to Information Act, 2005, (ii) it involves a particular instance of the violation of any laws, or disclose information about an ongoing investigation, (iii) it discloses a procedure or technique of investigation, (iv) it contains information of

<sup>1</sup>Section 3.3 of the Report on the functioning of the Board, FSLRC, *FSLRC Analysis and Recommendations*, see n. 2, at page 23.

<sup>2</sup>Section 34 (Meetings of the board of a Financial Agency) FSLRC, *IFC*, see n. 16.

a commercial nature with regard to a regulated entity, or (v) contains information that would deprive a person of a right to fair and impartial hearing.

- (d) Selected portions of records may be delayed if: (i) disclosure would lead to a major instability of the financial system, (ii) disclosure would significantly frustrate any action of the regulatory agency and such action has not been disclosed to the public, (iii) they involve discussion of any ongoing legal proceeding before a court, tribunal or arbitrator.
- (e) Any decision to not disclose information mentioned in point 2b above will be taken by a vote of the board, separately for each portion of the selected records.

### 7.3 Rationale

The *FSLRC Analysis and Recommendations* puts a focus on enhancing the rule of law in the financial sector, and notes that transparency is critical to legal process. Transparency provides a balance to the strong executive powers that regulators must possess.<sup>3</sup> This applies in particular to the functioning of the boards of regulators, who are expected to exercise a critical governance function.

The boards of regulators have a critical role in ensuring good governance in the financial system, both by ensuring that best practices apply to regulators, and by creating a regulatory environment where good governance norms are upheld. Given this central role of boards, the *FSLRC Analysis and Recommendations*, has made explicit reference to the need for transparency in board meetings.<sup>4</sup>

As with the general requirement of transparency, transparency in board meetings serves as a balance to the autonomy and authority that the regulator is expected to exercise, and may be subject to some limitations. However the overall philosophy is one of openness.

Transparency in general confers important benefits to regulated entities, who can then operate with greater clarity and confidence. Transparency in board meetings provides additional systemic benefits: It helps market participants who wish to develop compliance strategies that are responsive to and harmonious with the purpose and substance of the boards decisions. Transparency also helps policy-makers and regulators govern harmoniously and coordinate their messages. This promotes regulatory consistency within the financial system.

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<sup>3</sup>See FSLRC, *FSLRC Analysis and Recommendations*, see n. 2, Section 3.3 Functioning of the Board, p. 24.

<sup>4</sup>See *ibid.*, Section 3.3 Functioning of the Board, p. 24.

## 7.4 International Examples

### 7.4.1 United States

*Government in the Sunshine Act* is a **United States of America (US)** law governing disclosure of information by government agencies, regarding their rules, opinions, orders, records, and proceedings.<sup>5</sup>

The Act includes provisions obliging all agencies to publish information regarding, among other things:

- Where and from whom the public may request information regarding the agency;
- The general functioning of the agency, including all formal and informal procedures available;
- Rules of procedure and instructions regarding the scope of the various types of documents issued by the agency;
- General policies and substantive rules adopted by the agency;
- All amendments, revisions or repeals of policies or rules;
- Final opinions, including concurring and dissenting opinions, and order, made in the adjudication of cases; and
- Staff manuals.

*Commission Open Meetings* is a page from the **US** securities regulator's web-site, from which the public can access the regulator's Board meetings.<sup>6</sup> The extract provided in figure 7.1 shows that the regulator has made its board meetings available via live web-casts.

Additional features worth noting include:

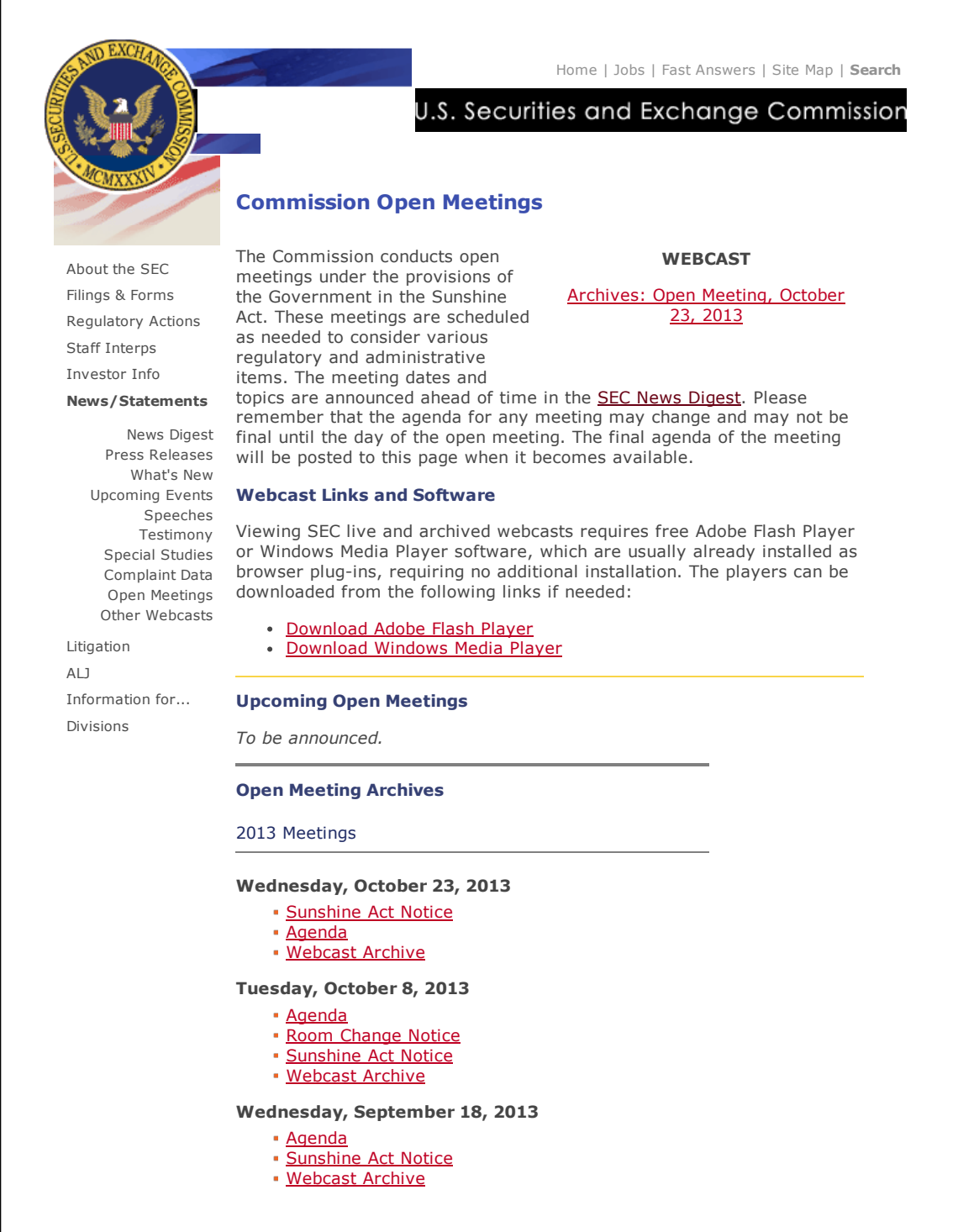
1. The page provides access to archived versions of earlier meetings.
2. For each meeting, links have been provided to the notice regarding the relevant transparency law, and to the agenda for that meeting.
3. The regulator has selected an electronic format which is widely accessible and unlikely to require that users install additional software in order to view the material.

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<sup>5</sup>United States, *Government in the Sunshine Act*, 1976, URL: [http://www.gsa.gov/graphics/ogp/SunshineAct\\_R2B-x3-g\\_0Z5RDZ-i34K-pR.pdf](http://www.gsa.gov/graphics/ogp/SunshineAct_R2B-x3-g_0Z5RDZ-i34K-pR.pdf) (visited on Dec. 22, 2013).

<sup>6</sup>Securities and Exchange Commission, *Commission Open Meetings*, 2013, URL: <http://www.sec.gov/news/openmeetings.shtml> (visited on Dec. 3, 2013).

Figure 7.1: Web-page of the **SEC** web-site giving details of the open meetings of the Commission



The screenshot shows the SEC's "Commission Open Meetings" page. On the left is a navigation menu with links like "About the SEC", "Filings & Forms", "Regulatory Actions", "Staff Interps", "Investor Info", "News/Statements", "Litigation", "ALJ", "Information for...", and "Divisions". The "News/Statements" section is expanded, showing links to "News Digest", "Press Releases", "What's New", "Upcoming Events", "Speeches", "Testimony", "Special Studies", "Complaint Data", "Open Meetings", and "Other Webcasts". The main content area is titled "Commission Open Meetings" and includes a "WEBCAST" section with a link to "Archives: Open Meeting, October 23, 2013". Below this is a "Webcast Links and Software" section explaining that viewing live and archived webcasts requires Adobe Flash Player or Windows Media Player software. It provides links to "Download Adobe Flash Player" and "Download Windows Media Player". The "Upcoming Open Meetings" section states "To be announced." The "Open Meeting Archives" section lists "2013 Meetings" and provides details for three specific dates: Wednesday, October 23, 2013; Tuesday, October 8, 2013; and Wednesday, September 18, 2013. For each date, it lists links for "Sunshine Act Notice", "Agenda", and "Webcast Archive".

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U.S. Securities and Exchange Commission

## Commission Open Meetings

The Commission conducts open meetings under the provisions of the Government in the Sunshine Act. These meetings are scheduled as needed to consider various regulatory and administrative items. The meeting dates and topics are announced ahead of time in the [SEC News Digest](#). Please remember that the agenda for any meeting may change and may not be final until the day of the open meeting. The final agenda of the meeting will be posted to this page when it becomes available.

### WEBCAST

[Archives: Open Meeting, October 23, 2013](#)

### Webcast Links and Software

Viewing SEC live and archived webcasts requires free Adobe Flash Player or Windows Media Player software, which are usually already installed as browser plug-ins, requiring no additional installation. The players can be downloaded from the following links if needed:

- [Download Adobe Flash Player](#)
- [Download Windows Media Player](#)

### Upcoming Open Meetings

*To be announced.*

### Open Meeting Archives

#### 2013 Meetings

##### Wednesday, October 23, 2013

- [Sunshine Act Notice](#)
- [Agenda](#)
- [Webcast Archive](#)

##### Tuesday, October 8, 2013

- [Agenda](#)
- [Room Change Notice](#)
- [Sunshine Act Notice](#)
- [Webcast Archive](#)

##### Wednesday, September 18, 2013

- [Agenda](#)
- [Sunshine Act Notice](#)
- [Webcast Archive](#)

**Source:** Securities and Exchange Commission, *Commission Open Meetings*, 2013, URL: <http://www.sec.gov/news/openmeetings.shtml> (visited on Dec. 3, 2013)

## 7.5 Implementation

### 7.5.1 Changes

Implementing the recommendations under the *IFC*, would require all regulators to:

1. Develop appropriate rules and processes for board meetings that are in compliance with the provisions of the *IFC*, and the Second Schedule:
  - (a) Take detailed minutes of all meetings;
  - (b) Record all minutes along with proceedings and decisions taken, and publish them within three weeks, save specific exceptions;
  - (c) Write narrow, specific carve-outs for redacting or delaying certain information, consistent with Schedule 2 (Procedure of meetings of the board of the Financial Agency) of the *IFC*; and
  - (d) Take a vote on, and record all decisions to not release information.
2. Ensure that the design of the user interface of the web-site is clear and accessible.

### 7.5.2 Instruments

1. The board of every regulator should pass a resolution adopting the provisions of Schedule 2 (Procedure of meetings of the board of the Financial Agency) of the *IFC*; and
2. The board of every regulator may pass a resolution to the effect that the regulator will publish all relevant information on its web-site in accordance with international best practices, some of which have been mentioned earlier in this section.

# Chapter 8

## Reporting

### 8.1 Introduction

The regulators, as per their *FSDC Resolution dated October 24, 2013*, decided that<sup>1</sup>:

*“All regulators should change the format of their annual reports, to move to a performance review system where functions of the regulator are reported with quantified indicators. These include:*

- 1. A review of the regulator’s activities in relation to its functions and objectives, and all related information.*
- 2. A statement of the deliberations of the regulator, along with the records of its meetings.*
- 3. A statement of major activities the regulator will undertake in the subsequent financial year.”*

Reporting refers to the practice of measuring, recording and publishing data and information about an organisation’s activities, measured against the organisation’s objectives.

The *Report of the Financial Sector Legislative Reforms Commission*, contains core recommendations regarding transparency.<sup>2</sup> As per these recommendations, regulators should move to a performance review system. Under such a system functions of the regulator are reported with quantified indicators. These include:

1. A review of the regulators activities in relation to its functions and objectives, and all related information.
2. A statement of the deliberations of the regulator, along with the records of its meetings.

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<sup>1</sup>Financial Stability and Development Council, Government of India, see n. 1.

<sup>2</sup>See FSLRC, *IFC*, see n. 16, Table of Recommendations 3.10 Performance Measurement and Reporting.



3. A statement of major activities the regulator will undertake in the subsequent financial year.

## 8.2 Provisions

Section 77 (Returns and reports) of the *IFC*, contains detailed provisions on the form and content of reports that regulators must send to the Central Government.<sup>3</sup> These include:

1. Periodical reporting of returns and statements and filing of annual reports;
2. Annual reports to contain:
  - (a) a review of the regulator's activities in relation to the discharge of its functions and the achievement of its objectives;
  - (b) all information required to understand the discharge of functions and the achievement of the objectives of the regulator, that has been published by the regulator;
  - (c) a statement of deliberations of the board of the regulator, along with the records of the meetings of the regulator;
  - (d) a statement indicating any statutory obligation that the regulator or its board has not complied with, and reasons for such non-compliance;
  - (e) a statement by the chairperson of the regulator in relation to the activities and performance of the board; and
  - (f) a statement of the major activities the regulator will undertake in the subsequent financial year.

Additional provisions govern reporting in the following contexts:

- Accounts and audit<sup>4</sup>;
- The annual report of the Reserve Bank<sup>5</sup>.

## 8.3 Rationale

The *FSLRC Analysis and Recommendations*, states<sup>6</sup>:

*“Measurement systems for assessing the performance of regulators should include an assessment of the regulators processes on metrics such as, the time taken for*

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<sup>3</sup>See, *ibid.*

<sup>4</sup>*Ibid.*, Section 78 (Accounts and audit).

<sup>5</sup>*Ibid.*, Section 375 (Annual report of the Reserve Bank).

<sup>6</sup>See FSLRC, *FSLRC Analysis and Recommendations*, see n. 2, Section 3.6 Performance assessment and reporting.

*granting an approval, measurement of efficiency of internal administration systems, costs imposed on regulated entities and rates of successful prosecution for violation of laws. Adopting such an approach would constitute a departure from the present system where most financial regulators focus on measuring the activities of regulated entities and financial markets as a standard for their own performance. The Commission noted that while these measurements are important, measurement of various activities undertaken by the regulator will provide much greater transparency and accountability.”*

A reporting regime that requires regulators to articulate their objectives in relation to their functions, measure and publish their performance against those objectives, and announce the major activities they plan to undertake, is an important source of transparency and accountability.

Effective reporting results in immediate and clear benefits to regulated entities and consumers. When regulators declare how they intend to perform their functions and fulfill their objectives in their reports, regulated entities better understand the nature and context of regulation imposed on them. This helps regulated entities to account for compliance costs. It also makes regulatory action more predictable and consistent, thereby increasing its legitimacy.

Reporting also helps in the measurement of performance as per well defined targets. Measuring and benchmarking performance against targets is a well recognised method for improving an organisation’s operational performance. By measuring performance against specific objectives the organisation also protects itself from being assessed against unrealistic or inappropriate standards. When the organisation falls short of its targets due to inadequate resourcing, benchmarked performance metrics allow it to justify its requests for additional resources.

Using public reports to articulate major upcoming activities has broader systemic benefits. Publication puts market participants on notice, allowing them to plan for changes in regulatory priorities and making it easier for them to structure their compliance strategies. It also allows regulators to harmonise their approaches and ensure that they project a coherent policy on behalf of the government.

## 8.4 International Examples

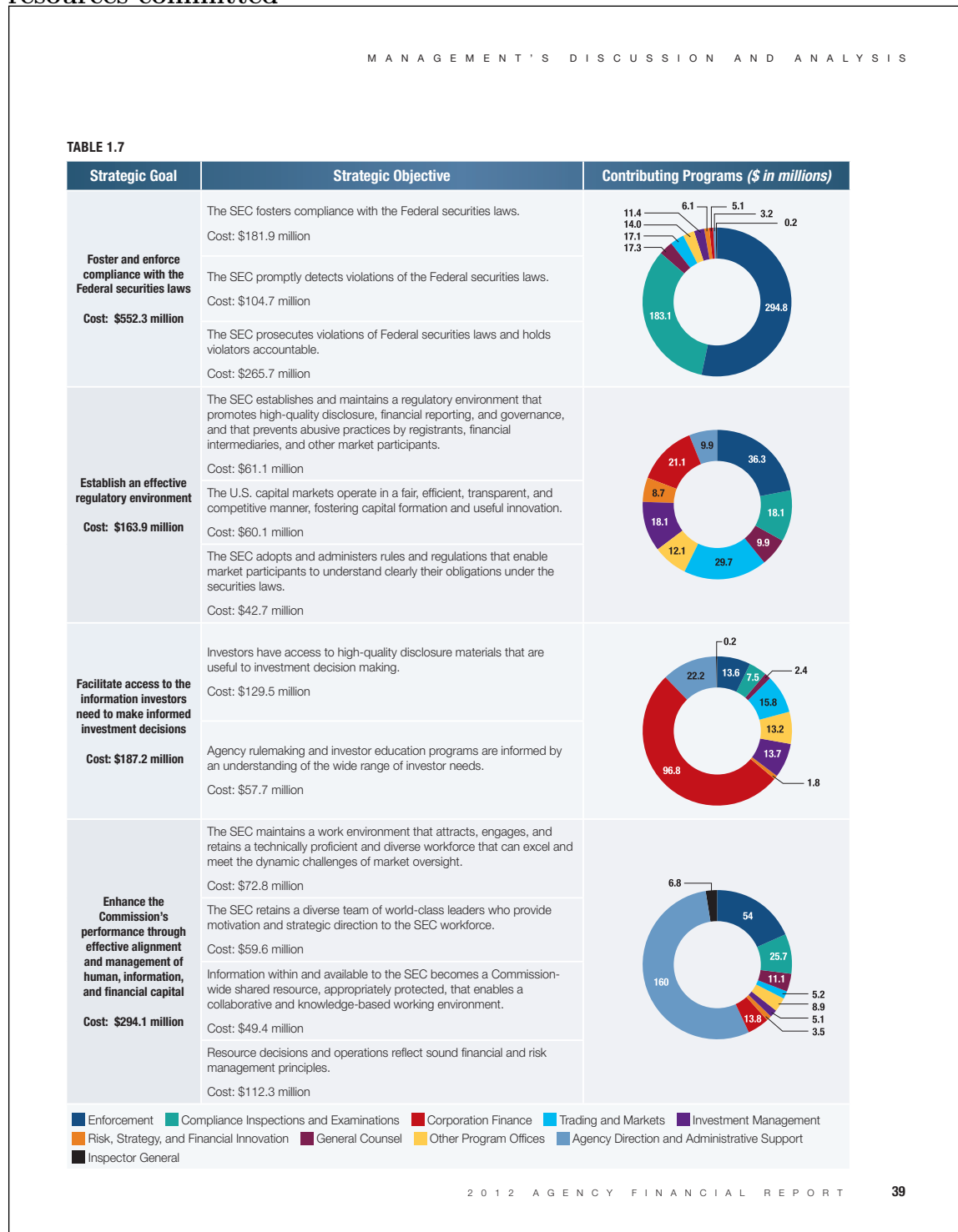
### 8.4.1 United States

The *Fiscal Year 2012 Agency Financial Report*, provides a comprehensive overview of the regulator’s performance.<sup>7</sup> The extract from Management’s Discussion and Analysis, given in Figure 8.1 shows how the regulator has tabulated its strategic objectives against its strategic goals. This diagram goes even further, showing the department-wise resources committed towards those goals.

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<sup>7</sup>Securities and Exchange Commission, *Fiscal Year 2012 Agency Financial Report*, Nov. 15, 2012, URL: <http://www.sec.gov/about/secpar/secafr2012.pdf> (visited on Dec. 19, 2013).

Figure 8.1: Combining tables and graphs to display objectives, goals and resources committed



**Source:** Securities and Exchange Commission, *Fiscal Year 2012 Agency Financial Report*, Nov. 15, 2012, URL: <http://www.sec.gov/about/secpar/secafr2012.pdf> (visited on Dec. 19, 2013)

The *Fiscal Year 2012 Summary of Performance and Financial Information*, is a concise summary of key information, which the SEC publishes alongside its annual report.<sup>8</sup> This notably includes:

1. an overview of the regulator's key activities over the last reporting period, stated in the form of strategic goals;
2. performance data with regard to these strategic goals; and
3. an articulation of its strategic goals for the following year.

The extract reproduced at figure 8.2 below shows how the regulator has chosen to resolve its complex activities into broad strategic headings, and chosen a performance metric that allows a reader to get a high-level snapshot of the regulator's performance. The full report includes and elaborates upon this information.

### 8.4.2 United Kingdom

The *Enforcement Annual Performance Account*, is an example of a specialised report from the FSA, which collates data on the regulator's enforcement activities.<sup>9</sup> The extracts reproduced below as shown in Figure 8.3 and in Figure 8.4 show how data is presented through a combination of tables and charts, providing a helpful understanding of the regulator's performance in key areas. The spacing and format of the charts and tables is conducive to both quick reading and close study.

## 8.5 Implementation

### 8.5.1 Changes

Under existing laws, the Central Government frames rules on the manner and content of returns and reports to be made to it by the regulators. The regulators have voluntarily agreed to move to a system of reporting that forms part of a performance review system where the functions of the regulator are reported with quantified indicators. To implement enhanced reporting requirements as laid out in detail in section 8.2, the Central Government will have to re-draft/amend its reporting rules.

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<sup>8</sup>See Securities and Exchange Commission, *Fiscal Year 2012 Summary of Performance and Financial Information*, 2012, URL: <http://www.sec.gov/about/secpar/secafr2012-summary.pdf> (visited on Dec. 19, 2013).

<sup>9</sup>Financial Services Authority, *Enforcement Annual Performance Account*, 2013, URL: <http://www.fca.org.uk/static/documents/annual-report/fsa-enforcement-performance-account-2012-13.pdf> (visited on Dec. 1, 2013).

Figure 8.2: High-level snapshot of organisational performance



**Source:** Securities and Exchange Commission, *Fiscal Year 2012 Summary of Performance and Financial Information*, 2012, URL: <http://www.sec.gov/about/secpar/secafr2012-summary.pdf> (visited on Dec. 19, 2013)

Figure 8.3: Use of table to report data

Enforcement Annual Performance Account 2012/13 17				
<h2>Data and analysis</h2>				
Enforcement statistics from the <i>Annual Report</i>				
<b>Appendix 2 of the 2012/13 Annual Report – Enforcement activity</b>				
Issue <sup>1</sup>	Open at 1st April 2012	Opened during the year	Closed during the year	Open at 31st March 2013
Systems and Controls	35	21	22	34
Treating Customers Fairly	20	15	13	22
Unauthorised Activities	24	2	12	13
SIF Holders	14	8	8	14
Market Protection	26	11	9	28
Listing Rules	5	3	5	3
Authorisations	0	1	0	1
Money laundering controls and Financial Fraud	24	2	7	19
<b>Totals (Excl TCT)</b>	<b>148</b>	<b>63</b>	<b>76</b>	<b>134</b>
<b>Threshold Conditions Team<sup>2</sup> (excluding RMAR and PSD cases)</b>	<b>35</b>	<b>123</b>	<b>126</b>	<b>32</b>
<b>TCT RMAR Cases<sup>3</sup></b>	<b>13</b>	<b>130</b>	<b>139</b>	<b>4</b>
<b>TCT PMD Cases<sup>4</sup></b>	<b>18</b>	<b>115</b>	<b>112</b>	<b>21</b>
<b>International Requests</b>	<b>132<sup>5</sup></b>	<b>885</b>	<b>793</b>	<b>224</b>

1 Cases may involve multiple parties and include both firms and individuals.

2 TCT (Threshold Conditions Team) cases involve regulated firms that fail to meet the FSA's minimum standards i.e. Threshold Conditions.

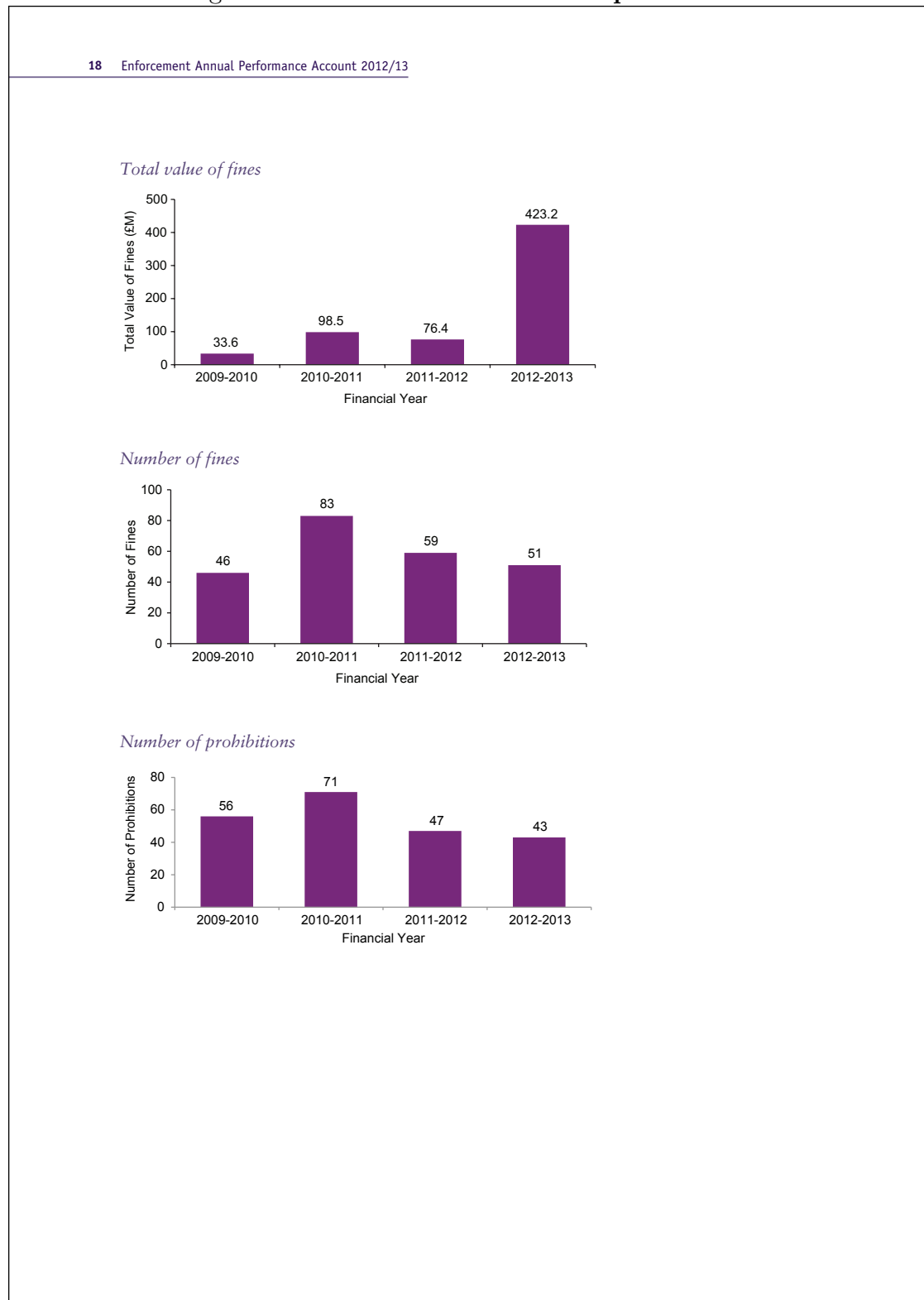
3 The RMAR (Retail Mediation Activities Return) enforcement project began in October 2005. It focuses on ensuring that firms comply with our requirement to submit electronic returns.

4 PSD (Payment Services Directive) cases involve enforcement action against firms failing to comply with the Payment Services Regulations.

5. In the 2011/12 Annual Report Appendix we reported that 225 cases were open at 31 March 2012, however this figure has since been corrected and the number of international requests open at the end of last year was 132.

**Source:**Financial Services Authority, *Enforcement Annual Performance Account*, 2013, URL: <http://www.fca.org.uk/static/documents/annual-report/fsa-enforcement-performance-account-2012-13.pdf> (visited on Dec. 1, 2013)

Figure 8.4: Use of bar charts to report data



**Source:**Financial Services Authority, *Enforcement Annual Performance Account*, 2013, URL: <http://www.fca.org.uk/static/documents/annual-report/fsa-enforcement-performance-account-2012-13.pdf> (visited on Dec. 1, 2013)

### 8.5.2 Instruments

The responsibility of implementing this measure lies with the Central Government. It should therefore frame rules under existing laws that require regulators to report the following in their annual reports:

1. A review of the regulator's activities in relation to the discharge of its functions and the achievement of its objectives;
2. All information required to understand the discharge of functions and the achievement of the objectives of the regulator, that has been published by the regulator;
3. A statement of deliberations of the board of the regulator, along with the records of the meetings of the regulator;
4. A statement indicating any statutory obligation that the regulator or its board has not complied with, and reasons for such non-compliance;
5. A statement by the chairperson of the regulator in relation to the activities and performance of the board; and
6. A statement of the major activities the regulator will undertake in the subsequent financial year.



# Chapter 9

## Approvals

### 9.1 Introduction

The regulators, as per their *FSDC Resolution dated October 24, 2013*, decided that:<sup>1</sup>

*“All regulators will move to a time-defined (90 days) approval process, subject to applicable laws, for all permissions including license to do business, as well as launch of products and services. ”*

Approvals refers to the permissions granted by regulators and government to carry out any regulated activity. In the Indian system, approvals are not only required to enter a specific business, but inside each silo there may be subsequent approvals for different aspects of a business like opening branches, offering new products or services, etc. The *Report of the Financial Sector Legislative Reforms Commission*, deals with all such approvals under a single legal procedure.

The resolution requires the regulators and government to develop detailed legal process governing the substantial powers or accepting and rejecting applications. This is in keeping with no change in the substantial power to accept or reject any applications.

The *FSLRC Analysis and Recommendations*, lays down the key features of the desired approval system, which are:<sup>2</sup>

1. Provide a system for persons to apply for authorisation to provide financial services;
2. Ensure that all applications are accepted or rejected within a specified time;
3. Ensure that whenever an application is rejected, reasons for the rejection are provided; and

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<sup>1</sup>Financial Stability and Development Council, Government of India, see n. 1.

<sup>2</sup>Table of Recommendations 4.7 Giving permission to carry out a business of the FSLRC, *FSLRC Analysis and Recommendations*, see n. 2, at pg. 34.

4. Provide that the regulator gives warning to the applicant before rejecting an application.

## 9.2 Provisions

Chapter 14: Disposal of Applications of the *IFC*, provides the detailed procedural requirements for dealing with applications generally. These provisions apply whenever the regulator requires any person to make an application for permissions.

1. They require the regulator to:<sup>3</sup>
  - (a) Make regulations governing how applications are to be made;
  - (b) Acknowledge receipt of applications quickly; and
  - (c) Give applicants an opportunity to withdraw or modify regulations.
2. The regulator may ask for additional information from the applicant only after providing the reasons for the relevance of the additional information.<sup>4</sup>
3. The entire internal procedure of granting the applications requires the regulator to:<sup>5</sup>
  - (a) Decide applications only on the requirements (if any), which must be mentioned in regulations.
  - (b) Not reject applications due to absence of regulations.
  - (c) Decide within 180 days.
  - (d) Issue a show cause notice, before considering to reject any application.<sup>6</sup>
  - (e) Issue a decision order when rejecting an application.<sup>7</sup>
  - (f) Clearly state in a public document, the approvals granted along with all conditions (if any).

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<sup>3</sup>See, S.68 (Procedure for making regulations) of the, FSLRC, *IFC*, see n. 16, at pg. 35.

<sup>4</sup>See S.69 (Additional information) of the, *ibid.*, at pg. 35.

<sup>5</sup>See S.70 (Procedure for determination of application) of the, *ibid.*, at pg. 35.

<sup>6</sup>Show cause notices have minimum standard and contents. See S. 400 (Content and standard of show cause notices) of the *ibid.*, at pg.166.

<sup>7</sup>Decision orders have minimum standard and contents. See S. 400 (Content and standard of show cause notices) of the *ibid.*, at pg.166.

## 9.3 Rationale

The *FSLRC Analysis and Recommendations*, considers approvals to be part of the general executive functions of the regulator.<sup>8</sup> The *FSLRC Analysis and Recommendations*, recognised that approvals of permissions have a substantial economic impact on regulated firms. The objective of the legal system envisaged by the **FSLRC** is:<sup>9</sup>

*“...that the power must be exercised in a manner guided by regulations. As far as possible the discretion of the regulator should be guided through an underlying duty to explain. The power of the regulator to reject applications should be balanced with the requirement for allowing legitimate parties getting approvals in a time bound manner for smoother functioning of the regulatory system.”*

The core principle of “rule of law” requires a substantial reduction in the discretion that regulators have. Regulated entities should also have a clear understanding of the standards on which their applications are judged. The system of regulatory governance where regulated entities do not have information about how and when their applications will be decided creates legal and economic uncertainties. These uncertainties hamper the development of financial markets. All uncertainties create costs for regulated entities which in turn pass these costs to the consumers.

Committing to a time-bound approval process increases predictability, and this helps firms to rationally plan for rollout of products and services. Commitment to clear service-level targets also lowers administrative and compliance costs, since time-consuming status checks and follow-up calls become unnecessary.

From the regulators’ perspective, commitment to time-bound approval processes allows the organisations to benchmark their own performance, and request appropriate resources when they are unable to meet these targets. Thus, operational planning and budgeting become rationalised, and resource allocation more efficient.

## 9.4 International examples

### 9.4.1 United Kingdom

The **United Kingdom (UK)** law governing regulators contains a provision, obliging its regulators to provide approval decisions within three months of receiving an application.<sup>10</sup>

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<sup>8</sup>See FSLRC, *FSLRC Analysis and Recommendations*, see n. 2, Table of Recommendations 4.6: General functions of the Regulator, p. 33.

<sup>9</sup>Section 4.2.1 of the *ibid.*, at pg.33.

<sup>10</sup>Section 61.(3) of the United Kingdom, *Financial Services and Markets Act 2000*, see n. 14.

“The Authority must, before the end of the period of three months beginning with the date on which it receives an application made under section 60 (the period for consideration), determine whether  
 (a) to grant the application; or  
 (b) to give a warning notice under section 62(2).”

The *Banking Authorisations Applicant Journey*, gives detailed information about:<sup>11</sup>

1. What information the applicant is required to provide;
2. In what order they will be analysed; and
3. Under what conditions, what restrictions will be applied.

Another key feature of the approval process is regular meetings for complicated businesses, before an application is made. This allows for the regulator to communicate to prospective applicants, the details of the requirements. The rules in the *New firm authorisation - Banking applications*, provide information to prospective clients about meetings for clarification, detailed forms for each step the regulator carries out and other requirements under the law in a single, comprehensive document.<sup>12</sup>

## 9.4.2 Australia

The regulatory system in Australia has a unified licensing system for all financial licenses. The regulator provides detailed documentation on:

1. How to apply for a new Australian Financial License;
2. How to apply for a variation of an existing Australian Financial; and License
3. How an application will be processed.

The detailed system of application is provided in the following three regulatory guides:

1. The *AFS Licensing Kit Part 1*<sup>13</sup>;
2. The *AFS Licensing Kit Part 2*<sup>14</sup>; and

<sup>11</sup>Financial Conduct Authority, *Banking Authorisations Applicant Journey*, June 26, 2013, URL: <http://www.fca.org.uk/static/fca/documents/banking-authorisations-applicant-journey.pdf> (visited on Dec. 1, 2013).

<sup>12</sup>Bank of England, *New firm authorisation - Banking applications*, Mar. 6, 2013, URL: <http://www.bankofengland.co.uk/pr/Pages/authorisations/newfirm/banking.aspx> (visited on Dec. 1, 2013).

<sup>13</sup>See, Australian Securities & Investments Commission, *AFS Licensing Kit Part 1*, Applying for and varying an AFS licence, June 2012, URL: [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rg1-published-12-June-2012.pdf/\\$file/rg1-published-12-June-2012.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rg1-published-12-June-2012.pdf/$file/rg1-published-12-June-2012.pdf) (visited on Dec. 1, 2013).

<sup>14</sup>See, Australian Securities & Investments Commission, *AFS Licensing Kit Part 2*, Preparing your AFS licence or variation application, June 2013, URL: [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rg2-published-28-June-2013.pdf/\\$file/rg2-published-28-June-2013.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rg2-published-28-June-2013.pdf/$file/rg2-published-28-June-2013.pdf) (visited on Dec. 1, 2013).

### 3. The *AFS Licensing Kit Part 3*<sup>15</sup>.

The *ASIC Service Charter*, provides the commitments the regulator makes to users published a separate document regarding containing its commitments to users. It contains:<sup>16</sup>

1. A list of all services the regulator provides to the public;
2. For each service, a list of commitments in terms of both manner and speed of response. This applies to its power to grant various kinds of approvals and licenses; and
3. Web links, through which further details and information about its statutory obligations can be accessed.

Figure 9.1 shows that the regulator commits to providing a decision within 28 days for most types of approval, and 12 weeks for a license to operate Australian financial markets - though it does indicate that approval decisions may take longer if an application raises new or complex policy issues.

## 9.5 Implementation

### 9.5.1 Changes

Implementation of proper regulatory governance principles to the way regulators grant or deny various permission under their respective laws will provide greater certainty and clarity to the regulatory process. The salient features of the process should be:

1. Clear information to be provided to regulated parties about:
  - (a) The form in which applications have to be made.
  - (b) All supporting documents which have to be provided with the application.
  - (c) The criteria on which their application will be judged.
2. Regulated entities should also have clear visibility of when applications will be decided.
3. Before any application is rejected, the applicant is given:

<sup>15</sup>See, Australian Securities & Investments Commission, *AFS Licensing Kit Part 3*, Preparing your additional proofs, June 2012, URL: [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rg3-published-12-June-2012.pdf/\\$file/rg3-published-12-June-2012.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rg3-published-12-June-2012.pdf/$file/rg3-published-12-June-2012.pdf) (visited on Dec. 1, 2013).

<sup>16</sup>See, Australian Securities & Investments Commission, *ASIC Service Charter*, Sept. 2012, URL: [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/ASIC-service-charter-published-12-September-2012.pdf/\\$file/ASIC-service-charter-published-12-September-2012.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/ASIC-service-charter-published-12-September-2012.pdf/$file/ASIC-service-charter-published-12-September-2012.pdf) (visited on Dec. 1, 2013).

Figure 9.1: **ASIC** service level commitments

<b>Registering as an auditor or liquidator</b>	<p>We aim to decide whether to register a person as an auditor, liquidator or official liquidator within 28 days of receiving a complete application (<i>target: 80%</i>).</p> <p>You can lodge applications online at <a href="http://www.asic.gov.au/auditregistration">www.asic.gov.au/auditregistration</a> and <a href="http://www.asic.gov.au/liquidator-registration">www.asic.gov.au/liquidator-registration</a>.</p> <p>These applications will take longer if they raise complex or new policy issues, or if you don't give us all the information we need.</p>
<b>Registering a managed investment scheme</b>	<p>By law, we must register a managed investment scheme within 14 days of receiving an application, except in certain circumstances (<i>target: 100%</i>).</p> <p>→ For more information, see <i>Regulatory Guide 134 Managed investments: Constitutions (RG 134)</i> at <a href="http://www.asic.gov.au/rg">www.asic.gov.au/rg</a>.</p>
<b>Applying for or varying an AFS licence</b>	<p>We aim to decide whether to grant or vary an Australian financial services (AFS) licence within 28 days of receiving a complete application (<i>target: 70%</i>).</p> <p>These applications will take longer if they raise complex or new policy issues, or if you don't give us all the information we need.</p> <p>→ For more information, go to <a href="http://www.asic.gov.au/afslicensing">www.asic.gov.au/afslicensing</a>.</p>
<b>Applying for or varying an Australian credit licence</b>	<p>We aim to decide whether to grant or vary an Australian credit licence within 28 days of receiving a complete application (<i>target: 70%</i>).</p> <p>These applications will take longer if they raise complex or new policy issues, or if you don't give us all the information we need.</p> <p>→ For more information, go to <a href="http://www.asic.gov.au/credit-licence">www.asic.gov.au/credit-licence</a>.</p>
<b>Applying for an Australian market licence</b>	<p>We aim to give the Minister our recommendation about simple applications to operate financial markets within 12 weeks of receiving all the information to support an application (<i>target: 100%</i>). (This does not include time for the Minister to consider our recommendation and make a decision.)</p> <p>These applications will take longer if they raise complex or new policy issues, or if you don't give us all the information we need.</p> <p>→ For more information, see <i>Regulatory Guide 172 Australian market licences: Australian operators (RG 172)</i> and <i>Regulatory Guide 177 Australian market licences: Overseas operators (RG 177)</i> at <a href="http://www.asic.gov.au/rg">www.asic.gov.au/rg</a>.</p>
<b>Applying for relief</b>	<p>If you lodge an application for relief from the Corporations Act or National Credit Act, we aim to give you an in-principle decision within 21 days of receiving a complete application, including all the necessary information to support the application and fees (<i>target: 70%</i>).</p> <p>Applications that raise complex or new policy issues are likely to take longer for ASIC to consider. If your application is complex or raises a new policy issue, we will aim to give you an interim response to inform you of our progress.</p> <p>If we require further information to proceed with your application, we will give you a reasonable time to provide this, whenever possible. We also expect you to provide us with timely and accurate information.</p> <p>In exceptional circumstances, we may consider applications on an urgent basis.</p> <p>→ For more information, see <i>Regulatory Guide 51 Applications for relief (RG 51)</i> at <a href="http://www.asic.gov.au/rg">www.asic.gov.au/rg</a>.</p>

**Source:** Australian Securities & Investments Commission, *ASIC Service Charter*, Sept. 2012, URL: [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC-service-charter-published-12-September-2012.pdf/\\$file/ASIC-service-charter-published-12-September-2012.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC-service-charter-published-12-September-2012.pdf/$file/ASIC-service-charter-published-12-September-2012.pdf) (visited on Dec. 1, 2013)

- (a) The reasons why the regulator proposes to reject the application; and
  - (b) A chance to appear and present its case before the regulator.
- 4. A decision to reject an application should clearly state:
  - (a) The reasons for the rejection; and
  - (b) The materials (including documents) which the regulator depended on to come to the decision to reject the application.
- 5. Whenever the deadlines for approving applications are not met, the fact and reason for delay should be communicated to a superior officer or authority within the regulator to review the reasons for delay and take corrective actions.

### 9.5.2 Instruments

As most of the changes mentioned in section 9.5.1 add legal process to the internal functioning of the regulator, the board of the regulator should pass a resolution to implement the following:

1. Creation of an internal manual on approval processes to ensure the processes outlined in the previous section are implemented as per the relevant *IFC*, provisions; and
2. Mechanisms to ensure that regulated entities are aware of their rights during the various stages of the approval process.

# Chapter 10

## Investigation

### 10.1 Introduction

The regulators, as per their *FSDC Resolution dated October 24, 2013*, decided that<sup>1</sup>:

- “1. All investigation should be time-bound and a higher authority within the regulator should review any investigation exceeding this time.
2. Persons within regulatory agencies carrying out investigations should be separated from persons determining violations and imposing penalty.”

Investigation refers to the process by which the regulator determines if there has been a violation of an provision of the law or subordinate regulation that the regulator enforces. It does not cover violations of the law which are punishable by imprisonment and therefore tried by courts established under the Code of Criminal Procedure. The regulator has an obligation to investigate violations. However, investigation places burdens on regulated entities and imposes costs on the financial sector. The investigation process may also be open to abuse. To prevent such abuse and provide clarity to the investigator, the investigated entity and the financial sector, The *Report of the Financial Sector Legislative Reforms Commission*, incorporates governance enhancing measures for investigation.

### 10.2 Provisions

Chapter 77 (Investigations) of the *IFC*, provides the minimum standards of governance appropriate for investigation. It provides for:

1. The proper documentation and processes required before commencing an investigation including:<sup>2</sup>

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<sup>1</sup>Financial Stability and Development Council, Government of India, see n. 1.

<sup>2</sup>The FSLRC, *IFC*, see n. 16, S.394 (Commencing investigations.)



- (a) The need for investigation;
  - (b) The scope;
  - (c) The time within which the investigation will be completed; and
  - (d) The formalised system of reporting.
2. The need for the investigator to record reasons for investigating a person<sup>3</sup>;
  3. The requirement of the investigator to make a final report<sup>4</sup>; and
  4. The requirement to review any preventive orders passed during an investigation, at regular intervals.<sup>5</sup>

### 10.3 Rationale

The *FSLRC Analysis and Recommendations*, states:

*“Long pending investigations create uncertainty for businesses. When news of on-going investigations leaks, it may inflict damage to the reputation of any financial firm. Similarly, injunctions placed on businesses under investigation have strong economic implications and should be placed for the shortest possible period. These problems can be checked by putting in place legal measures that require investigations to be finished within specified time, and kept confidential from the public.”*<sup>6</sup>

The **FSLRC** recommended that investigations should be:<sup>7</sup>

1. Carried out according to the written terms of investigation;
2. Carried out by an appointed investigator;
3. Finished within a time bound manner, unless extended by an administrative law officer; and
4. Carried out with least disruption to the function or reputation of a business.

The mandate of regulators is (a) to monitor regulated entities under their jurisdiction, (b) to ensure compliance with applicable laws, and (c) not to conduct indefinite surveillance on entities. Ongoing surveillance unless appropriately authorized, may infringe upon the rights of the investigated entity. A commitment to the rule of law requires that all investigations be time-bound, with narrowly defined exceptions. This benefits regulated entities, by giving them the freedom to operate without the burden of being under constant surveillance.

<sup>3</sup>The **ibid.**, S.395 (Process of Investigation).

<sup>4</sup>The **ibid.**, S.397 (Report of the Investigator).

<sup>5</sup>The **ibid.**, S.398.(10).

<sup>6</sup>The FSLRC, *FSLRC Analysis and Recommendations*, see n. 2, Section 4.2.3 at p. 34.

<sup>7</sup>**Ibid.**, Table of Recommendations 4.9 at p.35.

Regulators benefit from such a norm too. Investigations are expensive to carry out. As a matter of good managerial practice, investigations that are becoming lengthy and detailed should be referred to a higher managerial authority for review. Investigations that are taking time, or require sustained scrutiny of particular parties, may genuinely require broader involvement, commitment of resources, and co-ordination with other agencies, which can only occur following review by a higher authority.

The rule of law in the financial sector would be further enhanced where regulators assign investigative duties to specialized staff, who are not involved making a final evaluation as to whether a violation has occurred, and what penalties to impose. This is already being done by most regulators. The *IFC*, however requires clearer structure to the investigative process. The investigating staff would present the results of their investigation to a separate cell or specialized group within the regulatory body, whose job it is to determine violations and penalties.

## 10.4 International Examples

### 10.4.1 Australia

*ASIC's Approach to Enforcement - Information Sheet 151*, articulates ASIC's its approach to enforcement and summarised its information gathering powers.<sup>8</sup> Figure 10.1 is an extract from this document which summarises the entire enforcement approach in a process flowchart. The chart provides:

1. A clear sense of the major steps and the decisions which guide the regulator's actions;
2. The factors taken into account when making decisions; and
3. The remedies the regulators may choose to apply.

### 10.4.2 United Kingdom

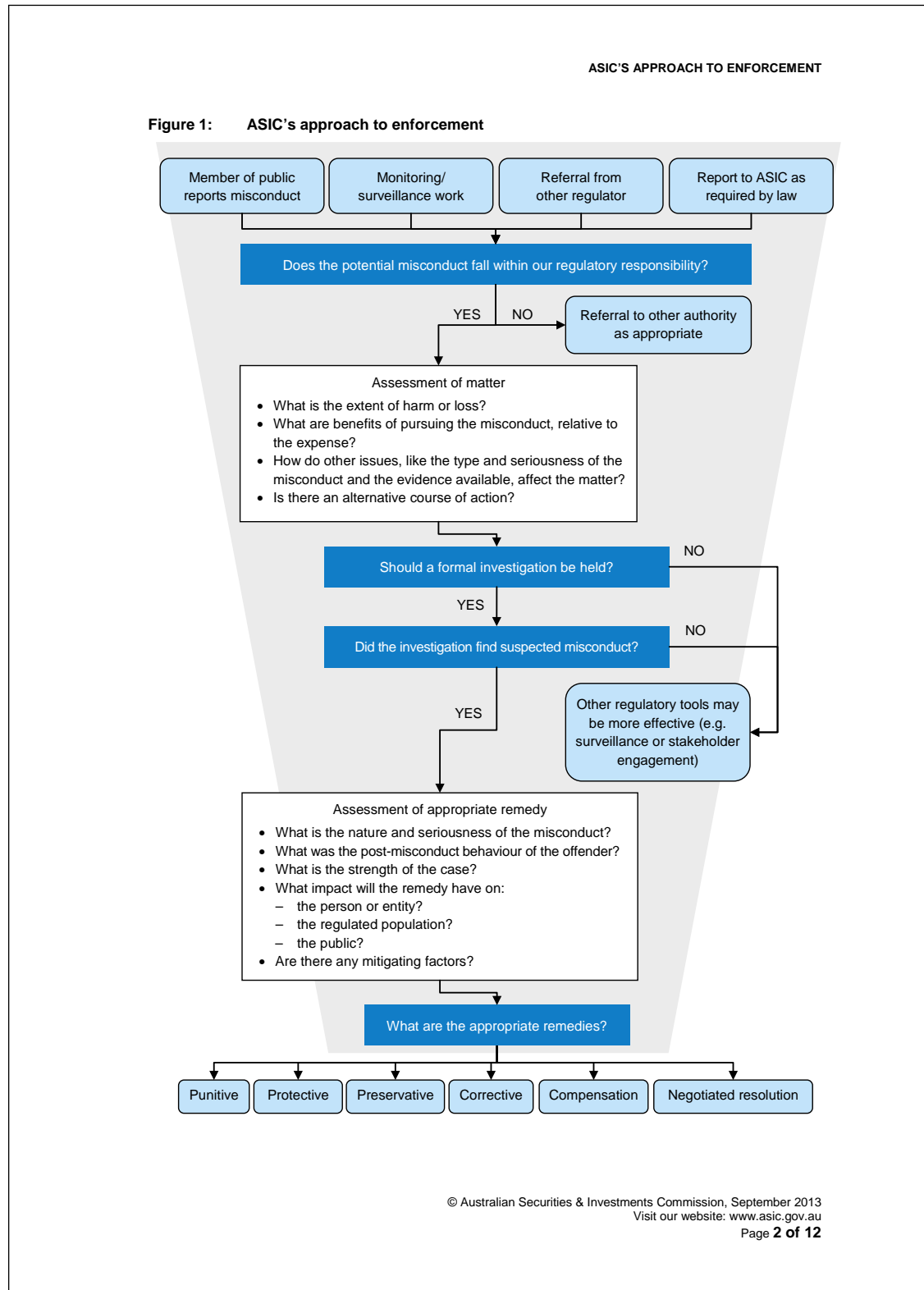
The flow chart given in figure 10.2, published by the UK's FCA shows how the enforcement procedure leads into adjudicatory proceedings.<sup>9</sup> This process is similar to the recommendations in *Report of the Financial Sector Legislative Reforms Commission*.

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<sup>8</sup>Australian Securities & Investments Commission, *ASIC's Approach to Enforcement - Information Sheet 151*, Sept. 2013, URL: [http://asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/INFO\\_151\\_ASIC\\_approach\\_to\\_enforcement\\_20130916.pdf/\\$file/INFO\\_151\\_ASIC\\_approach\\_to\\_enforcement\\_20130916.pdf](http://asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/INFO_151_ASIC_approach_to_enforcement_20130916.pdf/$file/INFO_151_ASIC_approach_to_enforcement_20130916.pdf) (visited on Dec. 1, 2013).

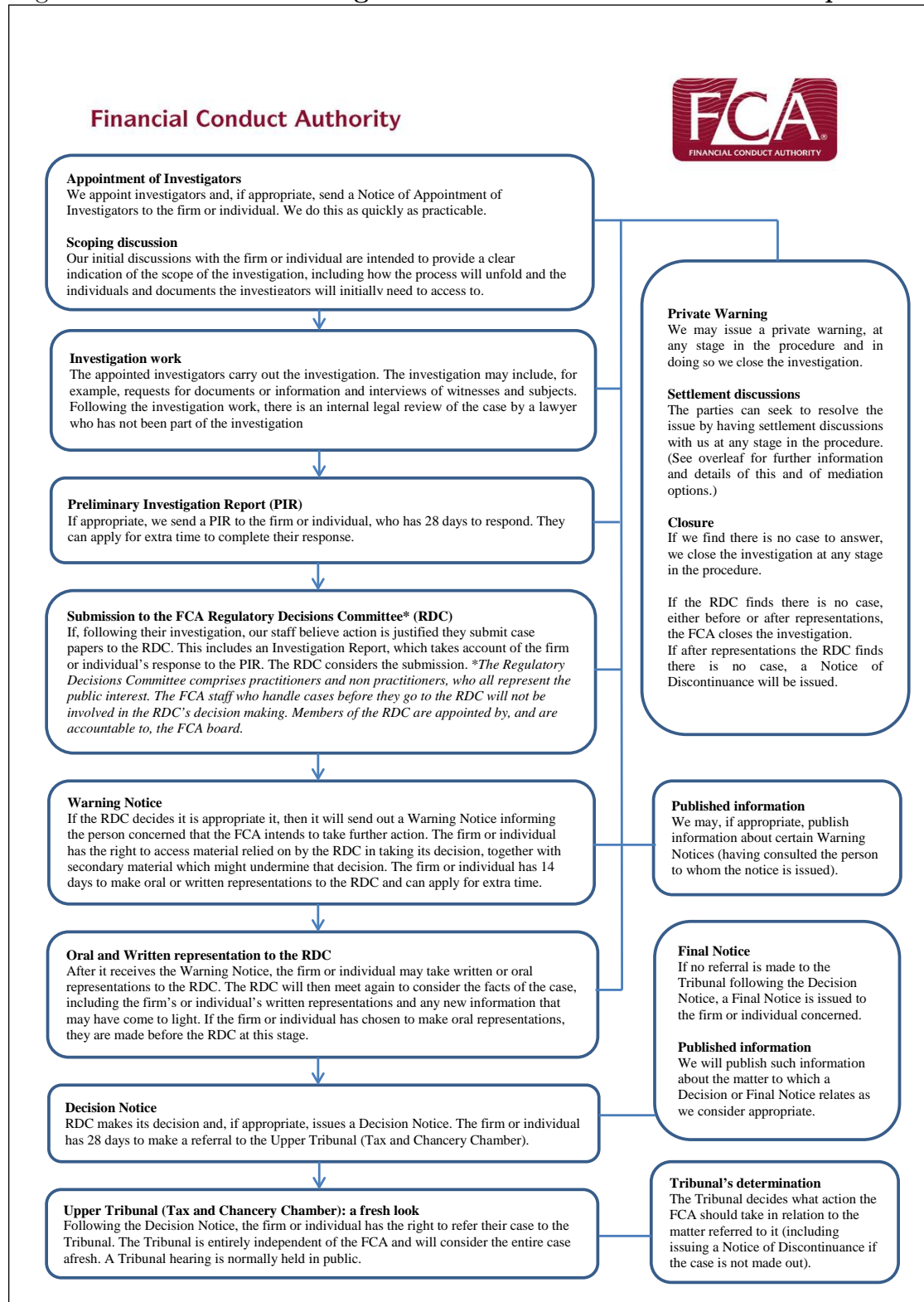
<sup>9</sup>See Financial Conduct Authority, *Enforcement Information Guide*, Apr. 2013, URL: <http://www.fca.org.uk/static/documents/enforcement-information-guide.pdf>.

Figure 10.1: Extract showing a flowchart of ASIC's enforcement process



**Source:** Australian Securities & Investments Commission, *ASIC's Approach to Enforcement - Information Sheet 151*, Sept. 2013, URL: [http://asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/INFO\\_151\\_ASIC\\_approach\\_to\\_enforcement\\_20130916.pdf/\\$file/INFO\\_151\\_ASIC\\_approach\\_to\\_enforcement\\_20130916.pdf](http://asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/INFO_151_ASIC_approach_to_enforcement_20130916.pdf/$file/INFO_151_ASIC_approach_to_enforcement_20130916.pdf) (visited on Dec. 1, 2013)

Figure 10.2: Extract showing a flowchart of FCA's enforcement process



Source: Financial Conduct Authority, *Enforcement Information Guide*, Apr. 2013, URL: <http://www.fca.org.uk/static/documents/enforcement-information-guide.pdf>

### 10.4.3 United States

*Title 17: Commodity and Securities Exchanges, Part 203 – Rules Relating to Investigations, Subpart B – Formal Investigative Proceedings*, sets out procedural safeguards to be observed during the conduct of an investigation by the SEC.<sup>10</sup> These safeguards reflect the recommendations of the FSLRC with respect to privacy of investigation and access to records. *Title 17: Commodity and Securities Exchanges, Part 203 – Rules Relating to Investigations, Subpart B – Formal Investigative Proceedings*, states:

**Section 203.5 Non-public formal investigative proceedings.**

Unless otherwise ordered by the Commission, all formal investigative proceedings shall be non-public.

**Section 203.6 Transcripts.**

Transcripts, if any, of formal investigative proceedings shall be recorded solely by the official reporter, or by any other person or means designated by the officer conducting the investigation. A person who has submitted documentary evidence or testimony in a formal investigative proceeding shall be entitled, upon written request, to procure a copy of his documentary evidence or a transcript of his testimony on payment of the appropriate fees: Provided, however, that in a non-public formal investigative proceeding the Commission may for good cause deny such request. In any event, any witness, upon proper identification, shall have the right to inspect the official transcript of the witness' own testimony.

Pursuant to this the SEC has created detailed documentation (a total of 141 pages) on how investigation and enforcement will be carried out. The *SEC Enforcement Manual*, provides a detailed treatment of:

1. Investigation stages;
2. Investigation practices;
3. Privileges and protections under the law;
4. Cooperation with other agencies; and
5. Fostering cooperation by regulated entities.

The *SEC Enforcement Manual*, reflects the view of the FSLRC on the requirements of:

1. A formal, recorded process for initiating investigations;

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<sup>10</sup>Securities and Exchange Commission, *Title 17: Commodity and Securities Exchanges, Part 203 – Rules Relating to Investigations, Subpart B – Formal Investigative Proceedings*, Mar. 21, 1964, URL: <http://www.gpo.gov/fdsys/pkg/CFR-2013-title17-vol2/xml/CFR-2013-title17-vol2-part203-subpartB.xml> (visited on Dec. 19, 2013).

2. Investigations to be conducted by staff, separated from staff authorising investigations or issue decision orders; and
3. That investigations be initiated after review by staff at appropriate levels after obtaining appropriate legal advice.

These ideas are visible in the following extract from the SEC enforcement manual:

### **2.5.1 The Action Memo Process**

*The filing or institution of any enforcement action must be authorized by the Commission. In addition, while the Commission has delegated certain authority to the Division Director or the Secretary, most settlements of previously authorized enforcement actions, as well as certain other aspects of civil litigation, among other things, require Commission authorization. Staff should consult with senior managers, OCC, and, if appropriate, OGC, before taking action to ensure that proper authorization is requested.*

*Commission authorization is sought by submitting an action memorandum to the Commission that sets forth a Division recommendation and provides a comprehensive explanation of the recommendations factual and legal foundation. All action memoranda submitted to the Commission must be authorized by the Director or a Deputy Director, with a few exceptions. For example, memoranda seeking authorization to seek a specific penalty in previously filed civil litigation, and memoranda seeking the termination or discharge of debts may be submitted to the Commission upon the authorization of an Associate Director or Regional Director, provided that they do not present significant issues that merit higher-level authorization. Staff should consult with senior managers to ensure that appropriate authorization within the Division is obtained before submitting any recommendation.*

## **10.5 Implementation**

### **10.5.1 Changes**

Implementation of proper regulatory governance principles to the way regulators carry out investigations will bring much greater regulatory clarity. The salient features of the process should be:

1. Clear record before initiating investigations:
  - (a) Identifying the objective of the investigation with specific reference to the violation and facts.
  - (b) Identifying a separate investigator from the persons determining penalties or ordering investigations.

- (c) Setting up scope of investigation.
  - (d) Setting up time for each investigation.
2. Investigators should:
- (a) Provide reasons for requiring presence of persons or collecting documents.
  - (b) Apply procedures which cause least burden on regulated entities.
  - (c) Keep investigations confidential.
  - (d) Make regular reports.
3. Investigations should:
- (a) Be time bound and reviewed when time is exceeded.
  - (b) Have regular reports of development and closure reports.
  - (c) Inform regulated entities with all documents that have been relied upon.

### 10.5.2 Instruments

As most of the changes mentioned here add legal process to the internal functioning of the regulator, the board of the regulator should pass a resolution to implement the following:

1. Creation of an internal manual on investigations to ensure the processes outlined in the previous section are implemented as per the relevant *IFC*, provisions; and
2. Mechanisms to ensure regulated entities know of their rights during various stages of investigation.

# Chapter 11

## Adjudication

### 11.1 Introduction

The regulators, as per their *FSDC Resolution dated October 24, 2013*, decided that<sup>1</sup>:

*“The Regulator must develop standardized adjudication systems and publish regulations governing them. Such regulations must include:*

- 1. An adversarial system of hearings by a neutral third party.*
- 2. Providing the accused party with all relevant documents that have been relied on and any exculpatory evidence.*
- 3. Any order imposing penalty should be reasoned.”*

The *FSLRC Analysis and Recommendations*, states:

*“In the normal functioning of Government, the three functions of regulation-making, enforcement and adjudication are kept separate under the separation of powers doctrine. When the Parliament delegates these functions to the regulators, it places them in the unique position of being mini-states with powers similar to the legislature, executive and judiciary all under a single entity. The Commission has strived to achieve greater separation of powers in the functioning of the regulator, particularly by separating out adjudication from other activities.”*<sup>2</sup>

To comply with this regulation, regulators have voluntarily agreed to introduce the following legal process within their internal adjudication process:

1. An adversarial system of hearings by a neutral third party;
2. Providing the accused party with all relevant documents that have been relied on and any exculpatory evidence; and

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<sup>1</sup>Financial Stability and Development Council, Government of India, see n. 1.

<sup>2</sup>FSLRC, *FSLRC Analysis and Recommendations*, see n. 2, Section 2.4.1 of the Report (Independence of Regulators).



3. Any order imposing penalty should be reasoned.

## 11.2 Provisions

1. The process of adjudicatory decision-making begins with the issue of a show-cause notice to the recipient, giving the person an opportunity to be heard in a specified manner<sup>3</sup>;
2. The *IFC* also requires that the opportunity to be heard requires a hearing before the administrative law officer in person, or through electronic communication<sup>4</sup>;
3. When the regulator issues a show-cause notice, it must allow the noticee access to the material that was relied upon in taking the decision to issue the show-cause notice or pass the decision order. The noticee also has the right to access any information with the regulator that might undermine the decision order<sup>5</sup>;
4. If any enforcement action is to be taken against the recipient of the show-cause notice, the action must be taken through a detailed, written decision order<sup>6</sup>; and
5. The action taken in the decision order must be the same action proposed in the show-cause notice<sup>7</sup>.

## 11.3 Rationale

A regulator is a “state unto itself” as it performs the legislative functions of regulation-making, executive functions of issuing licenses and permissions, and also “adjudicates” on violations of applicable laws. These include the power to determine whether legal violations have occurred, and impose penalties or cancel permissions.

All of these actions impact the rights of regulated entities. Even in the absence of explicit legal provisions, those performing functions of an adjudicatory nature should follow basic principles of natural justice and fairness. In order to ensure that the use of these powers is governed by the rule of law, effective procedural safeguards are required.

The “adversarial system” is one such basic procedural safeguard. It requires that the regulator and the regulated entity both present their case to a neutral third

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<sup>3</sup>FSLRC, *IFC*, see n. 16, Section 399 (Show cause notice for enforcement action).

<sup>4</sup>*Ibid.*, Section 400(5) (Content and standard of show cause notices).

<sup>5</sup>*Ibid.*, Section 401 (Access to material with regard to show cause notice and decision order).

<sup>6</sup>*Ibid.*, Section 402 (Content and standard of decision orders) mentions the requirements of a decision order in detail.

<sup>7</sup>*Ibid.*, Section 402.

party, who will evaluate the arguments and evidence according to the procedural rules that have been published. The benefit to regulated entities is that they are given an opportunity to mount the best defense they can. The benefit to regulators is that decisions from a neutral third party, arrived at after a fair process, have greater legitimacy and are less likely to be challenged.

For the adversarial system to work, regulated entities must be able to mount the best defense that they can. In order to do so, they must be provided with copies of all relevant documents, including all evidence, that the regulator is using to justify or argue an enforcement action.

Both regulators and regulated entities benefit when adjudicatory decisions are viewed as legitimate, are easy to understand, and serve as guidance to other parties in the future. For this reason, the adjudication process should mandate that adjudicatory decisions be accompanied by a reasoned opinion. An effective, transparent, fair adjudication process, accompanied by clear, well-reasoned decisions, is a critical mechanism for removing regulatory uncertainty.

## 11.4 International Examples

### 11.4.1 United States

The SEC commences its enforcement process through a “Wells notice”.

*“A Wells notice is a communication from the staff to a person involved in an investigation that: (1) informs the person the staff has made a preliminary determination to recommend that the Commission file an action or institute a proceeding against them; (2) identifies the securities law violations that the staff has preliminarily determined to include in the recommendation; and (3) provides notice that the person may make a submission...to the Commission.”<sup>8</sup>*

The Wells notice identifies specific charges the SEC has proposed against the recipient, accords an opportunity to the recipient to be heard, and informs the recipient that any submission in response to the Wells notice “may be used by the Commission in any action or proceeding that it brings and may be discoverable by third parties in accordance with applicable law.”<sup>9</sup>

The filing or institution of any enforcement action has to be approved by the Commission before its staff can proceed. The Commission votes to approve or disapprove of the proposed enforcement action in closed meetings. There are well-defined exceptions to this process.

The SEC then issues subpoenas to the concerned entities and asks for representations and information necessary for the investigation/enforcement proceedings.

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<sup>8</sup>See Office of the Chief Counsel, Division of Enforcement, see n. 15.

<sup>9</sup>See *ibid.*, at p. 23-24.

There are well defined procedures for recording testimonies, and the right to counsel of the subpoenaed persons.<sup>10</sup>

After an investigation is complete, an Administrative Law Judge who is a staff member of the Commission conducts an administrative proceeding to determine whether the allegations made in the investigation are true, and issues a decision within a specified period of time. “Administrative Law Judges are independent judicial officers who in most cases conduct hearings and rule on allegations of securities law violations initiated by the Commission’s Division of Enforcement”.<sup>11</sup>

This process is broadly similar to the process envisaged in the *Report of the Financial Sector Legislative Reforms Commission*, and seeks to uphold the same governance enhancing principles of detailed legal process.

Additionally, the SEC also provides video recordings of its adjudicatory proceedings on its website. A perusal of these highlights a carefully structured process, some of which has been elaborated in this section. The webcast of one such proceeding, *SEC Open Meeting Monday, December 16, 2013*, highlights the concerted effort to standardise the adjudicatory process and provide a strong, adversarial process of adjudication.

## 11.4.2 United Kingdom

The flow chart given in figure 11.1, published by the UK’s FCA shows how the enforcement procedure leads into adjudicatory proceedings. Similar principles govern the legal process of adjudicatory proceedings as the *Report of the Financial Sector Legislative Reforms Commission*.

## 11.5 Implementation

### 11.5.1 Changes

The provisions listed above add considerable legal process to the current process of adjudicatory decision-making functions that regulators currently perform. As can be seen, none of these provisions are repugnant to existing law. In fact, if regulators voluntarily adopt these provisions, enforcement actions will become standardised, structured, and therefore less open to legal challenges.

Incorporating the contents of these provisions will create a standardised process as follows:

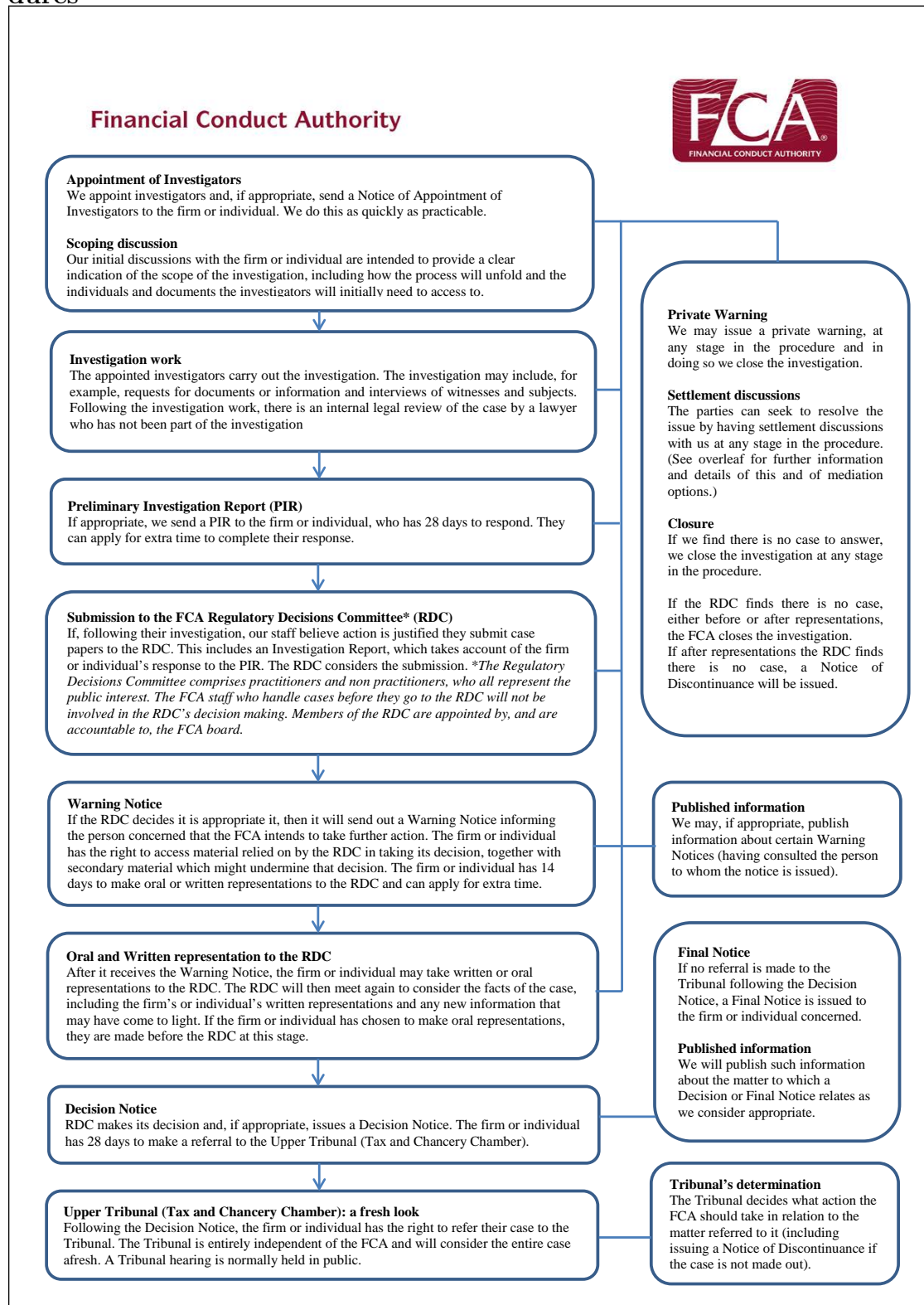
1. A show-cause notice will be issued to the noticee before any enforcement action is taken;

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<sup>10</sup>See *ibid.*, at p. 73-78,

<sup>11</sup>See Securities and Exchange Commission, *Office of Administrative Law Judges*, 2013, URL: <http://www.sec.gov/alj.shtml> (visited on Dec. 2, 2013).

Figure 11.1: Extract showing a flowchart of FCA's enforcement procedures



Source: Financial Conduct Authority, *Enforcement Information Guide*, Apr. 2013, URL: <http://www.fca.org.uk/static/documents/enforcement-information-guide.pdf>

2. The show-cause notice will mention (contents mentioned in Section 400 (Content and standard of show cause notices) of the *IFC*) the action the regulator proposes to take, and the causes which require the proposed action;
3. The show-cause notice will state how the noticee will be given an opportunity to be heard, including a hearing before the concerned officer. The hearing may be oral, or through electronic communication;
4. The show-cause notice must also state that the noticee has access to the material relied upon while issuing the show-cause notice;
5. The show-cause notice will provide the noticee at least 28 days to make representations to the regulator;
6. After the noticee has made any representations it chooses to make, the regulator may issue a decision order. The decision order will contain:
  - (a) Reasons for the decision to take the action given in the order;
  - (b) State what material the regulator has relied on in making the decision; and
  - (c) State the noticee's right to appeal to an appellate authority, and the procedure for making such review.
7. The action taken in the decision order must be the same as that proposed in the show-cause notice. If other action is to be taken, a fresh show-cause notice must be issued.

### 11.5.2 Instruments

The board of every regulator will have to draft internal bye-laws and manuals to implement this measure. Therefore the board of the regulator may pass a resolution to do the following:

1. Draft bye-laws/manual on enforcement proceedings in compliance with Sections 399, 400, 401, 402 and 403 of the *IFC*; and
2. Create the position of administrative law officers as independent of the investigation and enforcement staff to judge the findings of the enforcement staff. Administrative law officers should be the sole authority responsible for writing and communicating decision orders.

# Chapter 12

## Imposition of Penalty

### 12.1 Introduction

Regulators impose penalties on regulated entities for failing to comply with existing laws. Existing laws specify ranges or upper limits of penalties that may be imposed. This however leaves a wide amount of discretion with regulators to impose penalties subject to the existing limits. This chapter articulates principles governing the imposition of penalties, and the way these principles may be adopted by regulators.

The *FSLRC Analysis and Recommendations*, states:

*“The Commission noted that the present system of specifying statutory limits on the amount of penalties that can be imposed for any violation has a critical flaw it does not ensure that a violator pays a fine higher than the gain made through the violation. This is because it is impossible to predict the benefit a violator will gain by committing an offence. The maximum limit on penalties is sometimes lower than the benefit gained by the violator through violation. This leads to a situation where even if the violator is caught and required to pay the fine, he or she may still emerge monetarily better off.*

*The Commission notes that the level of penalties should be an effective deterrent to future violations and signal all other regulated entities that the potential of gain from violation will be outweighed by the penalty which will be applied in the case of detection of the violation. This principle also acknowledges that all violators of any law are never detected. Therefore, to act as a deterrence, the penalty should be a multiple of the illegitimate gain from the violation. The amount of penalty should also be dependent on whether the action was deliberately done or due to reckless behaviour or due to negligence of the person...”<sup>1</sup>*

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<sup>1</sup>FSLRC, *FSLRC Analysis and Recommendations*, see n. 2, Section 4.2.6 Imposition of mon-

## 12.2 Provisions

The following provisions govern penalties and enforcement actions in the *IFC*:

1. Every regulator must consider<sup>2</sup>:
  - (a) the nature and seriousness of the violation committed by the person;
  - (b) the consequences and impact of the violation, including the extent of (i) benefit or unfair advantage gained by the person, and (ii) loss caused, or likely to be caused to consumers or any other person as a result of the violation;
  - (c) conduct of the person after the violation; and
  - (d) prior violations.
2. The maximum amount of penalties has to be the higher of the multiples of the amount of loss caused to consumers and other persons, or benefit or unfair advantage to the accused<sup>3</sup>;

## 12.3 Rationale

Penalties perform several functions under any compliance regime. They serve to punish violators of the rules, and they perform an important deterrent function to other violators. Where penalties involve disgorgement or forced transfer of funds, they may also serve to restore parties to a pre-violation state, or offer compensation for harm suffered as a result of a violation.

One principle for applying penalties in a system governed by the rule of law, is proportionality. Proportionality scales the severity of the penalty to the violation, and this mirrors basic principles of justice applied in courts and other adjudicatory systems. The factors to be used in assessing proportionality each contribute to ensuring that the penalties are fair, and serve their larger regulatory purpose. Scaling penalties according to the nature and seriousness of the violation ensures that the most serious violations are most harshly deterred.

In some cases a regulated entity may engage in violations in pursuit of a small benefit, while causing significant harm to others. For this reason, the consequence and impact of the violation should be factored into the determining penalties. This may help to deter behavior that is risky, and likely to cause high degrees of harm. Penalties may take account of good faith efforts to mitigate the effects of their violation, or whether the violator is engaged in a pattern of violation. For this reason the conduct of the violator after the occurrence of the violation can be

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etary penalties, p. 36.

<sup>2</sup>FSLRC, *IFC*, see n. 16, Section 409 (Factors for determining appropriate enforcement action).

<sup>3</sup>*Ibid.*, Section 410 (Maximum amount of monetary penalties).

taken into account, as can prior violations or offences committed by the regulated entities.

Regulators can adopt these principles of imposing penalties within the constraints of existing laws. This can be done by publishing a clear and unambiguous standard of imposing penalties, with well-defined exceptions. This may be done by making a regulation, so it becomes binding.

While making regulations on the imposition of penalties in a proportional manner, regulators must consider the following factors (in addition to existing law):

1. The nature and seriousness of the violation, including whether it was deliberate, reckless or negligent;
2. The consequence and impact of the violation, including the extent of unfair enrichment of the violator, loss caused or likely to be caused;
3. The conduct of the violator after the occurrence of the violation; and
4. Prior violations or offences committed by the person.

## 12.4 International Examples

While the laws governing penalties that financial sector regulators in other jurisdictions are not exactly comparable, regulators have defined clear standards of imposing penalties by rules/regulations/manuals, and adhered to them.

### 12.4.1 United Kingdom

The **FCA** has created a detailed document informing regulated entities on how the decision to impose penalties will be guided.<sup>4</sup>

Figure 12.1 is an extract from the *Decision Procedure and Penalties Manual* which illustrates the principles guiding the amount of penalties to be imposed.

### 12.4.2 United States

The **SEC** has detailed documentation on guiding how penalties will be imposed by the regulator. The *Statement concerning financial penalties*, is an example of the reasoning that the **SEC** provides when deciding on penalties to be imposed.<sup>5</sup> This document is provided in Annexure-C.

<sup>4</sup>See Financial Conduct Authority, *Decision Procedure and Penalties Manual*, Nov. 2013, URL: <http://media.fshandbook.info/content/full/DEPP/6/5.pdf> (visited on Dec. 1, 2013).

<sup>5</sup>See Securities and Exchange Commission, *Statement concerning financial penalties*, Jan. 4, 2006, URL: <http://www.sec.gov/news/press/2006-4.htm> (visited on Dec. 19, 2013).



Figure 12.1: Extract from the **FCA** Decision Procedure and Penalties Manual

DEPP 6 : Penalties		Section 6.5 : Determining the appropriate level of financial penalty	
6		<b>6.5</b>	<b>Determining the appropriate level of financial penalty</b>
	6.5.1 FCA	G	For the purpose of ■ DEPP 6.5 to ■ DEPP 6.5D and ■ DEPP 6.6.2 G, the term "firm" means <i>firms , sponsors, primary information providers, recognised investment exchanges, qualifying parent undertakings, actuaries, auditors and those unauthorised persons</i> who are not individuals.
	6.5.2 FCA	G	The FCA's penalty-setting regime is based on the following principles: <ul style="list-style-type: none"> <li>(1) Disgorgement - a firm or individual should not benefit from any <i>breach</i>;</li> <li>(2) Discipline - a firm or individual should be penalised for wrongdoing; and</li> <li>(3) Deterrence - any penalty imposed should deter the firm or individual who committed the <i>breach</i>, and others, from committing further or similar <i>breaches</i>.</li> </ul>
	6.5.2A 6.5.3 FCA	G	<p>[Deleted]</p> <ul style="list-style-type: none"> <li>(1) The total amount payable by a person subject to enforcement action may be made up of two elements: (i) disgorgement of the benefit received as a result of the <i>breach</i>; and (ii) a financial penalty reflecting the seriousness of the <i>breach</i>. These elements are incorporated in a five-step framework, which can be summarised as follows: <ul style="list-style-type: none"> <li>(a) Step 1: the removal of any financial benefit derived directly from the <i>breach</i>;</li> <li>(b) Step 2: the determination of a figure which reflects the seriousness of the <i>breach</i>;</li> <li>(c) Step 3: an adjustment made to the Step 2 figure to take account of any aggravating and mitigating circumstances;</li> <li>(d) Step 4: an upwards adjustment made to the amount arrived at after Steps 2 and 3, where appropriate, to ensure that the penalty has an appropriate deterrent effect; and</li> <li>(e) Step 5: if applicable, a settlement discount will be applied. This discount does not apply to disgorgement of any financial benefit derived directly from the <i>breach</i>.</li> </ul> </li> <li>(2) These steps will apply in all cases, although the details of Steps 1 to 4 will differ for cases against firms (■ DEPP 6.5A), cases against individuals (■ DEPP 6.5B) and <i>market abuse</i> cases against individuals (■ DEPP 6.5C).</li> </ul>
■ Release -- ● November 2013		6.5.3	

Source: Financial Conduct Authority, *Decision Procedure and Penalties Manual*, Nov. 2013, URL: <http://media.fshandbook.info/content/full/DEPP/6/5.pdf> (visited on Dec. 1, 2013)

## 12.5 Implementation

### 12.5.1 Changes

In light of the discussion above, to voluntarily implement the provisions of the *IFC*, mentioned in section 12.2, regulators will have to implement internal processes so that the following outcomes are achieved:

1. There is a clear principle of proportionality governing the imposition of penalties by the regulator (as mentioned in the *IFC*);
2. Each factor for determining penalties should be considered individually by enforcement officials, and the decision of the enforcement official on each such factor be explained in writing to the concerned regulated entity.

### 12.5.2 Instruments

As most of the changes mentioned in section 12.5.1 add legal process to the internal functioning of the regulator, the board of the regulator should pass a resolution to implement the following:

1. Review existing practices of imposing penalties and harmonise them.
2. This should be done through creation of a manual that details the principle of proportionality the regulator will use for imposing penalties. The manual should be consistent with the *IFC* provisions mentioned in section 12.2 above.

# Chapter 13

## Capacity Building

### 13.1 Introduction

The decision of the regulators to voluntarily implement the twelve recommendations of the *Report of the Financial Sector Legislative Reforms Commission*, is a major milestone towards enhancing financial sector regulatory governance in India. The **Ministry of Finance (MOF)** however recognises that implementing these twelve steps requires considerable energy and resources on the part of regulators. Additionally, **MOF** itself needs to take into account the internal changes it would have to make to implement the *FSLRC Analysis and Recommendations*, recommendations effectively.

### 13.2 Measures

**MOF**, therefore, is resolved to do the following to assist regulators in implementing the changes that they have agreed to in the **FSDC** meeting:

#### 13.2.1 Internal capacity building

1. **MOF** and **Department of Economic Affairs (DEA)** will build internal capacity and expertise on the *Report of the Financial Sector Legislative Reforms Commission*, and in particular, on the twelve measures regulators voluntarily agreed to implement.
2. **DEA** will design effective mechanisms to co-ordinate with, and assist regulators in their implementation of these twelve steps (including strengthening the **FSDC**).

### 13.2.2 Certification programs for staff of regulators

DEA will design and initiate training and certification programs for staff of regulators, in order to bring them up to date on recent developments in financial regulatory governance, and common principles necessary to harmonise financial sector regulation. This will include the following processes:

1. The DEA will build a curriculum and testing infrastructure for certification tests for staff of regulators. Institutions like the National Institute of Securities Markets (NISM) and the National Institute for Bank Management (NIBM) will be encouraged to implement the curriculum in their programs;
2. The curriculum will broadly test knowledge of:
  - (a) *Hundred small steps*<sup>1</sup>;
  - (b) *FSLRC Analysis and Recommendations*<sup>2</sup>;
  - (c) *Report of the High Powered Expert Committee on Making Mumbai an International Financial Centre*<sup>3</sup>; and
  - (d) *Report of the Working Group on Foreign Investment*<sup>4</sup>.
3. Thirty-three percent of all existing staff employed with a regulator at the commencement of this certification program should pass the certification test every year. All new employees should also be required to pass this test within a year of the commencement of their employment. In this manner, all staff members of financial sector regulators will be adequately trained within a horizon of three years.

### 13.2.3 Certification programs for key managerial personnel in financial firms

All financial agencies need to issue regulations which require 15 per cent of all existing staff of all financial firms to pass the certification test every year. This would ensure that within a horizon of three years, a large swathe of individuals within financial firms would also possess adequate knowledge about the policy and legal environment.

<sup>1</sup>Committee on Financial Sector Reforms, *Hundred small steps, Report of the Committee on Financial Sector Reforms*, Planning Commission of India, Sept. 12, 2008, URL: [http://planningcommission.nic.in/reports/genrep/rep\\_fr/cfsr\\_all.pdf](http://planningcommission.nic.in/reports/genrep/rep_fr/cfsr_all.pdf) (visited on Dec. 1, 2013).

<sup>2</sup>FSLRC, *FSLRC Analysis and Recommendations*, see n. 2.

<sup>3</sup>High Powered Expert Committee on Making Mumbai an International Financial Centre, *Report of the High Powered Expert Committee on Making Mumbai an International Financial Centre*, Ministry of Finance, Feb. 10, 2007, URL: [http://finmin.nic.in/the\\_ministry/dept\\_eco\\_affairs/capital\\_market\\_div/mifc/mifcreport.pdf](http://finmin.nic.in/the_ministry/dept_eco_affairs/capital_market_div/mifc/mifcreport.pdf) (visited on Dec. 1, 2013).

<sup>4</sup>Working Group on Foreign Investment, *Report of the Working Group on Foreign Investment*, Department of Economic Affairs, Ministry of Finance, July 30, 2010, URL: [finmin.nic.in/reports/WGFI.pdf](http://finmin.nic.in/reports/WGFI.pdf) (visited on Dec. 1, 2013).

### 13.2.4 Workshops and conferences for senior staff

**DEA** will initiate a joint mechanism through which individuals from all financial agencies will attend workshops and conferences on financial policy and regulation, taking place through the year, to foster capacity building at senior levels. This will partly utilise workshops and conferences which are already taking place, and will partly initiate *de novo* activities.

# Chapter 14

## Implementation

This chapter compiles the sections on implementation items inside various chapters of this Handbook. **MOF** will track the implementation of these items and continue to provide guidance to regulators on the implementation process, if required.

### 14.1 Consumer Protection

*See chapter 2.*

#### 14.1.1 Requirement of professional diligence

*See section 2.2.*

Every regulator should take the following steps to ensure their regulations require professional diligence in dealings with consumers:

1. Document the existing regulations that deal with the standards of diligence that the financial service providers in different sectors must ensure in their dealings with consumers.
2. Use the text of section 85 (Requirement of professional diligence) of *IFC*, to issue regulations requiring all financial service providers regulated by the respective regulator to follow professional diligence in their dealings with consumers.
3. Create and publish a statement on the consistency between the requirement of professional diligence enshrined in section 85 of *IFC*, and the existing regulations governing interaction between financial service providers and consumers. Based on this statement, make amendments to sector-specific regulations to ensure consistency of regulations with the overarching regulation requiring professional diligence in dealing with consumers.

### 14.1.2 Protection from unfair terms in financial contracts

*See section 2.3.*

Every regulator should take the following steps to ensure there are regulations against unfair terms of contract:

1. Document the existing regulations that deal with unfair terms of contract in the sectors regulated by the respective regulators.
2. Use the text of sections 86 (Unfair terms in financial contracts) and 87 (Non-negotiated contracts) of the *IFC*, to issue a regulation prohibiting unfair terms contract in non-negotiated financial contracts. Every term in the regulation should be the same as that in these sections.
3. Specify by regulation, an illustrative list of terms that would be considered to be unfair terms. This list must be based on the observations and case laws in the regulated sector for each respective regulator, and application of the tests provided in section 86 of the *IFC*.
4. Create and publish a statement on the consistency between the protection against unfair terms of contract envisaged in section 86 of the *IFC*, and the existing regulations governing such terms in various sectors. Based on this statement, make amendments to sectoral regulations to ensure consistency of regulations with the overarching regulation protecting consumers from unfair terms of contract.

### 14.1.3 Protection from unfair conduct

*See section 2.4.*

Every regulator should take the following steps to ensure there are regulations to protect consumers against unfair conduct:

1. Document the existing regulations that deal with unfair conduct in the sectors regulated by the respective regulators.
2. Use the text of sections 89, 90 and 91 of the *IFC*, to issue a regulation prohibiting unfair conduct by financial service providers or their representatives. Every term in the regulation should be defined in the same way as it is defined in these sections.
3. Create a statement on the consistency between the prohibition of unfair conduct envisaged in sections 89, 90 and 91 of the *IFC*, and the existing regulations governing such conduct in various sectors. Based on this statement, make amendments to sectoral regulations to ensure consistency of regulations with the overarching regulation prohibiting unfair conduct.

### 14.1.4 Protection of personal information

*See section 2.5.*

Every regulator should take the following steps to ensure there are regulations to protect personal information of consumers of financial products or services:

1. Use the text of sections 92 and 93 of *IFC*, to issue a regulation protecting personal information of all consumers interacting with the financial sector regulated by the respective regulator. Every definition and obligation in the regulation should be the same as it is in these sections.
2. Document the existing regulations that deal with protection of personal information of financial consumers.
3. Create a statement on the consistency between the protection of personal information envisaged in sections 92 and 93 of *IFC*, and the existing regulations governing such information in various sectors. Based on this statement, regulators should make amendments to sectoral regulations to ensure consistency of regulations with the overarching regulation protecting personal information.

### 14.1.5 Requirement of fair disclosure

*See section 2.6.*

Every regulator should take the following steps to ensure there are regulations requiring initial disclosures and continuing disclosures:

1. Document the existing disclosure regulations in the sectors regulated by the respective regulators.
2. Use the text of sections 95 and 96 of the *IFC*, to issue a regulation requiring initial disclosures and continuing disclosures by financial service providers and their representatives. Every definition and obligation in the regulation should be the same as that in these sections.
3. Create a statement on the consistency between the disclosure requirements envisaged in sections 95 and 96 of the *IFC*, and the existing regulations governing disclosures in various sectors. Based on this statement, regulators should make amendments to sectoral regulations to ensure consistency of regulations with the overarching regulation requiring initial disclosures and continuing disclosures.

### 14.1.6 Redress of complaints

*See section 2.7.*



Every regulator should make regulations requiring all financial service providers to have in place effective mechanisms of redress for consumers. The regulators may take into account the issues in their respective regulated sectors, and specify, by regulations, the processes to be followed in providing redress to consumer grievances in the respective sectors.

Every regulator should take the following steps to ensure there are regulations requiring internal mechanisms to redress consumers grievances and to keep consumer informed of such mechanisms:

1. Document the existing regulations requiring internal mechanisms to redress consumer grievances in the sectors regulated by the respective regulators.
2. Use the text of section 98 of the *IFC*, to issue a regulation requiring each financial service provider to develop and maintain an internal mechanism for grievance redress.
3. Use the text of section 99 of the *IFC*, relevant information about the respective sectors, and international best practices, to issue regulations governing the systems and processes for handling consumer grievances through the internal mechanism for grievance redress.
4. Create a statement on the consistency between the requirements envisaged in section 98 of the *IFC*, and the existing regulations governing internal redress of consumer grievances in various sectors. Based on this statement, regulators should make amendments to sectoral regulations to ensure consistency of regulations with the overarching regulation requiring internal mechanisms to redress consumer grievances.

## 14.2 Consumer Protection for Retail Consumers

*See chapter 3.*

### 14.2.1 Suitability of advice for retail consumers

*See section 3.2*

Every regulator should take the following steps to ensure there are regulations requiring suitability of advice:

1. Use the text of Section 100 of the *IFC*, to issue a regulation requiring suitability assessment to be done by any retail advisor or its representative before giving advice to a retail consumer. The definitions and obligations in the regulations must be the same as those in the section.
2. Specify, by regulation, a list of financial products and financial services that must not be provided to retail consumers without being accompanied by

advice as per section 100 of *IFC*. *IFC*, This list must be based on the tests given in Section 101 of the.

3. Document the existing regulations that deal with suitability requirements in the sectors regulated by the respective regulators.
4. Create a statement on the consistency between the suitability requirement envisaged in sections 100 and 101 of the *IFC*, and the existing regulations governing advisors in various sectors. Based on this statement, make amendments to sectoral regulations to ensure consistency of regulations with the overarching regulation requiring suitability assessment.

### 14.2.2 Dealing with conflict of interests

*See section 3.3.*

Every regulator should make regulations requiring all financial service providers to ensure that in their and their representatives' dealings with consumers, consumers are informed about the conflicts of interest of the consumer-facing person. The regulators may also specify regulations requiring the financial service provider or its representative to give priority to the consumer's interest if there is a conflict between their interest and the consumer's interest. These regulations must be consistent with the principles laid down in the *IFC*.

Every regulator should take the following steps to ensure there are regulations dealing with conflicts of interest of retail advisors:

1. Use the text of section 102 (Dealing with conflict of interests) of the *IFC*, to issue a regulation requiring disclosure of conflicts of interest and the duty to give precedence to consumer's interest over other interests while giving advice to a retail consumer. The definitions and obligations in the regulations must be the same as those in the section.
2. Document the existing regulations that deal with conflicts of interest in the sectors regulated by the respective regulators.
3. Create a statement on the consistency between the regulation envisaged in section 102 (Dealing with conflict of interests) of the *IFC*, and the existing regulations governing conflicts of interest. Based on this statement, make amendments to sectoral regulations to ensure consistency of regulations with the overarching regulation requiring suitability assessment.

### 14.2.3 Access to a grievance redress mechanism

*See section 3.4.*

The *IFC*, envisages a hi-tech financial redress agency to redress grievances of consumers with a presence across the country. This agency, when it comes into

being, will redress consumer grievances from all sectors in the financial systems. Till the agency comes into existence, the following five-part strategy will help give consumers access to an effective grievance redress mechanism for expeditious settlement of complaints:

1. *Document the grievance redress systems:* The systems and processes of the existing *de jure* grievance redress systems – combining laws, regulations and internal policies – should be documented by each respective regulator. Each regulator should also create and publish a database of consumer grievances collected over the years.
2. *Identify gaps in de jure and de facto grievance redress systems:* Identify gaps, if any, between the *de facto* and *de jure* arrangements on grievance redress.
3. *Close the gap between de facto and de jure:* If there are gaps between the *de facto* and the *de jure*, they need to be closed. As an example, if there are positions which are vacant, then those posts need to be filled.
4. *Implement process and information systems as per FSLRC Draft Indian Financial Code:* Chapters 24, 25, 26 and 27 of *IFC*, provide a detailed framework for a comprehensive two-tiered redress system. This system has two steps in the redress process: mediation and adjudication. It also envisages use of modern technology to keep the proceedings efficient, and minimise costs for the consumers. The bulk of these practices can be implemented in consumer grievance redress systems operated by all financial agencies.
5. *Consolidate infrastructure:* The existing grievance redress systems under various financial sector regulators can make efficiency gains if they start using common infrastructure. This would also reduce the cognitive complexity faced by consumers, who should see a single point where grievances can be taken. Eventually when the Financial Redress Agency comes into existence, there will be one common set of facilities for consumer grievance redress in the financial system. Progress in this direction can be made by the existing systems of grievance redress if they plan and start sharing infrastructure.

## 14.3 Framing Regulations

See chapter 4.

### 14.3.1 Initiating Regulation: Changes & Instruments

See section 4.2.

All regulation making should therefore commence with the approval of the board of the regulator and comply with the following process:

1. Before initiating the regulation making process, the board should first consider whether a regulation should be drafted. The board has to consider what the requirement for the regulation is, whether a regulation is the best method to solve the problem at hand, and then direct its agency to commence the process of writing a regulation. Board discussion at this early stage would improve the quality of regulation, rather than placing of draft regulations to the board of the regulator at a later stage. Only after a resolution reflecting a decision on this issue has been made by the board should the staff of the regulator be empowered to start the process of making regulations.
2. After the process of drafting a regulation is complete, it should be approved by the board before being released for public comments.
3. After public comments have been considered, the final regulation should be approved by the Board by a resolution.

The board of every regulator may pass a resolution stating:

1. Every proposal to frame regulations should be approved by the board before further work on it is initiated;
2. The proposal to the board should have a clear statement explaining the need for the regulation, and what the regulation will do;
3. Once the board approves the proposal and the draft regulations have been prepared by the staff, the draft regulations and other related documents such as the cost-benefit analysis should be approved by the board;
4. Once the draft regulations and related documents are approved, the regulator should release the documents for public comments. The documentation packet that goes out should satisfy the requirements of the regulation-making process of the *IFC*.
5. The board should approve the final regulations after considering comments from the public and modifications of the regulation consequent to the comments (if any).

### 14.3.2 Contents of draft Regulations

See section 4.3.

#### Statement of objectives

See subsection 4.3.4.

Implementing the provisions of Section 52(2) of the *IFC*, will require correctly

identifying the objective of the regulation. The *FSLRC Analysis and Recommendations*, clearly states:<sup>1</sup>

*“If the parent legislation does not specifically refer to the subject matter of regulations, the regulator will have to establish a logical connection between the subject matter and the empowering provision in the law. The document must contain explanation on how the regulation stands vis-a-vis each of the relevant principles in the part(s) of the draft Code from which the powers are being drawn.”*

Therefore, the following changes will have to be implemented:

1. The statement should clearly state the objective(s) of framing the regulations. The objective of the regulation may be to prevent/rectify market failure, or to improve the collection of regulatory information by requiring reporting of additional information, or to improve the investigative process by standardising notice requirements. Market failures should be clearly stated in the cost-benefit analysis and a statement explaining the problem to be addressed published along with the draft regulations;
2. The statement should state what provision(s) of the existing law the regulator is complying with/ensuring compliance with, while framing the regulations; and
3. The statement should identify how the proposed regulations would help achieve the stated objective.

Instruments:

The board of every regulator should pass a bye-law/resolution stating that every draft regulation will contain a statement of objectives of the regulation explaining:

1. What the regulatory objectives are;
2. What legal provision(s) empower/obligate the regulator to pursue those objectives;
3. How the regulations will help the regulator in achieving the stated objective; and
4. The context in which the regulation is proposed.

### **Problem the regulation seeks to solve**

See subsection 4.3.5.

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<sup>1</sup>See FSLRC, *FSLRC Analysis and Recommendations*, see n. 2, Table of Recommendations 4.1: Issuance of documents for public consultation at p.31.

1. The board of every regulator should pass a bye-law/resolution stating that every draft regulation will contain a statement explaining the problem that the regulation seeks to solve.
2. The board of the regulator should ensure that its staff writes a detailed manual on how such a statement should be framed in line with Section 52(2) of the *IFC*.

### Cost Benefit Analysis

*See subsection 4.3.8.*

Regulators at present do not carry out systematic CBAs before framing regulations. The *IFC*, follows international best practices in regulation-making by requiring that regulators publish a detailed CBA along with the draft regulations.

As the examples in section 4.3.10 clearly show, all CBA handbooks recommend broadly similar steps to be performed. They all require:

1. the creation of a base-case;
2. the creation of alternate scenarios/options based on regulatory actions that may be considered;
3. identifying the costs and benefits of each option against the base-case, considering each and every possible cost and benefit that may occur directly or indirectly;
4. monetizing the costs and benefits after adjustment; and
5. presenting a conclusion on the basis of the CBA.

Regulators should compile detailed CBA manuals for framing regulations in line with the best practices mentioned above.

Instruments:

1. The board of every regulator should pass a resolution stating that every draft regulation will contain a CBA of the regulations; and
2. The regulator will draft internal manuals on CBA complying with the minimum requirements set out in Section 54 of the *IFC*, and in-line with international best practices, some of which have been mentioned as examples in this section.

### 14.3.3 Comments on draft Regulations

*See section 4.4.*

As per the provisions mentioned above, regulators would have to streamline the process by which representations from the public are solicited:

1. Comments/representations should be sought on all regulations;
2. Clear information on the manner of making comments should be provided;
3. All comments received should be considered while framing the final regulations;
4. All comments received should be published; and
5. The regulator should publish a general account of the response to the representations along with the final regulations.

The board of every regulator should pass a resolution stating:

1. Comments/representations will be sought from the public for all regulations, after the draft regulations have been approved by the board of the regulator;
2. All comments/representations, and responses to the same will be made publicly available on the website of the regulator.
3. While publishing the draft regulations, the regulator will provide information on the manner in which representations should be made, and the time within which representations should be made; and
4. The regulator should allow representations to be made in both paper and electronic formats.
5. The regulator should ensure that its staff drafts manuals to standardise this process and publish such a manual on its website.

### 14.3.4 Approval of final Regulation

*See section 4.5.*

At present, the role of the board of regulators in the framing and passing of regulations is unclear. Regulations may be drafted and issued by the staff of the regulator without any explicit approval by the board.

As per the *IFC*, provisions mentioned above, the board will have to approve the final regulations by a majority vote. This will require a deliberation on the regulations by the board of the regulator.

The board of every regulator should pass a resolution stating:

1. The final regulations will be published only after they receive the approval of the board. The board should vote on the regulations to approve them;
2. The board must consider the comments/representations received with regard to the draft regulations; and

3. The response of the regulator to the comments should be made public at the same time as the publication of the final regulations.

## 14.4 Notices

*See chapter 5.*

### 14.4.1 Changes

To implement the requirements of writing notices and mandating the issuance of notices to regulated entities in a standardised form, regulators will have to write detailed internal manuals on the form and content of notices (as defined in the *IFC*), and mandate that the staff of the regulator follows such manuals. The harmonisation of manuals on notices as per the provisions of the *IFC*, across financial agencies would reduce cost and complexity across the Indian financial system.

### 14.4.2 Instruments

1. The board of the regulator should pass a resolution defining the finite list of notices it will send to regulated entities;
2. The board of the regulator should pass a resolution stating that the regulator will prepare detailed manuals on the minimum content of each type of notice, and the circumstances in which such notice will be issued;
3. The regulators should make manuals governing the standards and minimum content of the notices, upholding best principles of governance; and
4. These manuals must be published.

## 14.5 Transparency

*See chapter 6.*

### 14.5.1 Changes

Implementation of the provisions of the *IFC*, will lead to the following outcomes:

1. The process of making regulations, including proposed regulations will become more transparent;



2. General and special guidances will be published;
3. Comments received during the rulemaking process will be published; and
4. Regulators will re-design their websites keeping in mind the global best practices on transparency in financial regulation.

### 14.5.2 Instruments

Implementing the recommendations under the *IFC*, would require all regulators to pass internal resolutions requiring their staff to:

1. Develop rules and processes for capturing the information that is required to be published under the *IFC*;
2. Developing and maintaining appropriate information systems for centralising and storing this information;
3. Developing rules and processes to ensure that all relevant information
4. Developing and maintaining a web site, through which this information can be found in a text-searchable format; and
5. Ensuring that the design of the user interface of the website is clear and accessible as per global best practices.

## 14.6 Transparency in Board Meetings

*See chapter 7.*

### 14.6.1 Changes

Implementing the recommendations under the *IFC*, would require all regulators to:

1. Develop appropriate rules and processes for board meetings that are in compliance with the provisions of the *IFC*, and the Second Schedule:
  - (a) Take detailed minutes of all meetings;
  - (b) Record all minutes along with proceedings and decisions taken, and publish them within three weeks, save specific exceptions;
  - (c) Write narrow, specific carve-outs for redacting or delaying certain information, consistent with Schedule 2 (Procedure of meetings of the board of the Financial Agency) of the *IFC*; and
  - (d) Take a vote on, and record all decisions to not release information.

2. Ensure that the design of the user interface of the web-site is clear and accessible.

### 14.6.2 Instruments

1. The board of every regulator should pass a resolution adopting the provisions of Schedule 2 (Procedure of meetings of the board of the Financial Agency) of the *IFC*; and
2. The board of every regulator may pass a resolution to the effect that the regulator will publish all relevant information on its web-site in accordance with international best practices, some of which have been mentioned earlier in this section.

## 14.7 Reporting

*See chapter 8.*

### 14.7.1 Changes

Under existing laws, the Central Government frames rules on the manner and content of returns and reports to be made to it by the regulators. The regulators have voluntarily agreed to move to a system of reporting that forms part of a performance review system where the functions of the regulator are reported with quantified indicators. To implement enhanced reporting requirements as laid out in detail in section 8.2, the Central Government will have to re-draft/amend its reporting rules.

### 14.7.2 Instruments

The responsibility of implementing this measure lies with the Central Government. It should therefore frame rules under existing laws that require regulators to report the following in their annual reports:

1. A review of the regulator's activities in relation to the discharge of its functions and the achievement of its objectives;
2. All information required to understand the discharge of functions and the achievement of the objectives of the regulator, that has been published by the regulator;
3. A statement of deliberations of the board of the regulator, along with the records of the meetings of the regulator;

4. A statement indicating any statutory obligation that the regulator or its board has not complied with, and reasons for such non-compliance;
5. A statement by the chairperson of the regulator in relation to the activities and performance of the board; and
6. A statement of the major activities the regulator will undertake in the subsequent financial year.

## 14.8 Approvals

*See chapter 9.*

### 14.8.1 Changes

Implementation of proper regulatory governance principles to the way regulators grant or deny various permission under their respective laws will provide greater certainty and clarity to the regulatory process. The salient features of the process should be:

1. Clear information to be provided to regulated parties about:
  - (a) The form in which applications have to be made.
  - (b) All supporting documents which have to be provided with the application.
  - (c) The criteria on which their application will be judged.
2. Regulated entities should also have clear visibility of when applications will be decided.
3. Before any application is rejected, the applicant is given:
  - (a) The reasons why the regulator proposes to reject the application; and
  - (b) A chance to appear and present its case before the regulator.
4. A decision to reject an application should clearly state:
  - (a) The reasons for the rejection; and
  - (b) The materials (including documents) which the regulator depended on to come to the decision to reject the application.
5. Whenever the deadlines for approving applications are not met, the fact and reason for delay should be communicated to a superior officer or authority within the regulator to review the reasons for delay and take corrective actions.

### 14.8.2 Instruments

As most of the changes mentioned in section 9.5.1 add legal process to the internal functioning of the regulator, the board of the regulator should pass a resolution to implement the following:

1. Creation of an internal manual on approval processes to ensure the processes outlined in the previous section are implemented as per the relevant *IFC*, provisions; and
2. Mechanisms to ensure that regulated entities are aware of their rights during the various stages of the approval process.

## 14.9 Investigation

*See chapter 10.*

### 14.9.1 Changes

Implementation of proper regulatory governance principles to the way regulators carry out investigations will bring much greater regulatory clarity. The salient features of the process should be:

1. Clear record before initiating investigations:
  - (a) Identifying the objective of the investigation with specific reference to the violation and facts.
  - (b) Identifying a separate investigator from the persons determining penalties or ordering investigations.
  - (c) Setting up scope of investigation.
  - (d) Setting up time for each investigation.
2. Investigators should:
  - (a) Provide reasons for requiring presence of persons or collecting documents.
  - (b) Apply procedures which cause least burden on regulated entities.
  - (c) Keep investigations confidential.
  - (d) Make regular reports.
3. Investigations should:
  - (a) Be time bound and reviewed when time is exceeded.
  - (b) Have regular reports of development and closure reports.

- (c) Inform regulated entities with all documents that have been relied upon.

### 14.9.2 Instruments

As most of the changes mentioned here add legal process to the internal functioning of the regulator, the board of the regulator should pass a resolution to implement the following:

1. Creation of an internal manual on investigations to ensure the processes outlined in the previous section are implemented as per the relevant *IFC*, provisions; and
2. Mechanisms to ensure regulated entities know of their rights during various stages of investigation.

## 14.10 Adjudication

*See chapter 11.*

### 14.10.1 Changes

The provisions listed above add considerable legal process to the current process of adjudicatory decision-making functions that regulators currently perform. As can be seen, none of these provisions are repugnant to existing law. In fact, if regulators voluntarily adopt these provisions, enforcement actions will become standardised, structured, and therefore less open to legal challenges.

Incorporating the contents of these provisions will create a standardised process as follows:

1. A show-cause notice will be issued to the noticee before any enforcement action is taken;
2. The show-cause notice will mention (contents mentioned in Section 400 (Content and standard of show cause notices) of the *IFC*) the action the regulator proposes to take, and the causes which require the proposed action;
3. The show-cause notice will state how the noticee will be given an opportunity to be heard, including a hearing before the concerned officer. The hearing may be oral, or through electronic communication;
4. The show-cause notice must also state that the noticee has access to the material relied upon while issuing the show-cause notice;
5. The show-cause notice will provide the noticee at least 28 days to make representations to the regulator;

6. After the noticee has made any representations it chooses to make, the regulator may issue a decision order. The decision order will contain:
  - (a) Reasons for the decision to take the action given in the order;
  - (b) State what material the regulator has relied on in making the decision; and
  - (c) State the noticee's right to appeal to an appellate authority, and the procedure for making such review.
7. The action taken in the decision order must be the same as that proposed in the show-cause notice. If other action is to be taken, a fresh show-cause notice must be issued.

### 14.10.2 Instruments

The board of every regulator will have to draft internal bye-laws and manuals to implement this measure. Therefore the board of the regulator may pass a resolution to do the following:

1. Draft bye-laws/manual on enforcement proceedings in compliance with Sections 399, 400, 401, 402 and 403 of the *IFC*; and
2. Create the position of administrative law officers as independent of the investigation and enforcement staff to judge the findings of the enforcement staff. Administrative law officers should be the sole authority responsible for writing and communicating decision orders.

## 14.11 Imposition of Penalty

*See chapter 12.*

### 14.11.1 Changes

In light of the discussion above, to voluntarily implement the provisions of the *IFC*, mentioned in section 12.2, regulators will have to implement internal processes so that the following outcomes are achieved:

1. There is a clear principle of proportionality governing the imposition of penalties by the regulator (as mentioned in the *IFC*);
2. Each factor for determining penalties should be considered individually by enforcement officials, and the decision of the enforcement official on each such factor be explained in writing to the concerned regulated entity.

### 14.11.2 Instruments

As most of the changes mentioned in section 12.5.1 add legal process to the internal functioning of the regulator, the board of the regulator should pass a resolution to implement the following:

1. Review existing practices of imposing penalties and harmonise them.
2. This should be done through creation of a manual that details the principle of proportionality the regulator will use for imposing penalties. The manual should be consistent with the IFC provisions mentioned in section 12.2 above.

## 14.12 Capacity Building

See chapter 13.

### 14.12.1 Internal capacity building

1. MOF and DEA will build internal capacity and expertise on the *Report of the Financial Sector Legislative Reforms Commission*, and in particular, on the twelve measures regulators voluntarily agreed to implement.
2. DEA will design effective mechanisms to co-ordinate with, and assist regulators in their implementation of these twelve steps (including strengthening the FSDC).

### 14.12.2 Certification programs for staff of regulators

DEA will design and initiate training and certification programs for staff of regulators, in order to bring them up to date on recent developments in financial regulatory governance, and common principles necessary to harmonise financial sector regulation. This will include the following processes:

1. The DEA will build a curriculum and testing infrastructure for certification tests for staff of regulators. Institutions like the National Institute of Securities Markets (NISM) and the National Institute for Bank Management (NIBM) will be encouraged to implement the curriculum in their programs;
2. The curriculum will broadly test knowledge of: 2
  - (a) *Hundred small steps*<sup>2</sup>;
  - (b) *FSLRC Analysis and Recommendations*<sup>3</sup>;

<sup>2</sup>Committee on Financial Sector Reforms, see n. 1.

<sup>3</sup>FSLRC, *FSLRC Analysis and Recommendations*, see n. 2.

- (c) *Report of the High Powered Expert Committee on Making Mumbai an International Financial Centre*<sup>4</sup>; and
  - (d) *Report of the Working Group on Foreign Investment*<sup>5</sup>.
3. Thirty-three percent of all existing staff employed with a regulator at the commencement of this certification program should pass the certification test every year. All new employees should also be required to pass this test within a year of the commencement of their employment. In this manner, all staff members of financial sector regulators will be adequately trained within a horizon of three years.

### 14.12.3 Certification programs for key managerial personnel in financial firms

All financial agencies need to issue regulations which require 15 per cent of all existing staff of all financial firms to pass the certification test every year. This would ensure that within a horizon of three years, a large swathe of individuals within financial firms would also possess adequate knowledge about the policy and legal environment.

### 14.12.4 Workshops and conferences for senior staff

DEA will initiate a joint mechanism through which individuals from all financial agencies will attend workshops and conferences on financial policy and regulation, taking place through the year, to foster capacity building at senior levels. This will partly utilise workshops and conferences which are already taking place, and will partly initiate *de novo* activities.

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<sup>4</sup>HPECMMIFC, see n. 3.

<sup>5</sup>Working Group on Foreign Investment, see n. 4.



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— *Government in the Sunshine Act*, 1976, URL: [http://www.gsa.gov/graphics/ogp/SunshineAct\\_R2B-x3-g\\_0Z5RDZ-i34K-pR.pdf](http://www.gsa.gov/graphics/ogp/SunshineAct_R2B-x3-g_0Z5RDZ-i34K-pR.pdf) (visited on Dec. 22, 2013).

— *Gramm-Leach-Bliley Act*, 1999, URL: <http://www.gpo.gov/fdsys/pkg/PLAW-106publ102/html/PLAW-106publ102.htm> (visited on Dec. 20, 2013).

Working Group on Foreign Investment, *Report of the Working Group on Foreign Investment*, Department of Economic Affairs, Ministry of Finance, July 30, 2010, URL: [finmin.nic.in/reports/WGFI.pdf](http://finmin.nic.in/reports/WGFI.pdf) (visited on Dec. 1, 2013).



# Acronyms

ASIC	Australian Securities & Investments Commission.
CBA	Cost Benefit Analysis.
DEA	Department of Economic Affairs.
FCA	Financial Conduct Authority.
FSA	Financial Services Authority.
FSDC	Financial Stability and Development Council.
FSLRC	Financial Sector Legislative Reforms Commission.
MAS	Monetary Authority of Singapore.
MOF	Ministry of Finance.
OBPR	Office of Best Practice and Regulation.
SEC	U.S. Securities and Exchange Commission.
UK	United Kingdom.
US	United States of America.

## **Annexure-A: Extracts from proposed SEC rules on pay ratio disclosure**



**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Parts 229 and 249**

**Release Nos. 33-9452; 34-70443; File No. S7-07-13**

**RIN 3235-AL47**

**PAY RATIO DISCLOSURE**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** We are proposing amendments to Item 402 of Regulation S-K to implement Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 953(b) directs the Commission to amend Item 402 of Regulation S-K to require disclosure of the median of the annual total compensation of all employees of an issuer (excluding the chief executive officer), the annual total compensation of that issuer's chief executive officer and the ratio of the median of the annual total compensation of all employees to the annual total compensation of the chief executive officer. The proposed disclosure would be required in any annual report, proxy or information statement or registration statement that requires executive compensation disclosure pursuant to Item 402 of Regulation S-K. The proposed disclosure requirements would not apply to emerging growth companies, smaller reporting companies or foreign private issuers.

**DATES:** Comments should be received on or before December 2, 2013.

**ADDRESSES:** Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/proposed.shtml>);

## **I. BACKGROUND**

### **A. Section 953(b) of the Dodd-Frank Act**

Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”)<sup>5</sup> directs the Commission to amend section 229.402 of title 17, Code of Federal Regulations, to require each issuer, other than an emerging growth company, as that term is defined in Section 3(a) of the Securities Exchange Act of 1934, to disclose in any filing of the issuer described in section 229.10(a) of title 17, Code of Federal Regulations (or any successor thereto) — the median of the annual total compensation of all employees of the issuer, except the chief executive officer (or any equivalent position) of the issuer; the annual total compensation of the chief executive officer (or any equivalent position) of the issuer; and the ratio of the median of the total compensation of all employees of the issuer to the annual total compensation of the chief executive officer of the issuer. Section 953(b) also requires that the total compensation of an employee of an issuer shall be determined in accordance with section 229.402(c)(2)(x) of title 17, Code of Federal Regulations, as in effect on the day before the date of enactment of the Dodd-Frank Act.<sup>6</sup>

We are proposing amendments to implement Section 953(b). We refer to this disclosure of the median of the annual total compensation of all employees of the issuer, the annual total compensation of the chief executive officer of the issuer and the ratio of the two amounts as “pay ratio” disclosure.

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<sup>5</sup> Public Law No. 111-203, 124 Stat. 1376 (2010), as amended by Public Law No. 112-106, 126 Stat. 306 (2012).

<sup>6</sup> Public Law No. 111-203, sec. 953(b), 124 Stat. 1376, 1904 (2010), as amended by Public Law No. 112-106, sec. 102(a)(3), 126 Stat. 306, 309 (2012). Section 102(a)(3) of the Jumpstart Our Business Startups Act (the “JOBS Act”) amended Section 953(b) of the Dodd-Frank Act to provide an exemption for registrants that are emerging growth companies as that term is defined in Section 3(a) of the Exchange Act.

## **Annexure-B: Extracts from Comments on SEC Amendments to Financial Responsibility Rules for BrokerDealers**



## Comments on Amendments to Financial Responsibility Rules for Broker-Dealers

**[Release No. 34-55431; File No. S7-08-07]**

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- |               |   |
|---------------|---|
| Jan. 28, 2013 | Scott E. Shjefte, Brooklyn Park, Minnesota  |
| Jan. 24, 2013 | Robert Fournier, Barstow, California  |
| Jan. 5, 2013  | Anonymous   |
| Jan. 4, 2013  | Marquis Wilkins   |
| Nov. 1, 2012  | Percy R. Moorman, Esquire, Washington, District of Columbia   |
| Oct. 25, 2012 | Eric Gamble, Ph.D., College Educator, Charlotte, North Carolina   |
| Oct. 24, 2012 | Paul L. Matecki, Senior Vice President, General Counsel, Raymond James Financial, Inc.  |
| Oct. 19, 2012 | Rick Louderbough, Albuquerque, New Mexico   |
| Sep. 28, 2012 | Robert LaPlante, M.P.A., Seacrest, Florida  |
| Sep. 27, 2012 | Jeff S. Clark, Saint Lucie West, Florida  |
| Sep. 18, 2012 | Memorandum from the Division of Trading and Markets regarding an September 17, 2012, meeting with a representative of National Investment Banking Association ("NIBA"), the Real Estate Investment Securities Association ("REISA"), the National Due Diligence Alliance ("TNDDA"), and the Financial Securities Exchange ("FSX") |
| Sep. 17, 2012 | Gene L. Finn, Ph.D., Baltimore, Maryland  |
| Aug. 26, 2012 | Mark Irwin, Rockville, Maryland   |
| Aug. 15, 2012 | Echeal R. Sigan, Plougasnou, France   |
| Aug. 6, 2012  | Gene Finn   |
| Jul. 30, 2012 | David Waddell, Arizona  |
| Jul. 18, 2012 | Gene L. Finn  |
| Jul. 12, 2012 | The Board of Directors of the National Investment Banking Association   |
| Jun. 26, 2012 | Cindy Walsh   |
| Jun. 25, 2012 | Gene L. Finn, Baltimore, Maryland   |
| Jun. 11, 2012 | Steve M. Brewer, Sr., ASG Securities, LLC, Houston, Texas   |
| Jun. 8, 2012  | James T. McHale, Global Head of Compliance, E*TRADE Financial Corporation   |
| Jun. 8, 2012  | Sarah A. Miller, Chief Executive Officer, Institute of International Bankers  |
| Jun. 8, 2012  | Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy  |

**Subject: File No. S7-08-07**  
**From: Scott E. Shjefte**

January 28, 2013

Rules on disclosure of self-directed brokerages on closure of an account are so definitive that they end up tying up the customer's account for long periods of time. During this time the brokerage has use of the money and the customer does not. I personally currently have \$330,000+ in my 401K plan tied up because of \$2.59 in residually Hewitt Money market payouts. This lock up of my funds is going to last at least 6 days and may last substantially longer. It is not fair or just that the 401K manager (BAE Systems) and Hewitt Financial Services tie up my money in this manner. Time is money and they are stealing my time value on a substantial sum of assets.

## **Annexure-C: SEC statement on penalties**



## Statement of the Securities and Exchange Commission Concerning Financial Penalties

### FOR IMMEDIATE RELEASE 2006-4

*Washington, D.C., Jan. 4, 2006* – The U.S. Securities and Exchange Commission today issued the following statement concerning financial penalties:

Today the Commission announced the filing of two settled actions against corporate issuers, *SEC v. McAfee, Inc.* and *In the Matter of Applix, Inc.* In one, the company will pay a civil money penalty; in the other, a penalty is not part of the settlement.

The question of whether, and if so to what extent, to impose civil penalties against a corporation raises significant questions for our mission of investor protection. The authority to impose such penalties is relatively recent in the Commission's history, and the use of very large corporate penalties is more recent still. Recent cases have not produced a clear public view of when and how the Commission will use corporate penalties, and within the Commission itself a variety of views have heretofore been expressed, but not reconciled.

The Commission believes it important to provide the maximum possible degree of clarity, consistency, and predictability in explaining the way that its corporate penalty authority will be exercised. To this end, we are issuing this statement describing with particularity the framework for our penalty determinations in these two cases. We have issued these decisions, and this statement of principles, unanimously.

In determining whether or not to impose penalties against the corporations in these cases, we carefully considered our statutory authority, and the legislative history surrounding that statutory authority.

In 1990, Congress passed the Securities Enforcement Remedies and Penny Stock Reform Act (the "Remedies Act"), which gave the Commission authority generally to seek civil money penalties in enforcement cases.<sup>1</sup> The penalty provisions added by the Remedies Act expressly authorize the Commission to obtain money penalties from entities, including corporate issuers. These provisions also enhanced the Commission's authority to fine individuals. Today, we limit our discussion to penalties against corporations, although we view penalties against individual offenders as a critical component in punishing and deterring violative conduct.

The Remedies Act legislative history contains express references to penalty assessments against corporate issuers of securities. In its Report on the legislation, the Senate Committee on Banking, Housing, and Urban Affairs expressly noted both that the civil money penalty provisions would be applicable to corporate issuers, and that shareholders ultimately may bear the cost of penalties imposed on corporate issuers. According to the Report, such penalties should be assessed when the securities law violation that is the basis of the penalty has resulted in an improper benefit to the shareholders. It also cautioned that the Commission and courts should, in considering corporate issuer penalties, take into account whether the penalty would be paid by shareholders who had been the principal victims of the violation:

"The Committee believes that the civil money penalty provisions should be applicable to corporate issuers, and the legislation permits penalties against issuers. However, because the costs of such penalties may be passed on to shareholders, the Committee intends that a penalty be sought when the violation results in an improper benefit to shareholders. In cases in which shareholders are the principal victims of the violations, the Committee expects that the SEC, when appropriate, will seek penalties from the individual offenders acting for a corporate issuer. Moreover, in deciding whether and to what extent to assess a penalty against the issuer, the court may properly take into account whether civil penalties assessed against corporate issuers will ultimately be paid by shareholders who were themselves victimized by the violations. The court also may consider the extent to which the passage of time has resulted in shareholder turnover."<sup>2</sup>

As this discussion indicates, a key question for the Commission is whether the issuer's violation has provided an improper benefit to the shareholders, or conversely whether the violation has resulted in harm to the shareholders. Where shareholders have been victimized by the violative conduct, or by the resulting negative effect on the entity following its discovery, the Commission is expected to seek penalties from culpable individual offenders acting for a corporation. This same point was made in the SEC's memorandum in support of the Remedies Act, which the then Chairman of the SEC, David Ruder, transmitted to the Senate in a January 18, 1989 letter.<sup>3</sup>

In addition to the benefit or harm to shareholders, the statute and its legislative history suggest several other factors that may be pertinent to the analysis of corporate issuer penalties. For example, the need for effective deterrence is discussed throughout the legislative history of the Remedies Act.<sup>4</sup> The Senate Report also notes the importance of good compliance programs and observes that the availability of penalties may encourage development of such programs.<sup>5</sup> The Senate Report also observes that penalties may serve to decrease the temptation to violate the law in areas where the perceived risk of detection of wrongdoing is small.<sup>6</sup> Other factors discussed in the



legislative history include whether there was fraudulent intent, harm to innocent third parties, and the possibility of unjust enrichment to the wrongdoer.<sup>7</sup>

The Sarbanes-Oxley Act of 2002 changed the ultimate disposition of penalties. Section 308 of Sarbanes-Oxley (the Fair Funds provision) allows the Commission to take penalties paid by individuals and entities in enforcement actions and add them to disgorgement funds for the benefit of victims. Penalty moneys no longer always go to the Treasury. Under Fair Funds, penalty moneys instead can be used to compensate the victims for the losses they experienced from the wrongdoing. If the victims are shareholders of the corporation being penalized, they will still bear the cost of issuer penalty payments (which is the case with any penalty against a corporate entity). When penalty moneys are ultimately returned to all or some of the investors who were victims of the violation, the amounts returned are less the administrative costs of the distribution. While the legislative history of the Fair Funds provision is scant, there are two general points that can be discerned. First, the purpose of the provision is to provide an additional source of compensation to victims of securities law violations. Second, the provision applies to all penalties and makes no distinction between penalties against individuals or entities.<sup>8</sup>

We have considered the legislative histories of both the Remedies Act and the Fair Funds provisions of the Sarbanes-Oxley Act in reaching the decisions we announce today.

We proceed from the fundamental principle that corporate penalties are an essential part of an aggressive and comprehensive program to enforce the federal securities laws, and that the availability of a corporate penalty, as one of a range of remedies, contributes to the Commission's ability to achieve an appropriate level of deterrence through its decision in a particular case.

With this principle in mind, our view of the appropriateness of a penalty on the corporation in a particular case, as distinct from the individuals who commit a securities law violation, turns principally on two considerations:

*The presence or absence of a direct benefit to the corporation as a result of the violation.* The fact that a corporation itself has received a direct and material benefit from the offense, for example through reduced expenses or increased revenues, weighs in support of the imposition of a corporate penalty. If the corporation is in any other way unjustly enriched, this similarly weighs in support of the imposition of a corporate penalty. Within this parameter, the strongest case for the imposition of a corporate penalty is one in which the shareholders of the corporation have received an improper benefit as a result of the violation; the weakest case is one in which the current shareholders of the corporation are the principal victims of the securities law violation.

*The degree to which the penalty will recompense or further harm the injured shareholders.* Because the protection of innocent investors is a principal objective of the securities laws, the imposition of a penalty on

the corporation itself carries with it the risk that shareholders who are innocent of the violation will nonetheless bear the burden of the penalty. In some cases, however, the penalty itself may be used as a source of funds to recompense the injury suffered by victims of the securities law violations. The presence of an opportunity to use the penalty as a meaningful source of compensation to injured shareholders is a factor in support of its imposition. The likelihood a corporate penalty will unfairly injure investors, the corporation, or third parties weighs against its use as a sanction.

In addition to these two principal considerations, there are several additional factors that are properly considered in determining whether to impose a penalty on the corporation. These are:

*The need to deter the particular type of offense.* The likelihood that a corporate penalty will serve as a strong deterrent to others similarly situated weighs in favor of the imposition of a corporate penalty. Conversely, the prevalence of unique circumstances that render the particular offense unlikely to be repeated in other contexts is a factor weighing against the need for a penalty on the corporation rather than on the responsible individuals.

*The extent of the injury to innocent parties.* The egregiousness of the harm done, the number of investors injured, and the extent of societal harm if the corporation's infliction of such injury on innocent parties goes unpunished, are significant determinants of the propriety of a corporate penalty.

*Whether complicity in the violation is widespread throughout the corporation.* The more pervasive the participation in the offense by responsible persons within the corporation, the more appropriate is the use of a corporate penalty. Conversely, within this parameter, isolated conduct by only a few individuals would tend not to support the imposition of a corporate penalty. Whether the corporation has replaced those persons responsible for the violation will also be considered in weighing this factor.

*The level of intent on the part of the perpetrators.* Within this parameter, the imposition of a corporate penalty is most appropriate in egregious circumstances, where the culpability and fraudulent intent of the perpetrators are manifest. A corporate penalty is less likely to be imposed if the violation is not the result of deliberate, intentionally fraudulent conduct.

*The degree of difficulty in detecting the particular type of offense.* Because offenses that are particularly difficult to detect call for an especially high level of deterrence, this factor weighs in support of the imposition of a corporate penalty.

*Presence or lack of remedial steps by the corporation.* Because the aim of the securities laws is to protect investors, the prevention of future harm, as well as the punishment of past offenses, is a high priority. The Commission's decisions in particular cases are intended to encourage the management of corporations accused of securities law violations to do everything within their power to take remedial steps, from the first

moment that the violation is brought to their attention. Exemplary conduct by management in this respect weighs against the use of a corporate penalty; failure of management to take remedial steps is a factor supporting the imposition of a corporate penalty.

*Extent of cooperation with Commission and other law enforcement.* Effective compliance with the securities laws depends upon vigilant supervision, monitoring, and reporting of violations. When securities law violations are discovered, it is incumbent upon management to report them to the Commission and to other appropriate law enforcement authorities. The degree to which a corporation has self reported an offense, or otherwise cooperated with the investigation and remediation of the offense, is a factor that the Commission will consider in determining the propriety of a corporate penalty.

This framework for the consideration of the propriety of corporate penalties is grounded in the Commission's statutory authority and supported by the legislative history underlying that authority. It is the Commission's intent that the elucidation of these principles will provide a high degree of transparency to our decisions in these and future cases, and will be of assistance to the Commission's professional staff, to corporate issuers and their counsel, and to the public.

# # #

<sup>1</sup> Before the enactment of the Remedies Act, the Commission's penalty authority was essentially limited to the ability to seek penalties in district court for insider trading violations.

<sup>2</sup> S. Rep. No. 337, 101<sup>st</sup> Cong., 2d Sess. at 17 (1990) ("1990 Senate Report").

<sup>3</sup> *Securities Law Enforcement: Hearings on H.R. 975 Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 101<sup>st</sup> Cong., 1<sup>st</sup> Sess. 47-48 (1989) (statement of David S. Ruder, Chairman, SEC, attaching Memorandum of the SEC in Support of the Securities Law Enforcement Remedies Act of 1989).

<sup>4</sup> See, e.g., 1990 Senate Report at 6-11; see also Section 21B(c)(5) of the Exchange Act.

<sup>5</sup> 1990 Senate Report at 10-11.

<sup>6</sup> 1990 Senate Report at 15.

<sup>7</sup> 1990 Senate Report at 14. See, e.g., Section 21B(c)(1)-(3) of the Exchange Act.

<sup>8</sup> See House Committee on Financial Services Release, "Baker Proposes FAIR Account to Return Funds to Defrauded Investors" (July 17, 2002) (including statements of Chairman Oxley and Chairman Baker), available at <http://financialservices.house.gov/news.asp>.

**Additional materials:**

- [Litigation Release 19520](#)
- [Administrative Proceeding Release No. 33-8651](#)

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