India Business Law Journal

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Inside India's courts

Senior counsel reveal the challenges facing the judiciary

Piracy in Bollywood

The dawn of Islamic finance

Money laundering laws in a spin

The best foreign law firms for India-related work

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Flies in the ointment

Faced with opposition to liberalizing China's economy 30 years ago, Deng Xiaoping is said to have retorted: "When you open the window, some flies come in"

This first anniversary issue of *India Business Law Journal* illustrates well the strains and stresses – the "flies" – that accompany any far-reaching attempt at reform. Much of our coverage this past year has investigated the different forms such difficulties take: frustration at the failure of the country's legal system to perform the facilitating role that should be one of its main functions; dissatisfaction with the unpredictable imposition of new, expensive and sometimes vague regulatory constraints; unhappiness with the shortcomings too often displayed by some of the country's legal professionals; and increased exposure to international economic influences over which domestic authorities have little or no control.

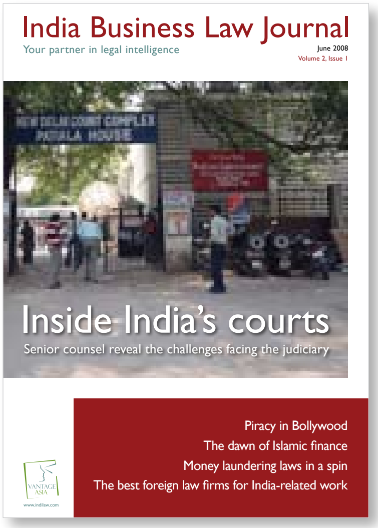
The magazine's focus has been to neither ignore these flaws nor dwell on them, but rather to explore how law firms, local and international, are crafting effective strategies to enable their clients to achieve their business goals. Devising suitable solutions is the responsibility of the nation's professional elites as well as its politicians.

As in the case of China, the benefits that accrue are undeniable: rapid economic growth, the chance to lift many millions out of poverty, and then some. Lawyers play a crucial role in this process. And their role is growing. The **Cover story** of our inaugural issue in June 2007 focused on how – and which – foreign law firms were "ready to pounce" on India-related business opportunities. A year on, we are pleased to revisit this important subject (*Jewels in the crown*, page 35).

A rich and diverse tapestry of international expertise is revealed and one inescapable conclusion is evident: the number and proficiency of lawyers outside the country devoted to India-focused legal work have increased dramatically over the past 12 months. New offices have been opened to be closer to the action, more foreign firms are establishing India practice groups and more local lawyers and graduates are working for, and training in, international law firms.

The pie is larger, but Indian law firms' slice of it is almost certainly shrinking. How much business India's lawyers are losing out on – and will continue to lose out on – cannot but come to mind. If nothing else, it is testament to India's arrival at the forefront of global business.

But global business brings with it exposure to the global threats so poignantly encapsulated in Deng's analogy.



In India's case, one such "fly" is the increasing incidence of money laundering. Criminal activity associated with "dirty money" has become a primary concern. But as our coverage illustrates, widely welcomed measures to tackle the clandestine transfer of funds have been undermined by infighting among the authorities (*Money laundering laws in a spin*, page 27). Controversy centres on the judicial bodies established to administer the anti-money laundering provisions. The formation of tribunals and the appointment of adjudicators have been suspended because the judiciary and the government are unable to agree on the allocation of adjudicating powers. In common with reforms to other areas of Indian jurisprudence, a hornet's nest of opposition was immediately disturbed. Legal limbo and paralysis are the result.

Similar examples appear throughout this issue of *India Business Law Journal* and it is hard to escape the conclusion that India's rapid economic growth is posing problems that the current regulatory and judicial architecture are too inflexible to address. The pressure points – in the government, the regulatory authorities and the courts – are increasingly noticeable.

Vantage point contributor Pradeep Dinodia of accountancy firm SR Dinodia & Co, writes powerfully on the undemocratic exigencies that parliament's predilection for retrospectivity can give rise to (page 19), while our examination of a recent case of music piracy (*Facing the music*, page 31) provides a pertinent reminder of the woefully inadequate mechanisms for enforcing intellectual property rights in India.

Meanwhile, the need for regulators to keep laws up to date or miss opportunities is well illustrated in our report on Islamic finance (page 21). Simple regulatory changes could transform India into a regional hub for *shariah*-compliant finance and clear the way for a much-needed wave of investment into infrastructure, a sector well-suited to the deployment of such funds. Yet the Reserve Bank of India's current regulations make it virtually impossible for a regulated bank to maintain compliance with *shariah* principles.

This month's **Cover story** (page 13) follows towering figures such as Ashok Desai, Soli Sorabjee and Justice Manmohan Singh as they ply their distinguished trade through the capital's legal corridors. How the courts work reveals a pervasive imbalance of power – between judges and lawyers, between lawyers and clients and between the need for effective and enforceable remedies and the inertia of the existing system.

Around Sorabjee and other eminences of the courtroom weaves a fascinating tale of appeals, deferments and case management; and all are united in calling for change. But as our coverage reports, seeking justice through India's infamous judicial system is not always as problematic as people are led to believe. Indeed, a series of encouraging developments promise significant improvements for lawyers and "consumers" of justice alike. ■

Money laundering laws in a spin

Widely welcomed measures to tackle the clandestine transfer of funds have been undermined by infighting over the allocation of adjudicating powers

Raghavendra Verma reports from New Delhi

In January 2007 a raid on Pune-based businessman Hassan Ali Khan's premises allegedly uncovered US$8 billion hidden in Swiss bank accounts. Government agencies claimed he had transferred US$300 million from one of his accounts to a Saudi arms dealer.

The case gained further prominence when Swiss bank UBS turned down India's request to divulge the details of the account, ostensibly because it hadn't received proper judicial documentation from Indian authorities. In retaliation earlier this year, as reported in the *Hindustan Times*, India obstructed UBS's US$118 million deal to buy Standard Chartered Bank's mutual fund business in the country.

A growing problem

High profile cases such as this, combined with India's increasing involvement in complex international financial transactions, have brought the issue of money laundering to the forefront of the political agenda. Criminal activity associated with "dirty money" has been the primary concern, particularly where foreign remittances through wire transfers are used as a means of funding.

Additional challenges have been posed by the spread of terrorist networks and the illegal trading of arms and drugs, all of which are activities that thrive on the clandestine transfer of funds.

According to Professor Aman Agarwal, vice-chairman of the Indian Institute of Finance in New Delhi, the "extensive use of electronic movements of money has made it difficult to trace suspected funds and identify their real ownership behind shell companies or offshore bank facades".

Tax heavens like Cyprus and Mauritius, which have minimal restrictions on financial transactions and the operations of foreign businesses, are seen as ideal centres for channelling and holding money laundering funds, Agarwal adds.

Sarabjeet Singh, a chartered accountant heading the

Extensive use of electronic movements of money has made it difficult to trace suspected funds and identify their real ownership behind shell companies or offshore bank facades

Professor Aman Agarwal
Vice-chairman
Indian Institute of Finance

anti-money laundering division of New Delhi-based BMR Advisors, says that banks' internal assessments give India a high risk rating for the potential for money laundering. This is a result, he says, of inadequate regulatory provisions, a poor track record of implementing laws and delays in the justice delivery system. India's cross-border financial transactions thus require extra due diligence, often leading to delays in their processing.

Fighting back

Eager to clean up its act, India is now implementing anti-money laundering regulations in line with those prescribed by the Financial Action Task Force (FATF), a 34-member inter-governmental body on which India holds observer status. "Being an emerging economy and heading towards fast-paced integration with global financial systems, India is getting its regulations in line with other FATF countries," Singh explains.

The FATF aims to develop and promote policies and measures to counter the use of the financial system by criminals. Its recommendations are frequently revised to ensure that they remain up to date and relevant to the evolving threat of money laundering.

India has also demonstrated its commitment to tackling money laundering with the implementation of the Prevention of Money Laundering Act (PMLA), 2002, and the establishment of the Financial Intelligence Unit (FIU) to counter suspicious cash transactions.

Criminal activities defined by the PMLA include offences under the Indian Penal Code such as murder, kidnapping and the counterfeiting of currency notes in addition to illegal trading in drugs, arms and wildlife, prostitution, the bribery of public servants and terrorism-related crimes. A new amendment to this list will include child labour, human trafficking, piracy and crimes relating to insider trading and the manipulation of stock markets.

Further amendments have been proposed to include offences committed in other countries, even if the offences are not constituted as criminal in those jurisdictions. The amendments were recently finalized bringing not only international credit card transactions and money transfers under the purview of the PMLA, but also a new category of offences with cross-border implications.

Legal challenge

The punishments prescribed under the act include penalties, the seizure of property, and even imprisonment. However, the system that deliberates on such cases and pronounces verdicts functions under acting tribunals with ad hoc appointments. Furthermore, the constitution of these tribunals and the appointment of adjudicators have been suspended because the judiciary and the government are unable to agree on adjudicating powers.

In November 2007, just two days before the selection procedure for the adjudicating body was to be notified, the Supreme Court deliberated on a public interest litigation and prevented the government from proceeding with the notification. A petition filed by Pareena Swarup, secretary of the Supreme Court Bar Association, objected to the provision under which the power of appointing the chairman of the adjudicating authority was held by a bureaucrat in the Finance Ministry. It also alleged that the rules permitted any individual to be appointed as chairman without due importance given to his or her legal knowledge or judicial training.

In March this year, the government partially relented by agreeing to transfer the powers of appointment to the chief justice of the Supreme Court. However, Swarup insists that the government should cede its powers of dismissal of the chairman, and alter the criterion for selecting the head of the appellate body.

According to the present provision, the government can appoint not only a former high court judge, but also anyone eligible to be a high court judge. This qualifies every lawyer with 10 years of practice, which Swarup strongly opposes.

KK Venugopal, a senior advocate in the Supreme Court, who is representing Swarup's public interest litigation, says that "the government gradually wants to take over all judicial tribunals", which he says is against the principle of the separation of powers between the judiciary and the executive.

Independent enforcement

Looking ahead of this legal battle, many observers feel that the PMLA will ultimately prove more successful than other legislative measures because of its inbuilt safety provisions that reduce its chances of being misused for the harassment of bona fide businesses.

When a suspicious transaction is identified, the FIU conducts a preliminary investigation before sharing the details with the Enforcement Directorate, the Customs and Excise Department, the Directorate of Revenue Intelligence, and the Central Board of Direct Taxes, which includes the country's Income Tax Department.

"Unlike the Income Tax Act, where the department collects information and also enforces the law, under the PMLA the collection and enforcement is divided between two independent wings," explains Agarwal. "[The] Financial Intelligence Unit can only inform the Enforcement Directorate about a fraud but can neither stop the activity nor go public about it."

Established in 2004, as an independent anti-money laundering agency, the FIU is answerable directly to the Economic Intelligence Council, which is headed by the finance minister. Working in close coordination with the Reserve Bank of India, the Securities and Exchange Board of India (SEBI), the Insurance Regulatory and Development Authority, and the National Housing Board, the FIU is responsible for coordinating and strengthening the collection and sharing of financial intelligence with national and international agencies. It also monitors money laundering trends to track suspicious transactions.

Following India's admission to the Egmont Group in 2007, the FIU has strengthened its awareness of suspected financial transactions through the group's special information exchange network. As an informal group made up of 108 FIUs around the world, the Egmont group allows its members to participate in forums to enhance support mechanisms for their individual national anti-money laundering and anti-terrorist financing programs.

Mandatory reporting

Since July 2005, when the PMLA rules took effect, it has been mandatory for banks and certain other financial institutions to notify the FIU on a monthly basis of all cash transactions (single or linked) of more than Rs1 million (US$25,000). Any suspicious transactions must be reported within a week. Financial institutions are also expected to initiate dealings with clients only after verifying the customer's proof of identity, the nature of their business and their financial status.

Financial institutions that fall within these mandatory reporting requirements include banks, chit funds, cooperative banks, non-banking financial companies and intermediaries such as stock-brokers, sub-brokers, share transfer agents, bankers and registrars to an issue, merchant bankers, underwriters, portfolio managers and investment advisers. In line with the latest legal amendments, overseas payment gateways, money-changers and money transfer service providers like Visa, MasterCard and Western Union, also face a mandatory reporting obligation.

Insurance companies have obligations too, as they are not allowed to remit any premium in cash valued above Rs50,000. If a person tries to subvert the system by entering into a series of small transactions that aggregate to Rs1 million or above, it is the responsibility of the concerned banking institution to report them to the FIU.

High-volume transactions that do not match the customer's financial profile, and policies issued in the name of unknown beneficiaries, or to an unrelated third party, also come under the scanner. To ensure this profiling, all policyholders are required to provide their permanent account numbers, issued by the Income Tax Office, and income details to their insurers.

Guilty until proven innocent

The current situation demands that companies in need of assistance from financial institutions must prove their credentials, a requirement that has become substantially more pertinent following the PMLA amendments.

According to Agarwal, in some cases these companies even engage the services of private consultants to prepare reports or conduct surveys to show that they are not involved in activities that could be deemed illegal.

Hiring a consultant is especially common when a foreign company without a prior presence in India plans to conduct an export transaction that needs a foreign exchange contract, explains Agarwal. "The local banks and financial institutions might refuse to support such contracts or approve any loans unless independent consultants like Ernst & Young or KPMG certify that [the] company has a strong base and there are sound provisions to go ahead."

This demand for added documentation and somewhat intrusive details has made traditionally conservative customers weary. "Instead of seeking KYC [know your client] information at the time of opening the account, many banks ask for documentation afterwards", says Agarwal, "the banks are either not clear about the KYC guidelines or their employees are not trained sufficiently."

It is not just the clients who are bothered by the new regulations, financial institutions themselves are facing difficulties. In addition to the cost of extra time and effort spent on collecting customer data, they are also expected to put in place systems that are supervised by special officers for the identification of fraudulent transactions. There is not much scope for error, as they face a fine of up to Rs100,000 for every failure to fulfil their obligations under the PMLA.

A common money laundering method adopted to cleanse "dirty" money is through the over-invoicing of goods traded across borders. For this reason, says Singh, banks must have a good understanding of their major clients' businesses, and exercise caution when taking on new customers.

Uniform enforcement

Arun Goyal, director of the FIU, tells *India Business Law Journal* that after relying on persuasive methods of formal and informal interactions, his unit is ready to take "proactive steps" against reporting agencies to ensure full compliance with PMLA guidelines. "We want [the] same standards, and compliance across the industry so that no one can bypass the regulations and no one [has an] undue advantage," he says.

India has a huge network of government-owned banking institutions that are now facing stiff competition from private banks, which are known for their innovative and customer-friendly approach.

Dirty business: Crime syndicates, terrorist networks and drug traffickers thrive on money laundering.

The government gradually wants to take over all judicial tribunals

KK Venugopal
Senior Advocate
Supreme Court

"Being a part of the government system we are more committed to implement any law, and our systems too, are better equipped to deal with fraudulent accounts", says a branch manager of a government-owned bank in New Delhi. "In private banks the agents responsible for opening new accounts have [minimal] regard [for] KYC norms."

With a monetary incentive of over US$100 for each new account opened, it is quite natural that the first priority of low-paid junior banking executives is to get a deal, even if it involves using their knowledge of banking systems to evade provisions that they perceive as unnecessary red tape.

Indeed, this conflict of interest extends to top management, as the primary objective of private bankers is rapid growth through attracting increasingly lucrative customers. To close a suspicious account or report it to the FIU would result in a direct loss of revenue, however, the penalty for not adhering to the norms puts them in a tight situation. As a result, Agarwal believes that they make sure they are safe by following the minimum requirements.

A senior executive at the New Delhi office of a large European bank disputes the notion that publicly owned banks are more likely to be vigilant. "Public sector banks can escape even after committing a murder, but we as a foreign bank will be crucified for a small error," he says.

Taking no chances with the provisions of the new law, this particular privately owned bank has laid out an elaborate plan to complete the necessary formalities. "Reviewing KYC information for the existing clients was indeed a big task, but we set a deadline for our relationship managers and they did it by making personal contacts, especially with the corporate accounts," says the executive. Strict warnings were also issued to many customers, and most of them submitted the required documentation. Some of the non-compliant accounts were suspended, he says.

In contrast to this approach, the executive claims that most government banks are simply writing letters to customers, the majority of which go unanswered. ■