

Report
of the
EXPERT COMMITTEE

headed by
SHRI VEPA KAMESAM

**ON ISSUES CONCERNING THE SERIOUS FRAUD
INVESTIGATION OFFICE**

April, 2009

**MINISTRY OF CORPORATE AFFAIRS
GOVERNMENT OF INDIA
NEW DELHI**



Shri Vepa Kamesam
Chairman
Expert Committee to advise Government
on issues concerning the SFIO

New Delhi, the 29th April, 2009

Dear Mr Minister,

Corporate Fraud is a highly complex phenomenon and is one of the many consequences of rapidly growing economy characterized by increasing number of corporate entities with a wide range of activities and each across several markets. Any case of serious fraud has devastating consequence on confidence of investors, credibility of the corporate sector, financial survival of company and its employees, losses to banks and financial institutions and setback to economy as a whole. As elsewhere in the world, the Indian corporate world has also been afflicted by various frauds starting with stock market scams of 1990s and early 2000s to accounting fraud in the case of Satyam. While the earlier frauds had an impact on Indian stock market, the latest accounting fraud perpetrated by promoters of Satyam was a fraud on the company itself as it endangered the very survival of the company. The impact of serious and complex frauds on a large number of stakeholders has intensified the concern for effective regulation of the corporate world.

SFIO was set up in 2003 as a multidisciplinary agency with experts drawn from various fields to carry out investigations under the provisions of Companies Act, 1956. SFIO has successfully investigated large number of cases assigned to it by MCA and has filed prosecution under various sections of Companies Act and Indian Penal Code. During investigation of cases it has unearthed different types of complex frauds.

This Committee, constituted by the Ministry in 2006 to examine various issues relating to SFIO and to suggest statutory, administrative and organizational changes for improving the effectiveness and to ensure efficient discharge of duties by SFIO was a timely move reflecting the need for statutory and institutional structures to grow and meet the challenges of a diversified and rapidly growing economy. The Committee has carefully considered views and opinions of different regulatory and investigative agencies drawn from their

experiences to develop insights into the nuances and subtleties of various issues involving corporate fraud. It is hoped that the recommendations of the Committee will go a long way in enabling the Ministry in developing its proposals for legislative change and institutional development towards dealing with corporate fraud effectively and also making SFIO an effective investigative and law enforcement agency.

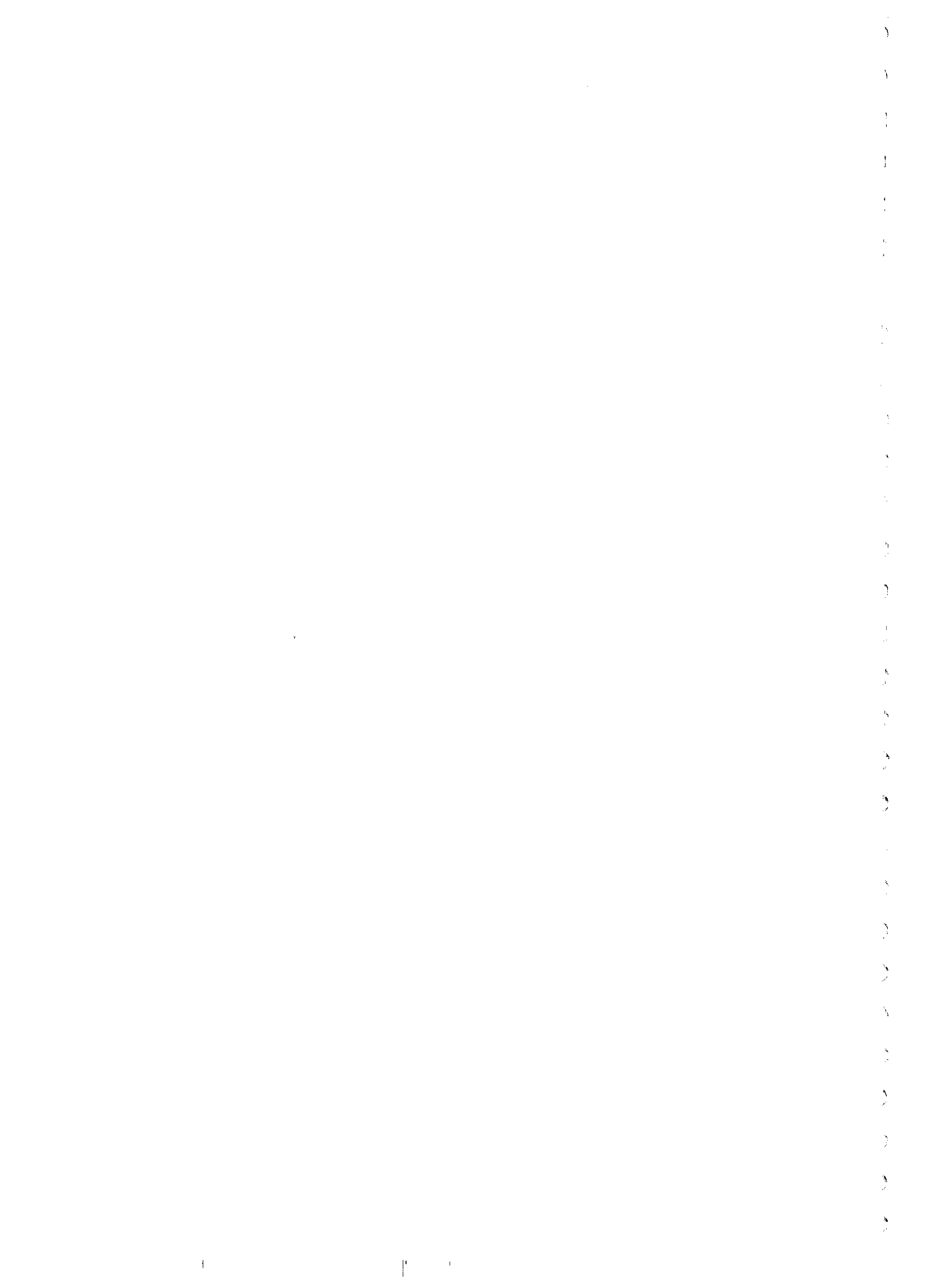
I acknowledge the valuable contributions made by all the Members of the Committee in the course of its deliberations and in firming up its recommendations. They have brought to bear a rich diversity of experience in consultation of a subject that involves some of the most complex issues in corporate regulation. Special thanks to Sh. Ajay Nath, Director SFIO, for providing inputs and support for the conduct of meetings and discussions of the Committee.

Yours sincerely,

Sd/-

Vepa Kamesam

The Honourable
Shri Prem Chand Gupta,
Ministry of Corporate Affairs
New Delhi



MEMBERS OF THE EXPERT COMMITTEE

1. **Shri Vepa Kamesam**, Ex-Deputy Governor, RBI Chairman

2. **Shri M.M.K. Sardana**, Member MRTP Commission Member

3. **Shri B. Swarup** IRS (Retd.), formerly Member Investigation, Central Board of Direct Taxes. Member

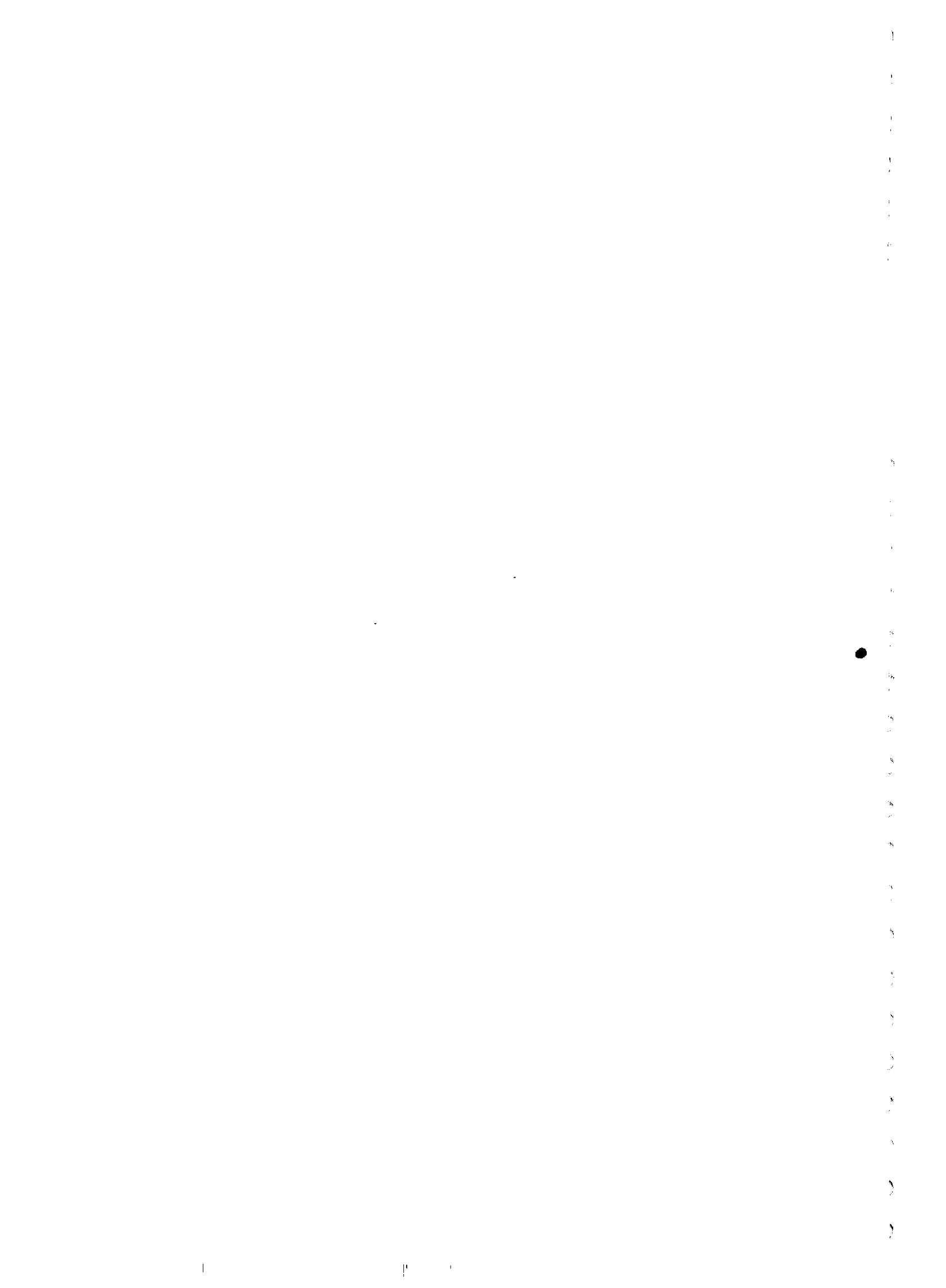
4. **Shri G. Anantharaman**, Ex-Whole Time Member, SEBI Member

5. **Shri Navneet Rajan Wasan**, Joint Director (MDMA), CBI Member

6. **Shri O.P. Verma**, formerly Addl. Govt. Counsel, Ministry of Law & Justice. Member

7. **Shri Jitesh Khosla**, formerly Joint Secretary, Ministry of Corporate Affairs. Member-Secretary

8. **Shri R. Vasudevan**, Director (Inspection & Investigation), Ministry of Corporate Affairs. Convener



Executive Summary

The Joint Parliamentary Committee (JPC) on Stock Market Scam 2001, recommended setting up of a Serious Fraud Investigation Office in India. Several other committees also suggested that suitable legislative framework should be considered to strengthen the investigation by SFIO and to make it more effective.

ii) The SFIO was set up in 2003 under the Ministry of Corporate Affairs through an executive order to carry out investigations under the Companies Act, 1956. With a view to review the functioning of SFIO and also to make it more effective, the Central Government constituted an Expert Committee under the Chairmanship of Shri Vepa Kamesam, formerly Deputy Governor, Reserve Bank of India.

iii) The Committee deliberated upon various issues relating to investigation of Corporate fraud, based on the experience of SFIO and the recent developments in Indian and global arena. The Committee also considered statutory and institutional frameworks in several jurisdictions such as US, UK, Germany etc. and presented its report.

iv) The main recommendations of the Committee are collated as under:-

1. Nature and implications of corporate fraud as distinct phenomena should be appropriately recognized and addressed separately in Law. (Para-2.6/3.6, Page No.13/22)
2. A comprehensive, inclusive definition, defining the offence of fraud with regard to the affairs of a company, may be included in the Companies Act, 1956. Such definition should draw upon the structure

provided for an analogous definition in the UK Fraud Act, 2006. Offences related to fraud should also be suitably defined in Companies Act, 1956 with stringent penalties. The Committee, therefore, recommends that an exclusive jurisdiction be carved out for corporate frauds under the Companies Act, 1956, irrespective of whether it has features of an offence under the IPC or not. Further, SFIO should be facilitated to assume jurisdiction seamlessly in corporate fraud wherever warranted. (Para 4.5.2b, Page 30-31)

3. Many provisions of the Companies Act, 1956 aim to deal with the cases of statutory contraventions and offences there under. This structure is necessary for various types of corporate fraud to be detected, identified and addressed. It would be appropriate to review the compliance and corporate governance regime in the Companies Act, 1956 so that it enforces transparency and accountability at all levels and provides adequate statutory means to address situations resulting from corporate fraud through an appropriate investigative, enforcement and penalty structure. (Para 4.5.2b, Page 30-31)
4. While defining fraud in the corporate context comprehensively, the Govt. should consider strengthening the investigative powers of SFIO and to accord statutory recognition to the SFIO in the Companies Act itself with the statutory obligation for other entities to cooperate with it. (Para-5.12(ii), Page No.36)
5. In the short term, Government may also consider making amendments to the Companies Act 1956 itself so as to streamline the procedures and strengthen the powers of the inspectors appointed under the Companies Act, 1956 more effective in dealing with frauds in relation to affairs of companies. (Para-5.12(i), Page No.36)

6. Govt. should consider in the long term, a special legislation, to deal with the subject of fraud in a broader sense and for the constitution, setting up, functions and powers of an agency to investigate fraud that enables it to function state jurisdictions. For this, the constitutional aspects may also be duly addressed as the basis of Government decision to order investigation into the affairs of a company (Para-5.12(iii), Page No.36)

7. Instead of solely depending on the report of Registrar of Companies u/s 234 of the Companies Act, 1956, Central Government may also take into account reports in writing, affirming prima-facie occurrence of fraud from a wider range of agencies like SFIO, CBI, DRI, Income Tax, SEBI etc. The order by the Government should however be speaking one, indicating the charges against the company/reasons for investigation and justification in public interest. A suitable amendment to the Companies Act may be considered to enable this. (Para-6.1.6 Page No.39)

8. Statutory recognition of SFIO under the Companies Act need not change the existing arrangements. These would require to be comprehensively reviewed once a special legislation to provide for SFIO is enacted. The manner in which investigative action may be initiated and closed may also be dealt with in such legislation. For the present, the existing arrangement whereby investigation is ordered by the government may continue.

SFIO being a specialized organization intended to bring together multi-disciplinary expertise to unravel fraud, should not be burdened with routine investigations or inquiries into various complaints. It would be

appropriate for the Central Government to strengthen its arrangements for inspections and inquiries to be carried out by field organization of the Ministry to handle such work without imposing this burden on SFIO. It would also be appropriate for the information gathered by the Ministry through its electronic registry or complaints received and inquired into to be shared with SFIO. (Para-6.1.7 Page No.39)

9. The issue of enabling SFIO to independently take up investigations, carry them out under oversight of the courts and taking them to their logical conclusion, or where there are inadequate grounds for proceeding further, closing such investigations, may be addressed through a separate statute for setting up the SFIO and providing for its constitution, functions and operations to be prepared and enacted in the future. Till such time, investigations may be ordered by the Central Government under the Companies Act, 1956. (Para-6.1.8 Page No.40)

10. The seriousness of an investigation may be assessed in terms of amount of funds, the number of stakeholders or complexity involved. No hard and fast guidelines are possible and the Committee would refrain from applying a monetary limit or threshold for a fraud to be considered serious. The nature of corporate fraud is such that while the acts *per se* may be innocuous, the fraud in totality may have a snowballing effect on stakeholders, banks financial institutions, market sentiment and thereby on capital markets etc. The assessment of seriousness would have to be based on the particular circumstances of each case. (Para-6.1.9 Page No.40)

11. The provisions of section 239 of the Companies Act, 1956 for investigation of related companies, along with the provisions vesting

powers on the inspectors appointed by the Government for such investigation, may be widened to include, in addition to the existing provisions, entities other than companies such as sole proprietorships, partnerships, trusts, companies registered overseas etc. that are related, associate to or otherwise connected to the subject company through promoters or their relatives or the controlling interest of the subject company or through participation in acts resulting in fraud in any manner. (Para-6.3 Page No.41)

12. Authority to call for information, evidence from bodies corporate other than the subject company under investigation should be vested in the Inspector drawn from Serious Fraud Investigation Office, if such Inspector is appointed by the Central Government to conduct investigation. This would be a special power to be exercised in recognition of a particular fraud being identified as serious fraud. In other cases, such powers may continue to rest with the Government as under the existing provisions. This would require suitable amendment to sub-section (1A) with resultant amendments to sub-section (2) and sub-section (3) of section 240 of the Act. (Para 6.4.1, Page No.42)

13. Furnishing of information to the investigating inspector is an important aspect of investigation and failure to do so without reasonable cause could imperil the investigation. Therefore, the Committee recommends that the level of imprisonment for such offence may be enhanced to a maximum of three years from the present level of six months. The offence should also be made non compoundable. the quantum of fine may also be enhanced. The fine for such refusal, in addition to the possibility of imprisonment should be enhanced to extend up to five lakh rupees with a minimum of twenty thousand

rupees. The penalty for continuing default in such cases should also retain (Section 240) (Para-6.5.1, Page No.42)

14. Penalty for furnishing false information or withholding relevant information under section 628 should be enhanced so that where any false statement or information, with regard to a company under investigation, is furnished to the inspector, appointed under the Companies Act to investigate that company, the term of imprisonment should be enhanced from the current two years to seven years along with a fine that may extend to five lakhs rupees, with a minimum of fifty thousand rupees. (Para-6.5.2, Page No.43)

15. Inspector should be vested with the power to compel appearance of any person he may suspect, for questioning. Whether to require physical appearance or to obtain written replies/ affidavits/ declarations on oath or otherwise, may be left to the inspector. There should be a penalty for ignoring an inspector's summons. Besides, non response to repeated summons should lead to arrest of the person through a warrant to be issued by a magistrate on a report filed by the inspector. (Para-6.5.3, Page No.43)

16. The Inspector should have the powers to seize books and papers of the company under investigation, including computers and computer readable devices which he may be authorized to retain for a limited period (180 days). Beyond this period, he may be authorized to retain for further period of 180 days with the permission of the Court. He may order such books and papers to be stored in a secure place on the premises of the company itself and seal the premises. The company or other authorities requiring use of such documents may be allowed access by the inspector on request. The inspector may also

make copies of the documents seized and authenticate them. The Inspector may also have the powers to compel, by order, safekeeping of books and records by specific officers of the Company for a period of up to one year. Any default should result in non-compoundable criminal liability involving fine and imprisonment for the officers of the Company so named in the order. Other provisions contained in section 240A may continue to apply to search and seizure done by SFIO. In other case, where the original incriminating documents /records are required to be produced before the court as evidence, the same be retained by the inspector with Court permission till the disposal of trial. He may issue an authenticated copy to the company for their use. (Para-6.6.2, Page No.44)

17. In addition, a separate offence may be defined to deal with actions resulting in unauthorized removal, concealment, destruction or tampering with company records for a company under investigation or a related entity. Such offence may be punishable with imprisonment that may extend up to seven years, and with fine of up to ten lakhs rupees with a minimum of Rs 50,000/-. (Para-6.6.3, Page No.44)

18. Persons other than the officers of the company under investigation should also be under a duty to assist the Inspector ordered to investigate affairs of the Company. The requisite provision should allow the inspector to apply to the officer in charge of the nearest Police Station for such assistance as may be necessary in the discharge of his duties. Failure to discharge this duty with due diligence may attract monetary penalties and civil liability for complicity in the fraud. (Para 6.7. Page No. 45)

19. The law should provide for provisional attachment of both movable and immovable properties of the company under investigation and its directors/promoters in respect of cases entrusted to SFIO. Such attachment may be made on discovery by the inspector himself on the basis of prima facie finding of fraud under the Act. However to obviate the possibility of misuse of powers, Inspector should intimate to CLB/Courts full details of properties attached and the grounds for such action within seven days of doing so and seek orders of the CLB court/tribunal/attaching/restraining the company from alienating any assets. The attachment/restraint order should continue at the discretion of the court. (Para 6.8.1 Page No. 45)

20. Suitable changes be made in Section 242 of the Companies Act, 1956 empowering the inspectors appointed under the Companies Act to file complaints with regard to offences under any other statute as well with the appropriate Court. If necessary provisions of other legislations may be reviewed. (Para 6.9.1 Page No. 46)

21. On the basis of findings through investigations carried out under the provisions of the Companies Act and the report submitted under Section 241, where a person or persons are found to have indulged in fraudulent activity in relation to the affairs of a company, such persons may be prosecuted under the Companies Act, along with provisions of other Acts as applicable. If found guilty of the offence of fraud, to be defined under the Companies Act, 1956, the concerned person may be punished with imprisonment for a term which may extend up to ten years and with fine that may extend up to one crore rupees. (Para 6.9.2 Page No. 47)

22. The Companies Act, 1956 may also provide the authority for the Court to impose punishment of imprisonment and/ or fine for various offences relating to corporate fraud as well as to offences relating to investigation in a cumulative manner, if in the opinion of the Court such punishment is warranted keeping in view the nature of the fraud. (Para 6.9.3 Page No. 47)
23. There is a need to provide for higher deterrent punishment, both in terms of imprisonment and monetary fine under section 63 of the Act, based on the amount of funds involved in public issue covered by the prospectus. The offence is also required to be made a non-compoundable one. (Para 6.10 Page No. 47/48)
24. The offence under section 68 is also required to be made non-compoundable with imprisonment and monetary penalty linked with the quantum of investment so procured. (Para 6.10 Page No. 47/48)
25. Presently, the penalty prescribed for violation of section 77 is merely a fine of ten thousand rupees which is too mild considering the gravity and consequential effects of the offence. There is a need to provide for separate and stringent penalties both for the company and its officer in default. The offence may be made non-compoundable with provision for imposition of penalty on the company and imprisonment and fine on the officers in default. (Para 6.10 Page No. 47- 49)
26. The penalty prescribed under section 233, i.e. a fine up to ten thousand rupees on auditor is considered to be too meager to act as a deterrent for the erring auditors. The offence may be made non-compoundable with imposition of both imprisonment and a much higher monetary fine linked to the amount of remuneration received by

him as auditor of the company. In addition, civil liability should also be imposed for restitution or compensation for the harm inflicted on the company as well as individual stakeholders who suffered on account of the acts, omissions or negligence of the auditors. (Para 6.10 Page No. 47/49)

27. Having regard to the gravity of financial implications and its contributory effect towards fraud, the offence under section 372A may be made non-compoundable with enhanced amount of fine linked to the amounts of loans and investments made, besides imprisonment of suitable duration. (Para 6.10 Page No. 47-50)

28. Sections 539 to 544 apply to cases of companies under liquidation and deal with offences of falsification of books, frauds by officers, situations where proper accounts are not kept, fraudulent conduct of business of a company etc against the directors and officers of such companies. Further, under section 406 read with Schedule XI these provisions can be made applicable to cases where an application is made under section 397/ 398 of the Act with regard to mismanagement or oppression. These provisions provide a framework that enables the identification of directors and officers involved in fraud and fixing personal liability on them by lifting of corporate veil. The Committee recommends that these provisions should be made applicable to any finding of fraud with relation to affairs of the company rather than restricting them only to the cases of winding up and liquidation or mismanagement or oppression. This may be done by a special provision to be read along with the general definition of fraud. (Para 6.11 Page No. 50)

29. The Companies Act may also specifically provide for disgorgement of assets created from the proceeds of fraud from the properties of the company or its delinquent officers and directors on the principle that no one should be allowed to profit from fraud. In addition, the law should provide for recovery of damages caused to victims of fraud from the delinquent directors and officers of the company, or the company itself. (Para 6.11 Page No. 50)

30. Under Section 203 of the Companies Act 1956, powers are available to the Court to restrain fraudulent persons from managing companies or being concerned in the promotion or formation of such company for a period not exceeding five years as may be specified in that order. Under this provision, it may be provided, in a manner similar to an undischarged insolvent under section 202, that a person convicted of the offence of fraud with regard to a company shall not be allowed to form, promote or manage a company. The upper limit of five years may be removed in such cases. (Para 6.13 Page No. 51)

31. Directors/ officers/ functionaries who may not have actively participated but may have contributed to fraud indirectly or passively should also be held accountable for the offence of criminal negligence, which may be punished by monetary penalties along with civil liability. In addition to the directors and officers of the company the liability under these provisions should also extend to the Internal and statutory auditors of a company if they are found to have been negligent so as to have allowed or enabled a fraud to take place. (Para 6.13 Page No. 51)

32. **Obligations of auditors in the event of fraud:** Where a company has been affected by fraud, there should be special provisions imposing

duties of cooperation and provision of information on the part of the internal and statutory auditors of the company. Such obligations should override any commitment or obligation towards confidentiality of client information. The inspector investigating fraud, may by written notice, ask the internal and statutory auditors of the company to provide information with regard to the financial affairs of the company as may be appropriate under the circumstances. The auditors/ internal auditors, while not being officers of the company, should be bound by the same obligations as would apply to the officers of a company with regard to information being asked from them by the inspector. Such obligation should extend to notes and working papers of the statutory auditor/ internal auditor. It would be possible for the inspector to make and retain copies of these documents or to furnish authenticated copies to other regulators such as the ICAI for purposes of disciplinary action by them as warranted. (Para 6.14 Page No. 52)

33. Criminal and civil liability of auditors: Where statutory auditors of a company are actually found to be involved in fraud criminal and civil liability should also devolve on them in a manner similar to that for directors and officers of the company. (Para 6.14 Page No. 52)

34. In a manner similar to that under section 9 of the UK Frauds Act, 2006, it should be an offence for a person knowingly to be a party to the carrying on of fraudulent business even where the business is not carried on by a company or (broadly speaking) a corporate body. Criminal and civil liability under the Companies Act may be extended to non-corporate entities as well. (Para 6.16 Page No. 52)

35. An offence of fraudulent trading should be created under the Companies legislation if he any person is knowingly party to the

carrying on of a company's business either with intent to defraud creditors or for any other fraudulent purposes. This should apply to persons knowingly party to the carrying on of non-corporate businesses in either of those ways. Obtaining services dishonestly should also be defined as a new offence in a manner similar to Section 11 of the UK Act. (Para 6.17, Page No.52)

36. Liability of company officers for offences by company should also be specified where persons who have a specified corporate role are party to the commission of an offence under the Act by their body corporate. Such persons should also be liable to be charged for the offence as well as the corporation. (Para 6.18, Page No.53)

37. **Whistle blower provisions:** It is to be recognized that corporate fraud is rarely the result of actions of only one person acting alone. It is most likely to be the result of a group of persons who may have the knowledge of fraud being committed but may not wish to get involved, or may even be intimidated in remaining silent. Yet such person can shed light on whether and in what manner fraud is taking place in a company. It is important to incentives such persons to cooperate and collaborate with the investigators. Therefore, the Committee recommends incorporation of whistle blower sections in the Companies Act that enable the person blowing the whistle on fraud to be imposed a lesser penalty or even be acquitted. Further there should be protection of employment of such person, with provision of monetary compensation if he chooses to leave the company. (Para 6.19, Page No.53)

38. In order to collect admissible evidence on various issues related to fraud, it is imperative that suitable provisions are made in the

Companies Act for getting letters rogatory issued on the lines of provision in Prevention of Money Laundering Act and sections 166A and 166B of Criminal Procedure Code. (Para 7.1 Page No. 54)

39.SFIO should also enter into reciprocal agreements for mutual assistance with other agencies which may be involved in the collection of economic collection of intelligence of and investigation of fraud (Para 7.1 Page No. 54)

40.A mechanism may also be provided to collect evidence by way of sending letters rogatory (letter of request) from outside India and for examination of a person residing outside India, by inserting suitable provision in the Act and authorizing a suitable authority to issue the same. (Para 7.2 Page No. 55)

41.Suitable provisions may be incorporated in the Companies Act, similar to the provisions of Sections 55 to 61 of "The Prevention Of Money Laundering Act, 2002", which deals with seeking mutual legal assistance from overseas authorities for collection of evidence as well as attachment of properties outside the country. (Para 7.3 Page No. 55)

42.A High-Powered Committee on a pattern similar to CFTF of USA be constituted by the Central Government having senior level officers of proven integrity, experience and expertise in matters of financial transactions, investigations and economic offences as members. (Para 8.3 Page No. 56)

43.There should be an institutional arrangement for sharing of the confidential information and intelligence gathered by financial

regulators such as banks, insurance, capital market and other financial institutions as well as intelligence agencies of Central and State Government relating to the entity under investigation. (Para 8.4 Page No. 57)

44. The High Powered Committee which may be termed as the Committee for Investigation and Monitoring of Fraud should be empowered by the Central Government to coordinate with other enforcement and regulatory agencies and monitor, review and direct the progress of investigation of cases referred to SFIO and prosecution of offences detected there from and to enable cooperation and coordination on the part of various ministries /departments/government agencies as well as state governments. In particular, this High Powered Committee may be empowered to decide on the lead investigating agency depending upon the merits and circumstances of the case and to decide on the manner of support and sharing of information, staff and other resources by other investigative agencies/bodies with the lead agency. (Para 8.5 Page No. 57)

45. In order to ensure speedy disposal of the prosecutions based on SFIO reports, it is proposed that Companies Act may be suitably amended so as to provide for establishing of special courts, vested with requisite civil and criminal jurisdiction, to deal with company matters including cases involving fraud. (Para 9.3 Page No. 58)

46. Market Analysis and Risk Management division which may be created in SFIO may take up information sharing and coordination with other enforcement and regulatory agencies, banks, financial institutions and the MCA 21 database, etc. Information gathered by this Division may be analyzed and risk management strategies evolved to record unusual

behaviour on the part of a company or a group of companies. (Para 10.2.2, Page No. 60)

47. In order to attract the best talent available across different departments like Customs and Central Excise, Income Tax, Enforcement Directorate, Intelligence Bureau, C & AG, and other ministries and departments, it is recommended that these posts may be upgraded and grade pay be raised. (Para 10.2.7, Page No. 62)

48. In addition to the above permanent structure, it is recommended that Director SFIO may be empowered to outsource the services of experts like Chartered Accountants, Cost Accountants, Legal Experts, and Experts in the field of Cyber Forensics and Computers etc. at the rates prescribed by their respective institutes / governing bodies. (Para 10.2.8, Page No. 62)

49. To provide continuity to the organization, it is recommended that a structure comprising of permanent and tenure based officers be created. (Para 10.3, Page No. 63)

50. Officers joining SFIO on deputation from other departments like CBI, IB, ED, SEBI and Banks etc. should be ensured protection of their existing pay, allowances and perks. In addition, all the officers posted to SFIO should be granted Investigation Allowance at the same rate and terms as applicable to officers in CBI and National Investigation Agency. (Para 10.3.1, Page No. 63)

51. The organizational structure of the SFIO should not be excessively rigid or hierarchical. Rather SFIO should have a flat structure so that it may constitute teams of experts quickly under team leaders to carry

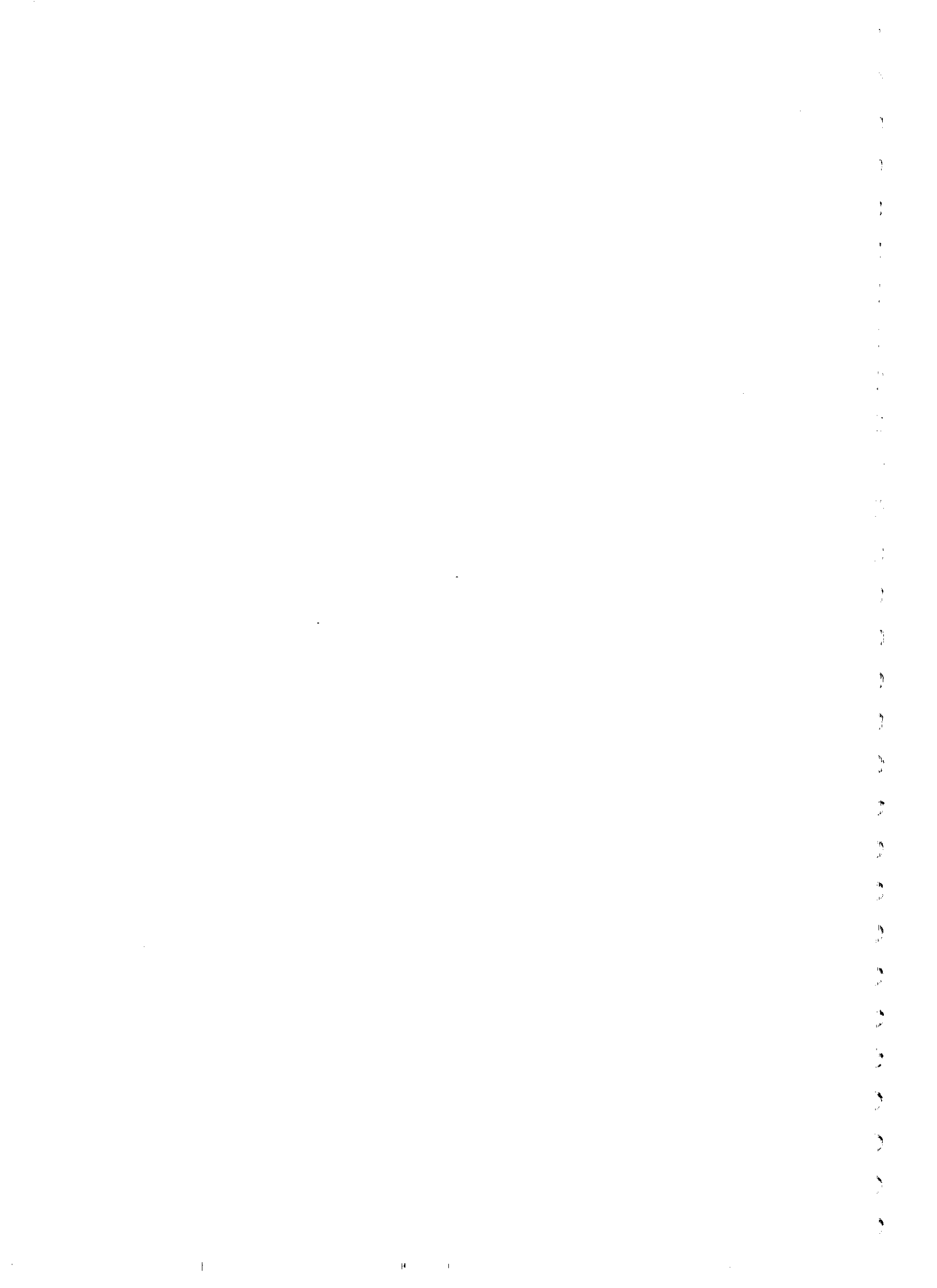
out investigations. The investigation team to investigate a corporate fraud may be constituted by Director SFIO with officers from different disciplines as per the requirement of investigation. In addition SFIO may also set up regional offices in selected locations across the country. This would improve the speed of response, coordination of investigation and prosecution with local authorities. (Para 10.4, Page No. 63)

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Annexes



I. Introduction

1.1 The Joint Parliamentary Committee (JPC) on Stock Market Scam 2001, in its report submitted to the Parliament recommended setting up of Serious Fraud Investigation Office. This issue was examined by several committees set up by the Government and RBI. These Committees were-

- i). **Dr. L. N. Mitra Committee on the legal aspects of Banking Frauds** set up in the year 2001 by the Reserve Bank of India.
- ii). **Naresh Chandra Committee on Corporate Governance** set up in the year 2002 by Department of Company Affairs under Ministry of Finance (Now Ministry of Corporate Affairs).
- iii). **Justice Malimath Committee on Criminal Justice System** set up in the year 2003 by the Ministry of Home Affairs.

All the three Committees made recommendations for setting up of Serious Fraud Office in the country. The Committees also recommended suitable legislative framework to deal with serious economic offences that would enable investigation of fraud and prosecution of its perpetrators in the appropriate courts.

1.2 The Expert Committee on Corporate Governance, headed by Shri Naresh Chandra, recommended the setting up of a Serious Fraud Investigation Office (SFIO) India, on the model of the Serious Fraud Office of the UK. SFIO India was proposed as comprising of multi-disciplinary teams that would investigate corporate frauds and also direct and supervise prosecutions under the provisions of the Companies Act, 1956. The Committee also proposed that a legislative framework could also be considered to enable the SFIO to investigate all aspects of corporate fraud and direct prosecution.

1.3 After considering the recommendations of Naresh Chandra Committee, the Central Government, on 9th January 2003, approved the setting up of the Serious Fraud Investigation Office (SFIO) as an independent office under the Ministry of Company Affairs (MCA) in two stages. In the first stage, the office was to be set up as a multi-disciplinary team with adequate infrastructure to carry out investigations into the alleged

corporate frauds under the provisions of the Companies Act, 1956. Once SFIO became operational and had gained some experience, the second stage, involving legislative changes to vest the office with further powers as may be necessary, was to follow.

1.3 The Advisory Committee on Company Law set up by the Government under the Chairmanship of Dr JJ Irani in its report submitted in May 2005, recommended that the SFIO should be strengthened further by recognition in the Companies Act, 1956, while retaining its multi-disciplinary character.

1.4 The SFIO, constituted in 2003, has now been functioning for nearly three years. It was considered appropriate that statutory, administrative and operational arrangements with respect to SFIO be reviewed to enable its effective functioning, long term institutional growth and sustainability. In order to examine its functioning and suggest further measures necessary for the development and effectiveness of the SFIO, an Expert Committee under the Chairmanship of Shri Vepa Kamesam, formerly Deputy Governor, Reserve Bank of India, was constituted to advise the Government (Annex I). The terms of reference of the Expert Committee were to make recommendations to the Government on:-

- a) Assessment of the need for and details of a separate statute to govern the constitution and functioning of SFIO;
- b) The nature and details of the legislative changes as may be required in existing laws, to enable effective functioning of SFIO including prosecution of offences detected by it;
- c) The mechanism for referral of cases to SFIO and coordination of activities of SFIO with other agencies/organizations of the Central and State Governments, including investigating;
- d) Powers of SFIO and its investigating officers;
- e) Specification of offences and penalties to enable effective conduct of investigation agencies and the need for special courts for trial of corporate fraud cases; and
- f) Other matters consequential to or in pursuance of the above.

1.5 In its deliberations the Committee took into account the recommendations of the earlier committees on the subject in light of contemporary developments in the Indian corporate sector, which has recently witnessed a major corporate fraud in one of the largest Information Technology companies of the country, namely Satyam Computer services Limited. The events in Satyam originating from a confession by the Chairman of the Company about falsification of the accounts and statutory financial statements of the company brought to the fore the serious impact of accounting fraud, which could be perpetrated by a few persons on the company and its stakeholders.

1.6 The Committee also took into account the experience of the SFIO gained over the past few years in conducting investigations and prosecuting those found involved in corporate fraud. SFIO has emerged as a unique organization with specialized knowledge about corporate functioning and the ways in which fraud may be carried out in this framework. As corporate structure is an essential structure for doing business and mobilizing funds, this knowledge and experience is very useful and needs to be developed further.

1.7 The Committee took into consideration the statutory and institutional frameworks in several jurisdictions such as the U.S, U.K., Germany etc. The Committee however felt that while good ideas and suggestions from different jurisdictions were useful, they needed to be carefully adopted in light of the Indian experience and situation. While noting the distinction between the U.K, which is a unitary system as compared to India, which is a federal system governed by a written Constitution, the Committee of particular interest subject to its concepts being suitably adapted to India. Therefore the Committee has gone into the statutory framework in the U.K. in some detail before examining the options for the Indian framework.

Chapter 2

2.1 Fraud in legal sense

2.1.1 Dictionary meaning of fraud is wrongful or criminal deception intended to result in financial or personal gain. Fraud in legal sense is any deceitful or dishonest conduct, involving acts or omissions or making of false statements knowingly, orally or in writing, with an object of obtaining money, or other benefits or gains, in illegal manner, from any person or authority, whether public or private or evading liability for personal benefit. In general, the term fraud connotes the use of deceit to obtain any undue advantage, financial or otherwise, or avoid an obligation. Due to its many dimensions, fraud is a complex offence comprising criminal acts.

2.1.2 Recognizing the damage fraud can inflict on the victim in various ways, and considering that it may comprise different acts or behaviour, all intended to achieve ends of deceit, its components have been sought to be isolated and addressed in law as criminal offences. Legislation has, however been enacted recently in the UK to deal with the issues relating to fraud and its investigation in a comprehensive manner through the *UK Fraud Act 2006*. This Act contains an elaborate definition of 'fraud'. It is worthwhile examining the treatment afforded to 'fraud' in the aforesaid UK legislation.

2.1.3 Fraud is defined in context of three situations covered in three separate provisions of the Act, namely, Sections 2, 3 and 4.

Section 2 of the UK Fraud Act provides as under:

Section 2 – Fraud by false representation

- (1) A person is in breach of this section if he –
 - (a) dishonestly makes a false representation, and
 - (b) intends, by making the representation –
 - (i) to make a gain for himself or another, or

(ii) to cause loss to another or to expose another to a risk of loss.

(2) A representation is false if –

- (a) it is untrue or misleading, and
- (b) the person making it knows that it is, or might be, untrue or misleading.

(3) “Representation” means any representation as to fact or law, including a representation as to the state of mind of –

- (a) the person making the representation, or
- (b) any other person.

(4) A representation may be express or implied.

(5) For the purposes of this section, a representation may be regarded as made if it (or anything implying it) is submitted in any form to any system or device designed to receive, convey or respond to communications (with or without human intervention).”

2.1.4 Section 3 of the UK Fraud Act defines ‘Fraud by failing to disclose information’.

It provides that a person is in breach of this section if he –

- (a) Dishonestly fails to disclose to another person information which he is under a legal duty to disclose, and
- (b) Intends, by failing to disclose the information –
 - (i) to make a gain for himself or another, or
 - (ii) to cause loss to another or to expose another to a risk of loss.

2.1.5 Section 4 of the UK Fraud Act relates to fraud by abuse of position. It provides that a person is in breach of this section if he –

- (a) occupies a position in which he is expected to safeguard, or not to act against, the financial interests of another person ,

- (b) dishonestly abuses that position, and
 - intends, by means of the abuse of that position –
 - (i) to make a gain for himself or another, or
 - (ii) to cause loss to another or to expose another to a risk of loss.

2.1.6 Thus, the offence of fraud under the UK Act is committed when three ingredients are present, namely (i) dishonesty, (ii) false representation; and, (iii) intention to make gain or cause loss. Broadly, dishonest intention and some act and in pursuance of this intention are sufficient to constitute the offence. Actual financial gain or loss is not necessary.

2.1.7 The above definition takes into account concealment, distortion or misrepresentation of information as important ingredients of fraud. The liability for fraud may arise out of failure to disclose such information that a person may be legally required to disclose under any statute or as a result of an obligation reasonably arising out of such statute. This is material in deciding the intention behind an act and the culpability for fraud, irrespective of other legal consequences arising from that act.

2.1.8 Simply stated, abuse of a position of trust per se by any person, either to make a gain for himself or for any other person, or to cause a loss or a risk of loss to another person also comprises an ingredient of fraud. This is of particular relevance in the corporate set-up where individuals may hold positions of power as well as of fiduciary responsibility. It may be possible for such a person/ persons to hold himself/ themselves out in a manner that may mislead other person(s) to believe something that is not true and to take certain actions on the basis of such mistaken belief.

2.1.9 In addition to the above, **Section 7** of the UK Act makes it an offence to make, adapt, supply or offer to supply any article knowing that it is designed or adapted for use in the course of or in connection with fraud, or intending it to be used to commit or

facilitate fraud. **Section 8** extends the meaning of "article" for the purposes of this and other connected provisions so as to include any program or data held in electronic form.

2.1.10 Fraudulent Trading : Section 9 of the UK Act makes it an offence for a person knowingly to be a party to the carrying on of fraudulent business where the business is not carried on by a company or (broadly speaking) a corporate body. This new offence parallels that of fraudulent businesses carried on by companies and certain other corporate bodies. Through this provision criminal liability under the companies legislation is extended to non-corporate entities including sole traders, partnerships, trusts, companies registered overseas, etc. A person commits the offence of fraudulent trading under the companies legislation if he is knowingly party to the carrying on of a company's business either with intent to defraud creditors or for any other fraudulent purposes. This section creates a similar offence that applies to persons knowingly party to the carrying on of non-corporate businesses in either of those ways. Fraudulent trading is in effect a general fraud offence, comparable to conspiracy to defraud, but requiring the use of a company instead of the element of conspiracy. It contains the following ingredients:

- dishonesty is an essential ingredient of the offence;
- the mischief aimed at is fraudulent trading generally, and not just in so far as it affects creditors;
- the offence is aimed at carrying on a business but can be constituted by a single transaction; and
- it can be committed only by persons who exercise some kind of controlling or managerial function within the company.

2.1.11 Section 11 makes it an offence for any person, by any dishonest act, to obtain services for which payment is required, with intent to avoid payment. The person must know that the services are made available on the basis that they are chargeable, or that they might be. It is not possible to commit the offence by omission alone and it can be

committed only where the dishonest act was done with the intent not to pay for the services as expected. The offence is not inchoate: it requires the actual obtaining of the service. The section would also cover a situation where a person is obtaining a service which is provided on the basis that people will pay for it or commit acts that enable him to avail of a service which was to be paid for without having any intention of paying.

2.1.12 Section 12 provides that if persons who have a specified corporate role are party to the commission of an offence under the Act by their body corporate, they will be liable to be charged for the offence as well as the corporation. This offence applies to directors, managers, secretaries and other similar officers of companies and other bodies corporate. If the body corporate charged with an offence is managed by its members the members involved in management can be prosecuted too.

Treatment of fraud under current laws in India

2.2 It would be relevant also to see how fraud is currently dealt with under the Indian Penal Code and the Companies Act, 1956 as also some other related legislations such as the SEBI Act 1992.

Indian Penal Code

2.2.1. Offences under the IPC relevant for the purpose are dishonest misappropriation of property, criminal breach of trust and cheating. These are defined in IPC as under:

2.2.1.1: Section 403 – *Dishonest misappropriation of property.*

Whoever dishonestly misappropriates or converts to his own use any movable property, shall be punished with imprisonment of either description for a term which may extend to two years, or with fine, or with both.

2.2.1.2: Section 405 – *Criminal breach of trust*

Whoever, being in any manner entrusted with property, or with any dominion over property, dishonestly misappropriates or converts to his own use that property, or dishonestly uses or disposes of that property in violation of any direction of law prescribing the mode in which such trust is to be discharged, or of any legal contract, express or implied, which he had made touching the discharge of such trust, or wilfully suffers any other person so to do, commits “criminal breach of trust”.

2.2.1.3: Section 415 – *Cheating*

Whoever, by deceiving any person, fraudulently or dishonestly induces the person so deceived to deliver any property to any person, or to consent that any person shall retain any property, or intentionally induces the person so deceived to do or omit to do anything which he would not do or omit if he were not so deceived, and which act or omission causes or is likely to cause damage or harm to that person in body, mind, reputation or property, is said to “cheat”.

Explanation, -- A dishonest concealment of facts is a deception within the meaning of this section.

2.2.1.4: Section 420 – *Cheating and dishonestly inducing delivery of property.*

Whoever cheats and thereby dishonestly induces the person deceived to deliver any property to any person, or to make, alter or destroy the whole or any part of a valuable security, or anything which is signed or sealed, and which is capable of being converted into a valuable security, shall be punished with imprisonment of either description for a term which may extend to seven years, and shall also be liable to fine.

2.2.1.5: These offences have ‘dishonestly’ or ‘fraudulently’ as necessary ingredients. These two expressions are defined in IPC as under:

(a) Section 24 defines “dishonestly” thus:

“Whoever does anything with the intention of causing wrongful gain to one person or wrongful loss to another person is said to do that thing dishonestly”.

(b) “Fraudulently” is defined in section 25 thus:

“A person is said to do a thing fraudulently if he does that thing with intent to defraud but not otherwise”.

2.2.1.6: As judicially held, the expression “defraud” involves two elements, namely, deceit and injury to the person deceived. Injury is something other than economic loss that is, deprivation of property, whether movable or immovable, or of money, and it will include any harm whatever caused to any person in body, mind, reputation or such others. In short, it may even be a non-economic or non-pecuniary loss. A benefit or advantage to the deceiver will in most cases cause loss or detriment to the deceived. Even in those rare cases where there is a benefit or advantage to the deceiver, but no corresponding loss to the deceived, the second condition would be satisfied.

2.2.1.7: The idea of deceit is a necessary ingredient of fraud, but it does not exhaust it; an additional element is implicit in the expression. The scope of that additional element is the subject of many decisions. In *Dr. Vimla V. Delhi Administration*, [(1963) Supp. 2 SCR 585] the Supreme Court held thus:-

“The word “defraud” includes an element of deceit. Deceit is not an ingredient of the definition of the word “fraudulently”. The former involves a pecuniary or economic gain or loss while the later by construction excludes that element. Further, the juxtaposition of the two expressions “dishonestly” and “fraudulently” used in the various sections of the Code indicates their close affinity and therefore the definition of one may give colour to the other. To illustrate, in the definition of “dishonestly”, wrongful gain or wrongful loss is necessary enough. So too, if the expression “fraudulently” were to be held to involve the element of injury to the person or person deceived, it would be reasonable to assume that the injury should be something other than pecuniary or economic loss. Though almost always an advantage to one causes loss to another and vice versa, it need not necessarily be so. Should we hold that the concept of fraud would include not only deceit but also some injury to the person deceived, it would be appropriate to hold by analogy drawn from the definition of “dishonestly” that to satisfy the

definition of “fraudulently” it would be enough if there was a non-economic advantage to the deceiver or a non-economic loss to the deceived. Both need not co-exist.”

2.2.1.8: All the acts in relation to a company, even if in breach of the provisions of the Companies Act requiring discharge of fiduciary responsibilities of individuals in charge of the company, may not attract the provisions of criminal law. This may be illustrated with respect to the ‘breach of trust’ under company law. Breach of trust is both a civil wrong and a criminal offence. There would, however, be certain situations where is would predominantly be a civil wrong and may or may not amount to a criminal offence. For instance company law may require the directors of a company to discharge their fiduciary duties in good faith and breach of this obligation may give rise to civil consequences only.

2.2.1.9: To constitute an offence of criminal breach of trust punishable under IPC, there must be an entrustment, misappropriation or conversion to one’s own use, or use in violation of legal direction or of any legal contract: and the misappropriation or conversion or disposal must be with a dishonest intention.

2.2.1.10 While several acts, which would contribute to fraud, are recognized in the IPC, there is no comprehensive definition of fraud. It is therefore necessary to identify the nature of the act or acts and combine different provisions of the IPC to deal with a situation of fraud. Specific acts dealt with under these provisions give rise to criminal liability with punishment as specified.

2.3 Fraud under SEBI Regulations

2.3.1 SEBI also exercises jurisdiction on frauds in the matter of ‘issue and transfer’ of securities in terms of Section 55A of the Companies Act, 1956. Therefore, it is useful to look at definition of fraud as it appears in SEBI’s Regulations on Prohibition of Fraudulent & Unfair Trade Practices (2003). Under Regulation 2(1)(c), fraud includes an

act, an expression, or omission or concealment committed whether in a deceitful manner or not, by a person, or by any other person with his connivance, or by his agent, while dealing in securities in order to induce another person or his agent to deal in securities, whether or not there is any wrongful gain or avoidance of any loss, and shall also include a) a knowing misrepresentation of the truth or concealment of material fact in order that another person may act to his detriment, b) a suggestion as to a fact which is not true by one who does not believe it to be true, c) an active concealment of a fact by a person having knowledge or belief of the fact.

2.3.2 Thus, definition of fraud under SEBI Regulations is an inclusive definition and seeks to lay down the elements constituting a fraudulent act. While this definition is included in the subordinate legislation under the SEBI Act, 1992 rather than in the principal Act itself, it is useful to take into consideration the ingredients of this definition. In sum and substance, the definition of fraud in the SEBI Regulations has *suppressio veri* and *suggestio falsi* as its underlying elements. The intention behind the action is relevant irrespective of whether the act committed with such intention actually results in any wrongful gain or avoidance of loss. The trappings of fraudulent act are considered as pernicious as its culmination with all its deleterious effects. The predisposing elements to the fraud, though by themselves may not be causing loss at that stage, have been included.

2.4 From the foregoing discussion, it is observed that the Indian Penal Code defines several offences, all or any of which, in varying combinations may be ingredients of fraud. The Code segregates such ingredients rather than dealing with a separate all-inclusive phenomenon of fraud, leaving it to the stakeholder/prosecution agency to combine his response depending upon the merits of the situation. The Companies Act, 1956 provides the statutory code for the structure of a company, its governance and regulation. In doing so, it recognizes certain situations, which may arise as a result of fraud and seeks to address them in a manner that is supportive to the main object of that Act. Each of the two legislations does not debar the application of the other. Practical difficulties, however, arise since the Companies Act is a Central Act, to be implemented

by the Central Government whereas the Indian Penal Code is implemented through the State Governments in exercise of their domain with regard to public order and police functioning. Special Acts such as the SEBI Act 1992 seek to define fraud both comprehensively in context of capital market operations. The SEBI definition, however, is a part of SEBI regulations rather than the main SEBI Act and consequently would lead to issues with regard to enforcement of criminal liability.

2.5 The Committee observes that given the phenomena arising out of the trends and forces generated by the modern day economy, it is possible for individuals to manipulate, through actions that would have ingredients of fraud, the decisions of millions of stakeholders, for the purpose of causing loss to them and leading to wrongful gain to the perpetrator. Such phenomena, if not checked and dealt with effectively, would seriously undermine the faith of the stakeholder in the modern economic system. Therefore, it is appropriate that the statutory framework of the country recognizes these new phenomena and addresses them suitably in a comprehensive manner.

2.6 Therefore the Committee is of the view that while fraud is a complex criminal offence in itself, the complexity is further compounded if such fraud takes within a corporate structure, with relation to the affairs of a company. Therefore, it is appropriate to examine the nature and implications of corporate fraud as a distinct phenomenon. In addition, companies in India are regulated by a comprehensive legislation, the Companies Act, 1956. This Act could provide a suitable vehicle to deal with situations involving corporate fraud through its provisions. However, the modified and amended provisions of the Companies Act, intended to deal with corporate fraud should generally be in addition to rather than in abrogation of provisions of other Acts. Therefore it is also necessary to see how the Companies Act addresses situations that may lead to fraud in relation to the affairs of a corporate entity and what can be done to make the provisions of the companies Act more effective in their treatment of fraud.

Chapter 3 Dimensions of Corporate Fraud

3.1 Over the years the corporate form has emerged as the preferred mode of doing business and of mobilizing resources. Companies bring people together for economic activity and mutual gain, facilitate rising of capital, invest resources in viable activity and provide employment to millions of people. The corporate structure and its governance has evolved over a long period of time to enable corporate operation with transparency and accountability and in a manner that harnesses and makes the best use of individual talent and merit. The need for efficient conduct of its operations has resulted in the development of business management as a separate professional discipline. Companies today have spread their operations across the globe and comprise organizations, governance structures and employees carrying out their allotted tasks. Components of such corporate organizations are very unlikely to have knowledge and information about their organization beyond their immediate area of function and control. The investors and shareholders are likely to know even less. For this reason the essential corporate governance requirements are addressed in most jurisdictions through statute. At the same time, some unscrupulous elements have also misused the corporate form for carrying out dishonest acts and transactions by misleading investors, creditors and other stakeholders, creation of artificial bubbles of expectation and misappropriation of public funds through what has sometimes been called “ugly manipulations of companies”. Such actions have often been the result of fraudulent actions on the part of those who are concerned with the conduct of the affairs of the company. Their impact can be catastrophic, shaking credibility and faith in business activity, wiping out investments of tens of thousands of crores of rupees and employment for lakhs of people in a flash. However, over the same period, laws and regulatory structures have also emerged, and continually need to develop, that have compelled more elaborate ways of investigation and bringing the culprits to book and devising of penalty structures that punish the wrong doer and compensate the victims of fraud. From time to time different forms and nature of fraud emerge. The vigil of the regulator therefore, has to take the complexity of the phenomena in its sweep while remaining dynamic to counter ever-changing situations. It is relevant to examine issues relating to corporate fraud in this context.

Corporate Fraud

3.2 When fraud is perpetrated through, or in relation to a company, it is termed as corporate fraud. In fact, in the case of serious frauds, involving large volumes of money and resulting in duping of large number of stakeholders, the company form is often the instrument through which such activities take shape and effect. In such cases individual culpability may be obscured by actions taken on behalf of the company and the real perpetrators of may take shelter behind the corporate veil. Fraud, however, would invariably be the outcome of actions of and individual or group of individuals. The task in such cases is to sift through the maze of corporate organization, scanning the corporate action and the intent behind it with reference to its impact on the victim of fraudulent action. Fraud can take place in various situations with regard to a company. Some of these are as discussed below.

3.2.1 Fraud in relation to the formation or promotion of a company

3.2.1.2 Corporate fraud may be in relation to the formation or promotion of the company. This may be done to disguise the real intention and identity of the promoters and first directors and may involve false representations with regard to the information relevant to the identity of the company, its control and management and its intended operations.

3.2.1.3 The Companies Act has provisions providing for offences arising 'in relation to the formation or promotion' of the company. Section 203 disqualifies a person from being a director if he is convicted of any offence in connection with the promotion, formation or management of a company. Section 455 (2) enables the Official Liquidator to file a report before the Tribunal, stating the manner in which the company was promoted or formed and whether in his opinion any fraud had been committed by any person in its promotion or formation. Section 478 permits public examination of persons where any person in the promotion or formation of the company has committed a fraud.

3.2.2 Fraud through the Company

3.2.2.1 A company may also be used as a 'vehicle' to commit the fraud. Here, the company is a mere cloak or a sham and the fraudster operates through the entity to conduct his deceitful activities. The fraud is not 'by the company' for which it can be indicted. Rather its structure is used to project an image based on statute and to make certain representations and projections to persons dealing with it that disguise the real intentions of the promoters. The reality behind the corporate veil is quite different.

3.2.2.2 In Skipper Construction Company (Private) Limited, the Supreme Court noted that the concept of corporate entity was evolved to encourage and promote trade and commerce but not to commit illegalities or to defraud people. Where, therefore, the corporate character is employed for the purpose of committing illegality or for defrauding others, the Court would ignore the corporate character and will look at the reality behind the corporate veil so as to enable it to pass appropriate orders to do justice between the parties concerned. Further, the fact that Promoters and members of his family had created several corporate bodies did not prevent the Court from treating all of them as one entity belonging to and controlled by the promoter and/or members of his family and arriving at the conclusion that the device of incorporation was really a ploy adopted for committing illegalities and/or to defraud people.

3.2.3 Fraud or offences in relation to the affairs of the company.

3.2.3.1 Similarly, there are provisions which use the expression fraud or offences in relation to the affairs of the company.

3.2.3.2 There may be cases of fraud where the corporate form is used to deceive, but without involving or siphoning of the company's assets. In a case where equity capital is falsely shown by mere circulation of funds through the bank accounts of the company and its associate companies without having any funds, genuinely contributed as equity in those accounts, no corporate assets may appear to be siphoned of, as the funds received

towards the so-called equity cannot be said to belong to the company. However such equity is used to reflect a certain image of the financial position of the company that is not true and fair, to lenders, investors etc. and is very much a component of fraud. Same position may result from turnover of a company built up through fictitious invoicing.

3.2.3.3 Where the method used for raising or receiving the funds is itself fraudulent since the corporate form is used for raising or receiving the funds, it ought to be covered by 'corporate fraud' even though no siphoning of the Company's assets has take place. A few persons in the company may practice such fraud surreptitiously, without the knowledge of others-or by the comprehensive involve of the structure of governance of the Company. In the former situation, the Company itself is inert and is merely used as a vehicle. In the second case issue of liability of the company itself, in addition of those charged with its governance may arise.

3.2.4 Fraud by the company

3.2.4.1 As the very expression suggests, "corporate fraud" is an act in relation to, or involving a company. The fraudulent act at times may be attributed to the company itself. In such case it may be termed as a fraudulent act 'by the company'. It is well settled that a company can be 'punished' for such an offence, even though *mens rea* [guilty mind] is an essential requisite of such offence. The question is under what circumstances may fraud be attributed to the company as a corporate person as distinct from physical person in control of its affairs.

3.2.4.2 It is well established that the courts will not allow the corporate form to be used for the purposes of fraud, or as a device to evade a contractual or other legal obligation. For certain purposes, the courts, while respecting the separate legal personality of a company, have treated the conduct or characteristics of its directors, managers or members as attributed to the company itself. Attribution of *mens rea* to a company **for the acts committed by its representatives** for the purposes of criminal or civil liability is an illustration of this principle.

3.2.4.3 A company is a 'person' under Section 11 of the Indian Penal Code, and can be prosecuted as such. It is now the settled position that a company may, in an appropriate case, be indicted by the corporate name. A company is indictable for criminal acts of its directors, or authorized agents or servants, whether, they involve *mens rea* or not, provided they have acted or have purported to act under authority of the company or in pursuance of its aims and objects. The question whether a company should or should not be liable for criminal action resulting from the acts of some individual depends on the nature of the offence disclosed by the allegations in the complaint, the relative position of the officer or agent vis-à-vis the company and the other relevant facts and circumstances which could show that the company, as such, meant or intended to commit that act. Any director who is a party to the fraud is personally liable. This is on the principle that whoever commits a wrong is liable for it himself. The company may also be liable but that does not exonerate the director.

3.2.4.3 One situation where a company itself may be liable for fraud may be arise out of the manner it deals with its contractual obligations. Another, where the undertaking or the business of the company is itself subordinated to fraudulent purpose or where the company lends itself to be used as such. Yet another situation may be where the governance structure of the Company – its board, key management personnel or managers and officers are knowingly involved in fraudulent act.

3.2.5 Fraud on the company

3.2.5.1 In a 'corporate fraud', the company itself may be the victim of the fraud. The fraud may be committed 'on the company' itself. The company may have no role in the commission of the fraud. The fraudulent act causing damage to the company may be committed by an outsider or an insider. Status of the fraudster is not a necessary ingredient of the fraud committed 'on the company', or 'in relation to the company'.

3.2.5.2 Such acts or transactions may be of a nature that falsifies the accounts or financial statements of a company. A few individuals acting secretly, without the knowledge of other employees or even other persons involved in the governance of the company who may believe the information so created to be true. Such false projection of the state of affairs of the company may be used to create false expectations in the stock market and inflate its scrip value through manipulation, or to generate resources, which may be siphoned away through a maze of connected/associate companies.

3.2.5.3 A company can also be made anaemic through suppression of its true financial position or actual drain of its financial and other resources through siphoning. That affects the interests not only of the shareholders, but also other stakeholders. The objective may be to suppress its valuation artificially and to squeeze out minority shareholders with low compensation. Or to arrange its takeover by another with part of the consideration being paid in a manner that deprives the real or minority shareholders of fair value while enriching a few through compensation paid outside the company. In other cases the undertaking of the company may be transferred to the benefit of shareholders, with the company itself being deprived of the same.

3.2.6 Cross border fraud

Extent and reach of fraud committed through corporate entities are not restricted to entities within the country only. Experience has shown that in many frauds of serious and complex dimensions, actions extend beyond national boundaries involving overseas corporate bodies to set up a complicated web of transactions and front companies/entities. Many companies also have their operations and subsidiaries abroad with transfer of funds arising out of business operations taking place in and out of the country. Proceeds of frauds are also siphoned off to entities outside the country and parked there. In many cases perpetrators of fraud skip the country so as to be outside the reach of local law enforcing agencies. The situation is made complex by the presence of tax havens that have secrecy laws making obtaining information or carrying out investigation more

difficult. Such inter-linkages also have security linkages in addition to being used as a means to move or launder proceeds of crime.

3.3 Fraud and the public dimension

3.3.1 Corporate assets are represented by capital which is contributed by the members of the public; or public deposits or loans from public raised through issue of securities; or loans from banks and financial institutions, which being drawn from public institutions, also possess the attributes of public funds. When the assets are misappropriated and are lost to the company, the real loss falls on the shareholders, depositors, other security holders, or the credit institutions. A fraud causing loss by misappropriation of such funds drawn from public sources, even within a corporate setting, amounts to a public fraud.

3.3.1.2 Fraud may be caused in raising of funds from public by misrepresentations/falsehoods in prospectus, statements, etc. as to the financial statements or financial or other affairs of the company or its intentions/future plans or as to promoter's contribution on the basis of fictitious entries etc. Frauds may also be caused in raising of funds from public sources through loans from banks/financial institutions. Term loans may be obtained by inflating project costs; overvaluation of inventory, booking bogus transactions, expenses; by misrepresentation with regard to equity promoters contribution, inventories, turnover etc.

3.3.1.3. The methods used for raising the funds and the treatment of funds thereafter would seem to have direct relevance to the definition of 'corporate fraud'. Following aspects need to be taken into account in this regard.

- a. Funds may be raised in fraudulent manner for the use of the company, money raised may also be accounted for in the company's books, and is may also be actually used towards the company's objects as permitted by its memorandum.;
- b. Company funds may be misappropriated/siphoned off

c. The method used for raising the funds may not be fraudulent, but money raised is not accounted in the company's books and hence does not form part of the company's assets.

d. The method used for raising the funds is not fraudulent, money raised is also accounted in the company's books and hence forms part of the company's assets, but is thereafter it is siphoned off.

3.4 The Company and its management: In *Raja Narayanlal Bansilal vs. Manech Phiroz Mistry and anr*, the Registrar of Companies issued notices to petitioners for conducting investigation against them on allegations of fraud in conduct of business. Confirming the Registrar's decision the High Court held that that investigation against person in charge of management making profit at cost of interest of company and other parties was distinct from ordinary breach of trust and misappropriation. "Persons in charge of management are distinct from other citizens. ----citizen can protect his interest but financial interest of large number of persons depends upon person in charge of management ---- it is legitimate to treat these companies and their managers as distinct class to provide safeguard against abuse of power vested in them." Considering these persons as separate class, conducting investigation into their affairs was held not violative of Article 14.

Further, "Directors are regarded as trustees of company's property which is in their hands or under their control. The primary consequence of this principle of trusteeship is that a director is answerable as a trustee for any misapplication of the company's property in which he participated and which he knew or ought to have known to be a misapplication. A misapplication in this context means any disposition of the company's property which by virtue of any provision of the company's constitution or any statutory provisions or any rule of general law the company or board is forbidden or incompetent or unauthorized to make, or which is carried out by the directors otherwise than in accordance with their duty to act bona fide in the interests of the company and for the proper purposes. This second limb covers not only misappropriations of the

company's property but also dispositions in favour of third parties which do not satisfy the test of bona fides." [Boyle & Birds' Company Law, 3rd ed., page 456].

3.5 There is a need to review and strengthen regulatory response to fraud comprising of effective powers of the Central Government for timely detection of corporate fraud including by intelligence gathering, ordering and conduct of investigation through experts to unravel the nature scope and impact of fraud, quick unravelling of the fraud or scam, an effective prosecution mechanism leading to speedy justice, maximum recovery of illegally acquired gains from frauds, restoration of such assets and money to their rightful owners. The beginning however must be made by a clear appreciation of fraud, in particular corporate fraud.

3.6 The Committee Observes That Fraud in a corporate framework has its own dimension and involves actions by perpetrators within the confines of, or in relation to the affairs of a virtual person, the Company, in a structure that is complex in itself. Besides the statutory framework that is designed to reward risk while dispersing and mitigating its negative consequences can well be subverted to mobilize funds through false pretences and to channel or siphon away the benefits for personal gain of a few, away from those who genuinely deserve them. All this is done with movement of funds at high speed through scores of entities, elaborate organizational and financial structures, behind the corporate veil that clouds liability and behind a veneer of apparent compliance. Very often the sharpest and the best minds devise the detailed elaborate and complex structures behind which corporate frauds take place. These cannot be unravelled except by expert teams having multidisciplinary expertise. Therefore corporate fraud is a phenomenon that is distinct in itself and needs to be treated separately in law.

Chapter 4 EXISTING PROVISIONS OF THE COMPANIES ACT DEALING WITH FRAUD.

4.1 In order to address corporate fraud, it is also important to review the provisions of the Companies Act 1956 and the manner in which they address situations involving fraud with relation to the affairs of a company. The Act deals with actions by the directors, officers and managers of the companies rather than by the companies as such. It also deals with investigation of fraud, the manner of appointment of persons to investigate fraud and their powers, prosecution for offences against the provisions of the Act and the associated punishments.

4.2 Nature of Offences under the Companies Act, 1956

4.2.1 The Companies Act contains several provisions, which specify the compliance requirements by companies and offences arising out of contravention, violation or non-compliance. In this regard, it is necessary at the outset to notice the objects of the Act. As observed by the Madras High Court in the case of Indian Express [44 CC 106 Mad] –

“The whole scheme of the Companies Act is to ensure proper conduct of the affairs of companies in public interest, and the preservation of the image of the company in the eyes of the public, and in the interests of the members of the company and also the creditors to ensure that the affairs of the company are conducted in a proper manner and its transactions are above suspicion. It is to ensure this that the various provisions under the Companies Act have been devised and returns have been prescribed for the purpose of enabling a close watch to be kept in regard to the transactions of the company and in regard to the manner in which its affairs are conducted.”

4.2.2 Statutory contraventions/offences or non-compliance may or may not involve criminal intention. Non-compliance may be inadvertent and unintentional in many cases.

The Companies act recognizes this and provides for consequences accordingly. Some procedural non-compliance is dealt with by monetary penalties which may be in the form of an escalating fee structure linked to the period of default. Some acts or omissions may give rise to civil liability. In other cases contravention or non-compliance may lead to criminal liability. This distinction has been recognized by the courts. The Supreme Court judgment in *Guljag Industries vs Commercial Taxes Officer* (2007)7SCC269 considered this issue in the context of the Rajasthan Sales Tax Act. Section 78 (5) of that Act provides for penalty in certain situations. The following extracts from the judgment are relevant:

“We are concerned with the goods in movement being carried without supporting declaration forms. The object behind enactment of Section 78(5), which gives no discretion to, the competent authority in the matter of quantum of penalty fixed at 30 per cent of the estimated value is to provide to the State a remedy for the loss of revenue. The object behind enactment of Section 78(5) is to emphasize loss of revenue and to provide a remedy for such loss. It is not the object of the said Section to punish the offender for having committed an economic offence and to deter him from committing such offences. The penalty imposed under the said Section 78(5) is a civil liability. Willful consignment is not an essential ingredient for attracting the civil liability as in the case of prosecution. Section 78(2) is a mandatory provision. If the declaration Form 18A/18C does not support the goods in movement because it is left blank then in that event Section 78(5) provides for imposition of monetary penalty for non-compliance. Default or failure to comply with Section 78(2) is the failure/default of statutory civil obligation and proceedings under Section 78(5) is neither criminal nor quasi-criminal in nature. The penalty is for statutory offence. Therefore, there is no question of proving of intention or of mens rea as the same is excluded from the category of essential element for imposing penalty. Penalty under Section 78(5) is attracted as soon as there is contravention of statutory obligations. Intention of parties committing such violation is wholly irrelevant.

27. For the afore stated reasons, we hold that Section 78(5) of the RST Act 1994 (Section 22A(7) of the RST Act 1954) is the section enacted to provide remedy for

loss of revenue and it is not enacted to punish the offender for committing economic offence and, therefore, *mens rea* is not an essential ingredient for contravention of Section 78(2) of the RST Act 1994.”

4.2.3. Having regard to this position, non-compliance with the statutory requirements under the Companies Act which provide for a penalty specific to the non-compliance or other civil consequences would not, in itself, lead to criminal liability. There are also offences defined under the Companies Act, which result in criminal liability and imposition of punishment accordingly. These offences may result in imposition of punishment or fine or imprisonment or both or fine and imprisonment. The quantum of punishment is defined in the provisions of the Companies Act.

4.2.4 However, in a corporate setting, acts of non-compliance resulting in penalties or civil consequences only, if committed with fraudulent intention they may result in a fraud, which is a criminal act, which, while not defined in the Companies Act is recognized in respect to several situations arising out of corporate structure and functioning. There are several provisions in the Companies Act, which use the expressions ‘fraud’ or ‘fraudulent’. It is necessary to appreciate that the provisions in which these expressions are used have a distinct purpose, and they have to be understood in the context of the underlying objects of those provisions and objects and scheme of the Companies Act. Keeping in view the main objectives of the Companies Act, these provisions are supplemental to those objects. There is no specific offence of fraud defined under the Companies Act as a punishable offence.

4.2.5 Where the ingredients of an offence defining it as an offence punishable under IPC are present, prosecution under the IPC is also feasible. The provisions of the Companies Act do not bar prosecution under IPC with application of Criminal Procedure Code.

“We can see nothing in the provisions of the Companies Act which would even by implication bar a recourse to the laying of the information before the police for the purpose of investigation and action under the Code of Criminal Procedure when there are

reasonable grounds for believing that cognizable offences under the Indian Penal Code had been committed in relation to the affairs of the company. It cannot be said that the Companies Act is exhaustive even in the matter of investigation into cognizable offences under the Indian Penal Code committed in relation to the affairs of a company. In fact, the Act does not touch that aspect at all.” [Indian Express 44 CC 106 Mad]

4.2.6 Thus, the provisions of the Companies Act do not exclude invoking the provisions of the Criminal Procedure Code by laying of information before the police or filing a private complaint in regard to offences under the Indian Penal Code where such offences are committed in relation to the affairs of a company.

4.2.7 At the same time, the provisions of the Companies Act are inter-linked. Monitoring of those provisions and particularly, the non-compliance with the provisions has to be viewed carefully, having regard to the corporate settings. The experience shows that a seemingly minor or technical non-compliance with a ‘insignificant’ provision may be symptomatic of a systemic infraction and may even turn out to be a foundation of a serious ‘corporate fraud’.

Provisions in the Companies Act dealing with fraud

4.3 Existing provisions, which address fraudulent conduct with regard to affairs of companies, are discussed as under:-

Specification of Offences, Prosecution and Penalties :

4.3.1. The provisions of the Companies Act addressing fraudulent actions by directors or officers of companies through its provisions comprising of sections 203, 388B to 388E ,Sections 397/398 read with sections 401,406 (read with provisions of section 539 to section 542 of schedule XI of the Act), 408 and Sections 539 to 542.

4.3.2 Section 203 provides powers to restraint fraudulent persons from managing company. However, this applies where a person is convicted of any offence in

connection with the promotion, formation and management of a company or during the course of a winding up of a company, it appears that the guilty of an offence for which he is punishable under section 542, or is otherwise guilty of any fraud or misfeasance in relation to the company etc.

4.3.3 Sections 388B to 388E provide power to the Central Government to remove any managerial personnel from the office on the recommendation of CLB and also debar him from holding any position in any company on finding him guilty of fraud, misfeasance, persistent negligence or default in carrying out his obligations and functions under the law, or breach of trust. However, for such violations, there is no provision for his punishment with imprisonment and monetary fine as such violations are not dealt in these provisions as criminal offences.

4.3.4 The provisions of Sections 397 /398 read with section 401 enable any member of the company or Central Government itself to file complaint with the Company Law Board (CLB) against such affairs of a company which are conducted in a manner prejudicial to public interest or in a manner oppressive to any member or members of the company. These provisions empower CLB to pass such orders, which may ensure the running of the affairs of a company in proper manner. Central Government is also empowered in such circumstances to appoint directors as per the order of CLB to run the affairs of the company in proper manner. These provisions, however, do not specifically define any criminal offence of the nature of financial fraud and do not provide for punishment to the directors or managers found guilty of running the affairs of the company in fraudulent manner.

4.3.5 Sections 539 to 542 of the Act also deal with the punishment for fraudulent conduct of business but these provisions are applicable only during winding up proceedings of a company. Punishments are provided in Section 539 to 542 of Schedule XI, of imprisonment up to two years for defrauding creditors or any other person and up to seven years for falsification or destruction of documents. However, prosecution for such punishment can be filed in the Court, only after it is established during proceeding before CLB, that business of the company was carried on with intent to defraud creditors

of the company or any other person or for any fraudulent purpose. Such proceedings before CLB are a long drawn process and could result in considerable delay in filing of criminal prosecution in Courts. Besides, the punishment of imprisonment for two or seven years provided presently may also be inadequate, considering the extent, gravity and impact of financial frauds taking place today.

4.3.6 Apart from the provisions of sections 397/398 and 539 to 542, there are certain other sections in the Companies Act at present, such as Section 58A, 63, 68, 628 etc that provide for punishment of certain actions by a company. Section 58A deals with the provisions relating to collection of fixed deposits by the company from public and provides for punishment, if fixed deposits are collected in wrongful manner. Section 63 provides for punishment for including any untrue statement in a prospectus issued by a company. Section 68 provides for punishment for fraudulently inducing persons to invest money in a company. Section 628 deals with the provisions for providing punishment for falsification of reports and records of the company.

4.3.7 Section 58A provides punishment only for collection of deposit in wrongful manner. In case the company does not return deposits collected by them to the public, there is no provision for punishing the company and its officers as in the case of criminal offence. In such circumstances, CLB may pass orders for repayment of the deposit amount by the company. Officers of the company are also punishable by three years imprisonment in case of non-compliance of order of CLB. However the proceedings before CLB are long and cumbersome. Many defaulting companies keep on prolonging the proceedings before CLB or thereafter in the courts, and in some cases even become untraceable.

4.3.8 Section 63 provides for punishment for any misstatement in prospectus for up to two years. There is no provision in the Companies Act for punishment of officers of the company, if they raise money from public or private institutions or banks in wrongful and deceitful manner and thereafter use this fund for their personal gain, causing financial loss to the entities concerned. Section 68 deals with situations resulting from collection of

funds by fraudulently inducing general public to invest in shares of a company and provides for punishment of up to five years imprisonment

4.3.9 From the foregoing, it is seen that while the possibility of fraud in companies is recognized in the Companies Act and several provisions have been included to situations resulting from fraud, the Companies Act provisions could however result in protracted litigation since the definition of offences is diffuse and several extenuating circumstances are provided which could make it difficult to fully establish criminal intent. Besides civil consequences of fraud are not adequately addressed. Therefore these provisions need to be more focused to provide a clear framework for action, providing for both civil and criminal remedies, in cases of fraud.

Investigation of fraud

4.4 At present, the company, which is suspected to be indulging in fraud, is being ordered for investigation by an officer of SFIO either u/s 235 or 237 of the Companies Act.

4.4.1 As envisaged in the above two provisions, investigation into the affairs of the company can be ordered only after fulfilling of either of the following statutory requirements:-

- (i) Receipt of report from Registrar of Companies (ROC) u/s 234(6)
- (ii) Passing of an order by Company Law Board (CLB) or Court

4.4.2 At present, officers of SFIO exercise powers as given in the provisions of Section 239, 240 and 240A. Section 239 provides for power of Inspectors appointed u/s 235/237 to carry out investigation into affairs of related companies, either subsidiaries or companies under common management. Section 240 provides power to enforce production of document and evidence either in writing or orally and Section 240A provides for power of search and seizure of documents by Inspectors.

Prosecution in Courts for Fraud committed by Corporates

4.5 At present, there is no separate provision in the Companies Act under which criminal prosecution against a company indulging in fraud could be launched directly in a criminal court. Therefore, SFIO is filing complaints under Section 190 of Cr.P.C., if any fraud is detected by it during investigation.

4.5.1 Section 242 of the Companies Act talks about criminal liability of a person found guilty during investigation of the affairs of a company but these provisions are not very clear as to whether they can empower SFIO to file criminal prosecution under the provisions of IPC in a court for the offence of fraud investigated by it.

4.5.2 In light of the above:

a) The Committee notes that a statutory contravention/ offence under the Companies Act, 1956, a criminal offence as defined in IPC and a corporate fraud all stand on a different footing. They may contain overlapping features or ingredients but cannot be equated with or used in replacement of each other. More importantly, the existing statutes in India do not deal with fraud or corporate fraud comprehensively.

b) The Committee is of the view that it is essential to identify fraud in all its dimensions as an offence that may be dealt with effectively under law. The Committee is further of the view that due its complex and multifarious dimensions, corporate fraud needs to be addressed as such. Therefore the Committee will not go into what changes or amendments may be necessary in the Indian Penal Code to define the general offence of fraud. Since companies are dealt with through a specific legislation, Companies Act 1956, and it provides a platform where corporate fraud may be dealt with suitably, the Committee recommends that “a comprehensive definition of fraud as an offence along with related offences, be included, with reference to the affairs of a company, as an inclusive definition, including the components defined in the UK Act, along with stringent penalties”.

c) The Committee recommends that an exclusive jurisdiction be carved out for corporate frauds under the Companies Act, 1956 irrespective of whether it has

features of an offence under the IPC or not. Further, SFIO should be facilitated to assume jurisdiction seamlessly in corporate fraud where warranted.

d) In general, many provisions of the Companies Act, 1956 aim to deal with the cases of statutory contraventions and offences there under, and those provisions will continue to be valid for dealing with cases involving corporate fraud. This structure is necessary for various types of corporate fraud to be detected, identified and addressed. It would be appropriate to review the compliance and corporate governance regime in the Companies Act, 1956 so that it enforces transparency and accountability at all levels and provides adequate statutory means to address situations resulting from corporate fraud through an appropriate investigative, enforcement and penalty structure. The Committee notes that this has already been attempted in the Companies Bill, 2008. The need to review the provisions dealing with fraud may be kept in view during the course of the examination of the Bill before the Parliamentary Standing Committee in due course. It is hoped that the suggestions/ recommendations of this Committee would contribute to a more robust and effective framework for dealing with corporate fraud.

Chapter 5: New legislation or Amendments to Companies Act

5.1 Issue of fraud has been a subject matter of examination by various expert committees in the past who have also deliberated and examined various means of dealing with fraud. One suggestion made been to enact a separate legislation for dealing with the cases of fraud. While the intention in dealing with this aspect through separate legislation is laudable, various issues associated with the implementation of this recommendation need to be carefully examined. These issues relate to the special nature of corporate fraud, the complexity involved in unearthing and dealing with it, the scheme of division of powers under the Constitution of India, the imperative of providing necessary jurisdiction to the investigating agency across state jurisdictions/ matters relating to prosecution etc.

5.2 Corporate fraud takes place within the complex framework of laws governing corporate structure and operations. Corporate structure is a platform that can be used and indeed is used to mobilize immense amounts of money, affecting a very large number of stakeholders. Normally such stakeholders entrust their money on faith to a few people comprising the corporate governance structure. The complexity of the corporate structure spanning huge organizations with wide geographical spread and the deployment of resources is often beyond the knowledge and understanding of most people even within the corporate organization. The corporate veil that clouds the accountability and limits legal liability, the imperative of freedom for business decisions often results in a combination where the fraudster may operate and even evade detection with impunity. Detection of fraud in such situation its investigation and prosecution therefore requires special skills and institutions that can bring multi-disciplinary skills to bear. Such investigations are complex and often beyond the normal police methods and techniques of investigation. It is this dimension of fraud for which special organizations like SFIO need to be developed.

5.3 A related question is the kind of statutory framework necessary to enable such an organization to function effectively. Indeed, mere establishment of such organization does not require statutory authority. It can be well established through administrative

action. Nor does it require statutory authority to be equipped with multidisciplinary skills or infrastructure. Statutory authority is required to enable it to investigate, compel discovery, collect evidence to and prosecute in courts of law. For this, it is debatable if an independent enactment is at all necessary for establishment of such a body since statutory authority can well be vested through any of the special acts regulating specific entities.

5.4 Investigation into offences, particularly economic offences, is not necessarily always a police function. Several instances can be cited where investigation powers have been vested in agencies other than police under special Acts. Particularly, investigation powers into offences under economic laws are vested in the agencies set up under such special statutes. The scheme of such legislation is that the statute defines the offence for the purpose thereof, lays down the punishment, and provides for investigation and prosecution, and other related matters. The issue arises where such investigation leads to criminal liability under the IPC. Criminal investigation is a police function, and police is listed in List II of Schedule VII of the Constitution as a State subject under the Constitution.

5.5 The Committee examined this issue in context of the experience relating to prosecution of the offences relating to fraud. The Companies Act provides for a legal framework for addressing fraud through its provisions. Acts committed fraudulently are defined in the IPC, but the offences that may be said to result in fraud are defined separately in IPC. There is also need to rationalize the procedures for filing complaints in the courts where offences under the provisions of both the Acts are cited. As per Section 242 of the Companies Act, 1956, Central Government could prosecute a person for any offence for which he was criminally liable. This has been interpreted by legal experts as a criminal offence under the Companies Act, 1956. However, fraud may often be the result of offences under various other enactments also, such as IPC for which SFIO would have to file a complaint under &.190 of CrPc..

5.6 The constitutional provisions provide for public law and order as a state subject in List II whereas Companies Act is a central subject falling in List I. This requires the State

police to register, investigate, file complaints for and prosecute in respect of offences under the IPC. In the case of investigations done by the SFIO, filing of an FIR with state police could, however, result in duplication of work and problems of coordination. This could cause in delays and make the process of prosecution more difficult. It is informed by SFIO that at present complaints in respect of offences under IPC are being filed by SFIO/MCA officials in the Courts directly under Section 190 of the Cr PC. This places additional administrative requirements on the resources of the SFIO in respect of prosecution of offences detected. Therefore, to enable SFIO to file complaints in respect of offences other than those under the Companies Act, 1956 significant changes to the Companies Act, 1956 would be required. In light of the constitutional provisions, this may not be feasible.

5.7 In the past, suggestion had also been made for legislation for dealing with cases of fraud by defining the offence of 'financial fraud' and a draft suggested containing provisions for its investigation and prosecution, including establishment of Special Courts. The issue however needs a detailed examination from various angles. This Committee would like to focus on corporate fraud rather than on general legislation on financial fraud.

5.8 For the purpose of the present Committee, the issue is restricted to corporate fraud, its investigation and prosecution. The ideal pattern seems to follow the code contained in the special statutes like the economic laws. The cause of corporate fraud being exclusively in relation to companies, there appears to be no need to enact a separate legislation for this limited purpose. The Companies Act contains extensive provisions dealing with fraud and investigation thereof. Powers are vested on the inspectors appointed by the Central Government under the provisions of this Act to carry out the investigation alones necessary to deal with corporate fraud. Presently investigations are carried out by the SFIO under the provisions of the Companies Act 1956. It may be that the statutory framework needs to be made more comprehensive or be tightened up procedurally to enable investigations and related follow up actions to be taken speedily. The issue therefore seems to be not the absence of a statutory framework but that of

strengthening of the existing one. Accordingly, it would appear that as in other special Acts, this purpose can be achieved by reviewing the provisions of the Companies Act, strengthening them where necessary and adding special provisions if need be.

5.9 However Government may, in the long run, consider a special legislation combining the powers under various legislations to deal with fraud in its various aspects. If a special legislation for the establishment of the SFIO is thought of, its provisions would broadly need to cover the following areas.

1. Establishment of the investigative agency,
2. Its composition, functions and powers
3. Procedure for reference of cases to it
4. Coordination /Sharing information with other investigative agencies
5. Process of initiating and pursuing prosecution in the courts;
6. Cross border investigation, sharing of information and other cooperation

5.10 While devising such a statute the constitutional aspects would also have to be addressed. Company law is a central subject. An organization so set up would be a central organization. Yet it would need to investigate and prosecute entities located in states for criminal acts. This would require statutory overlay of powers that would need to be consistent with the constitution. It would also not be appropriate to sacrifice the multidisciplinary nature of the organization and to create it as a special police organization merely for it to be able to formally cooperate with the state police.

5.11 A statute dealing with all these would be very complex. It would also have to guard against making the structure very rigid, unable to deal with the changing requirements of dealing with corporate fraud. It would also result in avoidable litigation on issues relating to many structural and administrative aspects of the organization since the provisions of the statute would be justiciable. This situation, in view of the Committee, is best avoided. At the present stage of institutional development adequate powers can be vested on the SFIO through the Companies Act itself. Only if, in the future, the organization eventually becomes huge and unwieldy beyond administrative control, so that its operations cannot be regulated except through a law regulated by the courts, enactment of a special legislation for establishment of SFIO may be thought of.

5.12 The objective of setting up SFIO was to establish an agency with multi disciplinary capacity that also had an understanding of the complexities of corporate structure and operation to conduct investigations into corporate fraud, since such cases were complex and the nature of fraud perpetrated was difficult to uncover. On the basis of experience gained through investigations it is felt that the Companies Act, 1956 provides an adequate framework to investigate corporate fraud by the SFIO. Suitable amendments to the Companies Act, combined with strengthening of SFIO at its organizational level, coordinated intelligence gathering, specialized skills of investigations based on information from regulators and investigative agencies and strengthening of prosecution set up of SFIO would go in a long way in improving the functioning of SFIO. This should be appropriately the immediate objective.

5.12 The Committee therefore recommends the following approach:

- (i) In the short term, Government may consider making amendments to the Companies Act 1956 itself so as to streamline the procedures and strengthen the powers of the inspectors appointed under the Act more effective in dealing with frauds in relation to affairs of companies;**
- (ii) The Government has also introduced the Companies Bill 2008. This opportunity may be taken, while defining fraud in the corporate context comprehensively, to also strengthen the investigative powers to SFIO inspectors, to accord statutory recognition to the SFIO in the new Companies Act itself with the statutory obligation for other entities to cooperate with it;**
- (iii) Consider in the long term a special legislation, to deal with the subject of fraud in a broader issues and for constitution, setting up, functions and powers of the SFIO that enables it to function irrespective of state jurisdictions**

Chapter-6: Changes Required in Companies Act 1956 to enable more effective investigation and action against Fraud

6.1. Introduction:

6.1.1 The Serious Fraud Investigation Office (SFIO) has been set up by the Central Government in July, 2003 to conduct investigations under the Companies Act, 1956. The office has been set up as multi-disciplinary investigative agency with experts drawn from various Government Departments dealing with Law, Company Law, Income Tax, Central Excise, Finance & Accounts, SEBI, Banks and CBI etc. The SFIO conducts such investigations as are entrusted to it by the Central Government either under section 235 or section 237 of the Companies Act, 1956. The office has so far completed 37 investigations and submitted the reports to Central Government and investigations in respect of around 30 companies are presently in progress. The experience gained during the said investigations has thrown up an urgent need to have certain legislative changes in the present provisions of the Companies Act dealing with fraud, investigations and other matters incidental thereto. In fact, the matters relating to corporate fraud need to be dealt with in a separate Chapter. However, some of the existing provisions of the Companies Act, which have a direct bearing on corporate frauds, have been discussed in subsequent paragraphs

6.1.2 Under the Companies Act 1956, the report of ROC under the provisions of section 234, forms the basis of the decision by the Central Government to issue orders for investigation of a company under section 235 of the Act. Under the Act the CLB or the Court could also give directions/orders for investigations under section 235/237 of the Act. It was felt that these provisions were appropriate to enable any stakeholder to approach the court and seek directions for investigation. The procedure is time consuming and depends on the report of the ROC who may not be able to fully comprehend the nature of the fraud in many cases due to its complex nature. The intention however appears to be to avoid orders of investigation on vexatious and frivolous grounds and to cause a preliminary enquiry to determine

that an investigation is justified. It was noted that the existing provisions of section 234 of the Act gave an opportunity to the company to be heard before the Government ordered it to be investigated. However it was observed that a long and tedious procedure of obtaining information would not enable effective investigation. Rather in some cases it may enable a company or persons engaging in fraudulent behaviour an opportunity of tampering with facts and evidence. In any case, this opportunity would be available to the Company even when the Inspector investigates it since the inspector would seek information through issue of notices. Further, not only would the Company be provided the investigation report, prosecution would take place in a judicial forum where all the rights and privileges under the Constitution would be available to the Company.

6.1.3 A request for investigation by any of the company's stakeholders should in any case be put to a preliminary enquiry or a judicial test. The issue is whether a report by the ROC should be the only source of information or the basis on which the Government may order an investigation. Today, there are a number of agencies such as SEBI, Income Tax, and Directorate of Enforcement etc from where information with regard to fraud taking place in a company could originate. With application of e-Governance, the Government or the SFIO itself may have access to information pointing towards the possibility of fraud. An order of investigation causes serious consequences to the company including lack of its credibility and creditworthiness and therefore is not to be issued lightly. In such situations the need is for the Government to take a well-reasoned decision for investigation rather than to use these powers to harass companies or their managements.

6.1.4 Another issue is that as and when SFIO is given statutory recognition, whether it would be able to initiate investigation suo motu or would it require Government directions to take up this activity. If it is allowed to initiate investigations on its own whether and under what circumstances would it be allowed to close it so that the process does not result in abuse of power? Currently various agencies assist in forming the prima facie opinion. Actual investigation is subject to the orders of the

Government under the Act. Thereafter the investigators use the powers vested on them on account of being appointed inspectors for investigation.

6.1.5 An associated issue is that the SFIO should not be burdened with all kinds of investigations- big or small. This would overburden the agency and reduce its effectiveness. It should be entrusted with investigations of a serious nature depending on the amount involved, the number of stakeholders affected or the seriousness of the fraud in terms of its systemic impact.

6.1.6 The Committee felt that while it was appropriate for the orders of investigation to be issued by the Government in exercise of its statutory powers under the Act, the existing system of ordering investigation by the Central Government under section 235 of the Companies Act, solely on the basis of the report of ROC under section 234 of the Act was inadequate and needed to be modified. Central Government's opinion as to the necessity for an investigation into the affairs of a company may also take into account reports in writing, affirming prima-facie occurrence of fraud from a wider range of agencies like SFIO, CBI, DRI, Income Tax, SEBI etc. The order by the Government should however be speaking one, indicating the charges against the company/reasons for investigation and justification in public interest. A suitable amendment to the Companies Act may be considered to enable this.

6.1.7 Statutory recognition of SFIO under the Companies Act need not change the existing arrangements. These would require to be comprehensively reviewed once a special legislation to provide for SFIO is enacted. The manner in which investigative action may be initiated and closed may also be dealt with in such legislation. For the present, the existing arrangement whereby investigation is ordered by the government may continue. However, SFIO is a specialized organization which is intended to bring together multi-disciplinary expertise to unravel fraud. Therefore, SFIO should not be burdened with routine investigations or inquiries into various complaints. This would impose an unmanageable quantum of work on SFIO. It

would be appropriate for the Central Government to strengthen its arrangements for inspections and inquiries to be carried out by field organization of the Ministry to handle such work without imposing this burden on SFIO. It would also be appropriate for the information gathered by the Ministry through its electronic registry or complaints received and inquired into to be shared with SFIO. However, only serious investigations should be referred to the SFIO.

6.1.8 The issue of enabling SFIO to independently take up investigations, carry them out under oversight of the courts and the manner in which they may be taken to their logical conclusion, or where there are inadequate grounds for proceeding further closure of such investigations, may be addressed through a separate statute for setting up, constitution, functions and operations of SFIO that may be prepared at the appropriate time. Till such time, SFIO need not take up investigations on its own.

6.1.9 The seriousness of an investigation may be assessed in terms of amount of funds, the number of stakeholders or complexity involved. No hard and fast guidelines are possible and the Committee would refrain from applying a monetary limit or threshold for a fraud to be considered serious. The nature of corporate fraud is such that while the acts *per se* may be innocuous, the fraud in totality may have a snowballing effect on stakeholders, banks financial institutions, market sentiment and thereby on capital markets etc. The assessment of seriousness would have to be based on the particular circumstances of each case.

6.2 Apart from corporate entities, entities such as individuals, firms, trusts, societies, associations etc. may also be involved in fraudulent activities or may take active part in facilitation of the said fraud. Section 239 of the Companies Act 1956 provides for the circumstances under which investigation may extend to other related companies. Such relationship is as defined in the provisions of this section. However two entities may be related to each other through a host of transactions not limited to the cases described

under section 239. Besides the provisions of section 239 do not cover relationships through promoters or controlling interests. Therefore it would be necessary to broaden the ambit of relationship to cover any entity which is connected to the subject company through promoters or their relatives or found to have participated in or acted as a means of commission of a fraudulent act or acted as agents of perpetrators of fraud or having acted as recipients of the proceeds of fraud. In addition, in a manner similar to section 582 of the Act, whereby winding up provisions under the Companies Act, 1956 are extended to certain entities other than companies; the powers of the central government to investigate may also extend to entities other than companies through the exercise of these provisions. This is considered necessary as experience of investigation has shown many instances of such other entities acting as conduits for siphoning away of corporate funds.

6.3 Therefore the provisions of section 239 of the Companies Act, 1956 for investigation of related companies, along with the provisions vesting powers on the inspectors appointed by the Government for such investigation, may be widened to include, in addition to the existing provisions, entities other than companies such as sole proprietorships, partnerships, trusts, companies registered overseas etc. that are related, associate to or otherwise connected to the subject company through promoters or their relatives or the controlling interest of the subject company or through participation in acts resulting in fraud in any manner.

6.4 Matters relating to production of documents/evidence during investigation.

Section 240 of the Companies Act, 1956 deals with production of documents and evidence before the Inspector appointed under section 235 or 237 of the Act for the purpose of investigation. Sub-section (1A) of the said section deals with power of Central Government to allow an inspector to call for information/documents and other books and papers from a body corporate other than the body corporate originally ordered for investigation. This requirement of obtaining permission from the Central Government

may result in procedural delay, and needs to be streamlined to reduce the time taken to complete an investigation.

6.4.1 The Committee is of the view that authority to call for information, evidence from bodies corporate other than the subject company under investigation may be vested in the Inspector drawn from Serious Fraud Investigation Office, if such Inspector is appointed by the Central Government to conduct investigation. This would be a special power to be exercised in recognition of a particular fraud being identified as serious fraud. In other cases, such powers may continue to rest with the Government as under the existing provisions. This would require suitable amendment to sub-section (1A) with resultant amendments to sub-section (2) and sub-section (3) of section 240 of the Act.

6.5 Penalty for incorrect information or withholding/ concealment thereof from the inspector. Section 240 imposes obligation on all the officers and employees and agents of a company related to the company under investigation under Sections 235 and 239, to preserve and produce all records and documents of the company to the inspector that may be called for by the inspector with the previous approval of the Central Government and to otherwise give him all assistance. This Section also empowers the inspector to examine the officers and employees of the subject companies on oath. Failure or refusal without reasonable cause to produce books/ documents/ information or to appear before the inspector etc is punishable with imprisonment for a term which may extend to six months or with fine which may extend to twenty thousand rupees or with both and also with a further fine which may extend to two thousand rupees for every day after the first during which the failure or the refusal continues.

6.5.1 The Committee feels that furnishing of information to the investigating inspector is an important aspect of investigation and failure to do so without reasonable cause could imperil the investigation. Therefore, the Committee recommends that the level of imprisonment for such offence may be enhanced to a maximum of three years from the present level of six months. The offence should

also be made non compoundable. the quantum of fine may also be enhanced. The fine for such refusal, in addition to the possibility of imprisonment should be enhanced to extend up to five lakh rupees with a minimum of twenty thousand rupees. The penalty for continuing default in such cases should also retain.

6.5.2 In addition to the above, the Committee recommends that the penalty for furnishing false information or withholding relevant information under section 628 should be enhanced so that where any false statement or information, with regard to a company under investigation, is furnished to the inspector appointed under the Companies Act to investigate that company, the term of imprisonment should be enhanced from the current two years to seven years along with a fine that may extend to five lakhs rupees, with a minimum of fifty thousand rupees.

6.5.3 Power to Compel appearance: An essential starting point for any investigation is to start the process of enquiry by questioning persons who may be expected to reasonably in the know of matters. In the beginning, it is not feasible to zero on to those few who would be most likely connected with the fraud. It may be difficult to even prepare a list of suspects without an initial round of questioning. **Therefore, it is necessary for the inspector to be vested with the power to compel appearance of any person he may suspect, for questioning. Whether to require physical appearance or to obtain written replies/ affidavits/ declarations on oath or otherwise may be left to the inspector. There should be a penalty for ignoring an inspector's summons. Besides, non response to repeated summons should lead to arrest of the person through a warrant to be issued by a magistrate on a report filed by the inspector.**

6.6 Search and Seizure:

6.6.1 Section 240A of the Companies Act, 1956 provides for search and seizure of documents by inspector for the purpose of investigation. Presently, search of premises and seizure of documents by inspector is permitted by the court of Magistrate of the First Class or the Presidency Magistrate upon an application moved by the inspector. This

process can be time consuming resulting in delays in gaining access to critical documents and information. Moreover this process may also not yield desired results in cases of hot pursuit. Accordingly, it is suggested that in respect of cases which are entrusted to officers of SFIO, the inspector may be empowered to enter into a premises and seize the books and papers for the purpose of investigation. Such seizure may be allowed for a fixed period. For continuation of seizure beyond this period court permission may be required.

6.6.2 The Inspector may, therefore, have the powers to seize books and papers of the company under investigation, including computers and computer readable devises which he may be authorized to retain for a limited period (180 days). Beyond this period, he may be authorized to retain for further period of 180 days with the permission of the Court. He may order such books and papers to be stored in a secure place on the premises of the company itself and seal the premises. The company or other authorities requiring use of such documents may be allowed access by the inspector on request. The inspector may also make copies of the documents seized and authenticate them. The Inspector may also have the powers to compel, by order, safekeeping of books and records by specific officers of the Company for a period of up to one year. Any default should result in non-compoundable criminal liability involving fine and imprisonment for the officers of the Company so named in the order. Other provisions contained in section 240A may continue to apply to search and seizure done by SFIO. Further, in other case, where the original incriminating documents /records are required to be produced before the court as evidence, the same be retained by the inspector with Court permission till the disposal of trial. He may issue an authenticated copy to the company for their use.

6.6.3 In addition, a separate offence may be defined to deal with actions resulting in unauthorized removal, concealment, destruction or tampering with company records for a company under investigation or a related entity. Such offence may be

punishable with imprisonment that may extend up to seven years, and with fine of up to ten lakhs rupees with a minimum of Rs 50,000/-.

Duty to assist in investigation of corporate fraud

6.7 Persons other than the officers of the company under investigation should also be under a duty to assist the Inspector ordered to investigate affairs of the Company. This is particularly relevant for other central and state government agencies banks and financial institutes. The requisite provision should allow the inspector to apply to the officer in charge of the nearest Police Station for such assistance as may be necessary in the discharge of his duties. Failure to discharge this duty with due diligence may attract monetary penalties and civil liability for complicity in the fraud.

6.8 Attachment of Assets/Property: In the existing provisions of the Companies Act, there is no provision for attachment during the course of investigation, of movable or immovable assets, including cash suspected to be created out of the proceeds of fraud. Such action can be taken only after CLB passes order to this effect against the fraudulent activities of the company. However, in case of financial fraud of serious nature, there is every possibility that proceeds of the fraud may disappear by the time, the final order of CLB or the court, as the case may be, is passed.

6.8.1 With a view to strengthen and expedite the actions for *attachment of immovable* properties, created out of fraudulent activity, suitable provisions may be incorporated for attachment of properties, with adequate oversight by the Courts, during the course of investigation so that necessary recoveries could be made after the decision of the court.

This could be done by providing for provisional attachment of both movable and immovable properties of the company under investigation and its directors/promoters in respect of cases entrusted to SFIO. Such attachment may be

made on discovery by the inspector himself on the basis of prima facie finding of fraud under the Act. However to obviate the possibility of misuse of powers, it is suggested that Inspector should intimate to CLB/Courts full details of properties attached and the grounds for such action within seven days of doing so and seek orders of the CLB court/tribunal/attaching/restraining the company from alienating any assets. The attachment/restraint order should continue at the discretion of the court.

6.9 Prosecution of persons based on inspector's report submitted under section 241 of the Act. Section 242 of the Companies Act deals with filing of prosecutions consequent to the investigation report submitted under section 241 of the Act. As per section 242, if from any report of investigation under the Act it appears to the Central Government that any person has in relation to the company or other body corporate whose affairs have been investigated being guilty of any offence for which he is criminally liable the Central Government may after taking such legal advice as it thinks fit prosecute such person for the offence. This provision has generally been interpreted to mean ability of the Central Government to file prosecution for offences under the Companies Act, 1956. This is a restrictive interpretation on account of which the officers of the SFIO have been filing complaints of offences other than those under the Companies Act under section 190 of the Criminal Procedure Code in the form of complaint or information received from any person other than a police officer, indicating that such criminal offence under another Act has been committed. This leads to difficulties in prosecution. In some cases, it has also lead to confusion with the Court directing that in the first instance a first information report be filed by the inspector in a police station. The investigative processes under the Companies Act are not feasible to be replicated under ordinary police investigation. Even otherwise, it would lead to duplication of work.

6.9.1 Therefore, the Committee is of the view that suitable changes be made in Section 242 of the Companies Act, 1956 providing clarity and empowering the inspectors appointed under the Companies Act to file complaints with regard to

offences under any other statute as well with the appropriate Court. If necessary provisions of other legislations may be reviewed.

6.9.2 On the basis of findings through investigations carried out under the provisions of the Companies Act and the report submitted under Section 241, where a person or persons are found to have indulged in fraudulent activity in relation to the affairs of a company, such persons may be prosecuted under the Companies Act, along with provisions of other Acts as applicable. In addition to specific offences such persons may also be prosecuted for the offence of fraud to be defined in the Companies Act in a comprehensive manner. If found guilty of such offence, the concerned person may be punished with imprisonment for a term which may extend up to ten years and with fine that may extend up to one crore rupees.

6.9.3 The Companies Act, 1956 may also provide the authority for the Court to impose punishment of imprisonment and/ or fine for various offences relating to corporate fraud as well as to offences relating to investigation in a cumulative manner, if in the opinion of the Court such punishment is warranted keeping in view the nature of the fraud.

6.10 Amendments required to various provisions of the existing Companies Act which have direct bearing on Corporate Frauds

(i) During investigation of various cases it has been observed that following sections of the Companies Act have substantial influence in regard to committing of corporate frauds. In addition some of the sections which regulate conducting of investigations and liability of auditor have also been covered in these recommendations. The present quantum of penalties for violation of these sections has been found to be grossly inadequate.

- (a) Section 63: Criminal liability for mis-statement in prospectus.
- (b) Section 68: Penalty for fraudulently inducing persons to invest money.

- (c) Section 77: Restrictions on purchase by company, or loans by company for purchase of its own or its holding company's shares.
- (d) Section 233: Penalty for non-compliance by auditor with sections 227 and 229 of the Act.
- (e) Section 372A: Inter-corporate loans and Investments.

(ii) Section 63 of the Companies Act provides for penalty for mis-statements in the prospectus. These penalties have not been found commensurate with the gravity of offence involved as often companies resort to false/mis-leading statements in prospectus with a view to collect large sums of investments from gullible investors. These false/mis-leading statements in the prospectus often lead to inducement of the investors to invest their hard earned money in the companies. Due to this, the unscrupulous managements are able to collect the crores of rupees from small investors and the investors are often left high and dry if the promises made in the prospectus turn out to be false and mis-leading. Presently the penalty provided for mis-statement in prospectus is compoundable also. **Accordingly, there is a need to provide for higher deterrent punishment, both in terms of imprisonment and monetary fine under section 63 of the Act, based on the amount of funds involved in public issue covered by the prospectus. The offence is also required to be made a non-compoundable one.**

(iii) Section 68 of the Companies Act provides for penalty for fraudulently inducing persons to invest money. On the basis of false, mis-leading promises and reckless statements in various statements or otherwise, the unscrupulous managements are able to collect the crores of rupees from investors. The offence under this section is also compoundable at present. **The offence under section 68 is also required to be made non-compoundable with imprisonment and monetary penalty linked with the quantum of investment so procured.**

(iv) Section 77 of the Companies Act places restrictions on purchase by company or making of loans by company for the purchase of its own or its holding company's shares. Investigations by the SFIO have revealed large scale rotation of funds and violation of

this section by resorting to purchase by companies of their own shares out of their own funds, through rotation of funds involving various closely related companies/entities controlled by the same set of management/promoters. This activity has been found to be a clear case of fraudulent action to present/create bogus equity shown to be out of promoters' funds in the prospectus leading to defrauding of gullible investors and creditors. **Presently, the penalty prescribed for violation of section 77 is merely a fine of ten thousand rupees which is too mild considering the gravity and consequential effects of the offence. Accordingly, there is an urgent need to provide for separate and stringent penalties both for the company and its officer in default. The offence may also be considered to be made non-compoundable with provision for imposition of penalty on the company and imprisonment and fine on the officers in default.**

(v) Section 233 of the Companies Act provides for penalty for non-compliance with section 227 and section 229 of the Act. These sections deal with the powers and duties of auditor (including form and content of auditors report) and signing of the auditors report. Investigations conducted by the SFIO have revealed that the auditors have generally acted in connivance with the unscrupulous management of the companies in perpetration of frauds. **Under this situation the penalty prescribed under section 233, i.e. a fine up to ten thousand rupees on auditor is considered to be too meager to act deterrent for the erring auditors. Therefore, there is an urgent need to make the offence non-compoundable with imposition of both imprisonment and a much higher monetary fine linked to the amount of remuneration received by him as auditor of the company. in addition, civil liability should also be imposed for restitution or compensation for the harm inflicted on the company as well as individual stakeholders who suffered on account of the acts, omissions or negligence of the auditors**

(vi) Section 372A of the Companies Act provides for making of inter-corporate loans and investments. Investigations by the SFIO have revealed that often companies resort to large scale making of inter-corporate loans and investments, in excess of limits

prescribed under this section eventually the funds are siphoned off from the company under investigation. Presently, the offence under this section is compoundable with maximum penalty by way of imprisonment up to two years or with fine which may extend to fifth thousand rupees. **Having regard to the gravity of financial implications and its contributory effect towards fraud it is necessary to make the offence under section 372A non-compoundable with enhanced amount of monetary fine linked to the amounts of loans and investments made exceeding the limits prescribed, besides imprisonment of suitable duration.**

6.11 Sections 539 to 544 apply to cases of companies under liquidation and deal with offences of falsification of books, frauds by officers, situations where proper accounts are not kept, fraudulent conduct of business of a company etc against the directors and officers of such companies. Further, under section 406 read with Schedule XI these provisions can be made applicable to cases where an application is made under section 397/ 398 of the Act with regard to mismanagement or oppression. These provisions provide a framework that enables the identification of directors and officers involved in fraud and fixing personal liability on them by lifting of corporate veil. The Committee recommends that these provisions should be made applicable to any finding of fraud with relation to affairs of the company rather than restricting them only to the cases of winding up and liquidation or mismanagement or oppression. This may be done by a special provision to be read along with the general definition of fraud.

6.12 In addition to the criminal liability arising out of act of fraud and the punishment for the same, it is equally important to provide for civil liabilities in terms of recovery of damages from the persons found guilty of fraud by those who are victims of fraud. The Companies Act provides for this principle under section 62 with regard to mis-statements made in a prospectus, a similar principle is incorporated in section 542 with regard to a company under liquidation, which can be extended to proven cases of mismanagement/ oppression. This principle needs to be articulated and extended to situations of fraud in a

company in general. **Therefore, the Companies Act may specifically provide for disgorgement of assets created from the proceeds of fraud from the properties of the company or its delinquent officers and directors on the principle that no one should be allowed to profit from fraud. In addition, the law should provide for recovery of damages caused to victims of fraud from the delinquent directors and officers of the company, or the company itself.**

6.13 Under Section 203 of the Companies Act powers are available to the Court to restrain fraudulent persons from managing companies or being concerned in the promotion of formation of such company for a period not exceeding five years as may be specified in that order. Under this provision, it may be provided in a manner similar to an undischarged insolvent under section 202 that a person convicted of the offence of fraud with regard to a company shall not be allowed to form, promote or manage a company. The upper limit of five years may be removed in such cases.

6.13.1 The concept of criminal negligence: In addition to the strengthening of the framework dealing with the process of uncovering and investigation of the process of fraud it is important to realize that the management of the company has a fiduciary responsibility to ensure that the affairs of a company are conducted in a manner that is above board and fair. Often when the directors and officers of the company actively collude or are negligent that frauds are perpetrated. Those who are found to be involved with fraud would of course be proceeded against under the provisions of the law. They must be held accountable for their role and mitigating factors, with regard to punishment for which they may be liable should be counterbalanced by the fact that they held position of trust and as such their offence was greater. At the same time others, who may not have actively participated but may have contributed to fraud indirectly or passively should also be held accountable. Particularly so if some knowledge of possible fraud or likelihood of fraud is attributable to them, or if they are found to have not exercised the required level of due diligence. **Such directors/ officers/ functionaries should be held guilty of the offence of criminal negligence which may be punished by monetary penalties along with civil liability. In addition to the directors and officers of the company the liability under these provisions should also extend to the Internal and**

statutory auditors of a company if they are found to have been negligent so as to have allowed or enabled a fraud to take place.

6.14 Obligations of auditors in the event of fraud: Where a company has been affected by fraud, there should be special provisions imposing duties of cooperation and provision of information on the part of the internal and statutory auditors of the company. Such obligations should override any commitment or obligation towards confidentiality of client information. The inspector investigating fraud, may by written notice, ask the internal and statutory auditors of the company to provide information with regard to the financial affairs of the company as may be appropriate under the circumstances. The auditors/ internal auditors, while not being officers of the company, should be bound by the same obligations as would apply to the officers of a company with regard to information being asked from them by the inspector. Such obligation should extend to notes and working papers of the statutory auditor/internal auditor. It would be possible for the inspector to make and retain copies of these documents or to furnish authenticated copies to other regulators such as the ICAI for purposes of disciplinary action by them as warranted.

6.15 Criminal and civil liability of auditors: Where statutory auditors of a company are actually found to be involved in fraud criminal and civil liability should also devolve on them in a manner similar to that for directors and officers of the company.

6.16 In a manner similar to that under section 9 of the UK Frauds Act, 2006, it should be an offence for a person knowingly to be a party to the carrying on of fraudulent business even where the business is not carried on by a company or (broadly speaking) a corporate body. Criminal and civil liability under the Companies Act may be extended to non-corporate entities as well.

6.17 An offence of fraudulent trading should be created under the Companies legislation if he any person is knowingly party to the carrying on of a company's business either with intent to defraud creditors or for any other fraudulent purposes. This should apply to persons knowingly party to the carrying on of non-corporate businesses in either of those

ways. Obtaining services dishonestly should also be defined as a new offence in a manner similar to Section 11 of the UK Act.

6.18 Liability of company officers for offences by company should also be specified where persons who have a specified corporate role are party to the commission of an offence under the Act by their body corporate. Such persons should also be liable to be charged for the offence as well as the corporation.

6.19 **Whistle blower provisions:** It is to be recognized that corporate fraud is rarely the result of actions of only one person acting alone. It is most likely to be the result of a group of persons who may have the knowledge of fraud being committed but may not wish to get involved, or may even be intimidated in remaining silent. Yet such person can shed light on whether and in what manner fraud is taking place in a company. It is important to incentivize such persons to cooperate and collaborate with the investigators. Therefore, the Committee recommends incorporation of whistle blower sections in the Companies Act that enable the person blowing the whistle on fraud to be imposed a lesser penalty or even be acquitted. Further there should be protection of employment of such person, with provision of monetary compensation if he chooses to leave the company.

Chapter 7 PROVISIONS TO BE INCLUDED IN THE EXISTING COMPANIES ACT RELATING TO INVESTIGATION OF FRAUDS HAVING CROSS BORDER IMPLICATIONS.

7.1 Provisions for dealing with investigation of frauds having cross border implications: During the course of investigation of fraud, generally it is found that suspected fraud has links outside the country either in execution of fraud or siphoning of proceeds of fraud outside the country. National borders rarely prove to be barriers to determined fraudsters. Investigations by SFIO have revealed that in many cases corporate frauds have roots in foreign countries. In either case proceeds resulting from fraud may be siphoned out of India. Presently SFIO does not have any mechanism or authority to question suspects or connected persons located abroad, or to collect evidence and relevant materials to complete the investigation properly in case the persons concerned located in India fly the country. It has been noticed in various investigations that offshore accounts are used for siphoning off money from the company through front entities located abroad. Successful investigation requires following the trail of movement of funds as well as piercing the corporate veil in case of front entities. This is possible only through proper legal and administrative mechanisms. Therefore, for offshore fraud investigation, it is necessary to enter into **Mutual Legal Assistance Treaty (MLAT)** with concerned overseas authorities for seeking their assistance in collection of necessary evidence from their jurisdictions or getting the alleged fraudster extradited. So far, no such provisions exist in the present Companies Act to enter into the MLAT with overseas authorities. **In order to collect admissible evidence on various issues related to fraud, it is imperative that suitable provisions are made in the Companies Act for getting letters rogatory issued on the lines of provision in Prevention of Money Laundering Act and sections 166A and 166B of Criminal Procedure Code.** This will help in collection of documentary evidence from agencies located abroad, recording of statements of foreign and Indian nationals settled abroad, and also taking the help of outside investigative agencies in accessing their database as well as obtaining local information. **SFIO should also enter into reciprocal agreements for mutual assistance**

with other agencies which may be involved in the collection of economic collection of intelligence of and investigation of fraud .

7.2 It may also be appropriate to provide for a mechanism to collect evidence by way of sending letters rogatory (letter of request) from outside India and for examination of a person residing outside India, by inserting suitable provision in the Act and authorizing a suitable authority to issue the same.

7.3 Suitable provisions may be incorporated in the Companies Act, similar to the provisions of Sections 55 to 61 of “The Prevention Of Money Laundering Act, 2002”, which deals with seeking mutual legal assistance from overseas authorities for collection of evidence as well as attachment of properties outside the country.

Chapter 8 THE MECHANISM FOR COORDINATION OF INVESTIGATIONS BY SFIO AND FOLLOW UP THEREOF WITH OTHER AGENCIES/ORGANISATIONS OF THE CENTRAL AND STATE GOVERNMENTS, INCLUDING INVESTIGATION:

8.1 The Naresh Chandra Committee in its report had observed that the success of operations to be entrusted to the proposed CFSO (now SFIO) would chiefly depend upon the level of coordination that can be achieved among the various enforcement agencies. It would be prudent to anticipate inter-departmental disputes as one or the other agency would be reluctant to share with others the jurisdiction vested in it under law or extant orders of Government.

8.2 Therefore, for coordinated and speedy progress of investigation by SFIO with proper coordination among all agencies/departments of Government, regulating activities of the company under investigation, Naresh Chandra Committee recommended setting up of a high-level coordination committee to monitor, review and direct progress of cases handed over to the SFIO. Similarly, Dr. L.N. Mitra Committee recommended setting up of a fraud detection committee, jointly constituted by nominees from all financial regulators to make a preliminary inquiry about the allegation and advise the regulator either to refer the matter to the investigating authority, if there is an offence committed as alleged or deal with such incidences of contractual or tortuous fraud that might be committed by the parties.

8.3 **This Committee is of the view that the Corporate Fraud Task Force (CFTF) of U.S.A, which focuses on both enhancing the criminal enforcement activities within the Department of Justice, and on maximizing cooperation and joint regulatory and enforcement efforts throughout the federal law enforcement agencies provides a suitable model for adoption in India. Accordingly it recommends that a High-Powered Committee on a pattern similar to CFTF of USA be constituted by the Central Government having senior level officers of proven**

integrity, experience and expertise in matters of financial transactions, investigations and economic offences as members.

8.4 There should be an institutional arrangement for sharing of the confidential information and intelligence gathered by financial regulators such as banks, insurance, capital market and other financial institutions as well as intelligence agencies of Central and State Government relating to the entity under investigation.

8.5 The High Powered Committee which may be termed as the Committee for Investigation and Monitoring of Fraud should be empowered by the Central Government to coordinate with other enforcement and regulatory agencies and monitor, review and direct the progress of investigation of cases referred to SFIO and prosecution of offences detected there from and to enable cooperation and coordination on the part of various ministries /departments/ government agencies as well as state governments. In particular, this high powered Committee may be empowered to decide on the lead investigating agency depending upon the merits and circumstances of the case and to decide on the manner of support and sharing of information, staff and other resources by other investigative agencies/bodies with the lead agency.

Chapter 9 NEED FOR SPECIAL COURTS FOR TRIAL OF CORPORATE FRAUD CASES:

9.1 At present prosecution for violations of existing provisions of the Companies Act are being filed in the Companies Court constituted one each in every State separately. In such Courts, there is already a large number of pendency of cases of routine nature relating to technical and procedural violations of the provisions of the Companies Act. If cases relating to financial fraud committed by corporate are filed in such courts, it would take considerable time in deciding the matter and thus the whole purpose of dealing with corporate frauds in swift and purposeful manner as pointed out by Naresh Chandra Committee, Malimath Committee and Dr. L.N. Mitra Committee as well as Joint Parliamentary Committee would be defeated.

9.2 Considering the recommendations of above mentioned committees and JPC, it is felt necessary that special courts may be constituted for speedy trial of the cases relating to serious nature of criminal offences such as financial fraud committed by corporate. Number of such courts may be decided depending upon the detection of frauds committed by corporates from time to time. Necessary provisions for constitution of such special courts, their power and functioning may be incorporated in the Companies Act.

9.3 **Accordingly, in order ensure speedy disposal of the prosecutions based on SFIO reports, it is proposed that Companies Act may be suitably amended so as to provide for establishing of special courts, vested with requisite civil and criminal jurisdiction, to deal with company matters including cases involving fraud.**

Chapter 10. PROPOSED ORGANISATIONAL STRUCTURE OF SFIO FOR EFFECTIVE AND COORDINATED INVESTIGATION AND LAUNCHING OF SUCCESSFUL PROSECUTION

10.1 The Serious Frauds Investigation Office (SFIO), though envisaged on the lines of Serious Frauds Office (SFO) of the UK, is not set up or constituted on a statutory basis. The SFIO is functioning as an administrative organization attached to the Ministry of Corporate Affairs and carries out investigations under the Companies Act, 1956. Cases of serious fraud are entrusted to officers drawn from the SFIO under Section 235 of the Companies Act, 1956. Thereafter, such inspectors exercise the powers vested of them under the Companies Act. The SFIO is conceived as a professional unit that brings together multi-disciplinary teams to investigate complex corporate frauds. This organizations is not intended for carrying out routine investigations. More specifically, the SFIO is to take up investigation of frauds characterized by:

- a) Complexity, having inter-departmental and multi-disciplinary ramifications;
- b) Substantial involvement of public interest to be judged by size, either in terms of monetary misappropriation, or in terms of the persons affected;
- c) The possibility of investigations leading to, or contributing towards a clear improvement in systems, laws or procedures.

10.1.1 The SFIO started its operations from October 2003 and since then it has set up a full-fledged office in Delhi and one Branch Office in Mumbai. Director SFIO, an officer of the level of Joint Secretary/ Additional Secretary to the Government of India, was appointed by obtaining his services from the Central Government on deputation. A team of 12 Addl./Jt. Directors of the level of Director/Dy. Secretary to Government of India and 26 Assistant Directors, drawn from different investigating agencies and departments dealing with auditing, taxation, capital market, banks etc was assembled. So far, this organization has been entrusted with investigation into the affairs of 69 companies. It has completed investigation in 38 cases. Prosecution has been approved in 31 cases and also filed under various provisions of the law.

10.2 Fraud is a crime of very complex nature. Success of prosecution in such cases depends upon thorough investigation and proper collection of evidence. For this purpose, in addition to the statutory framework, it is essential that the institutional arrangements are also adequate for the performance of a complex role. In this context it is important to ensure that the institutional and organizational environment is conducive to carrying out of complex investigation involving a group of experts from multi disciplinary background. A very useful measure was adopted when the SFIO was set up. This organization has done well in investigation of corporate frauds so that perpetrators of such actions may no longer rest content that their deeds would never be discovered behind the corporate veil. The organization, however must continue to grow in response to growing needs and expectations. The following organizational issues may however be considered in context of the SFIO for its further development.

Organisational structure

10.2.1 Presently SFIO, headed by a Director, has the following four divisions:

- i) Investigation Division
- ii) Technical Analysis & Research Division
- iii) Legal Assistance and Prosecution Division
- iv) Administration Division.

10.2.2 SFIO needs to be equipped to take up research and analysis to study market information, company data and information to assess situations of potential fraud. It would also be appropriate to do some research on modus operandi used by fraudsters in different situations. This Division would also study the international experience in investigation of cases involving fraud, carried out by the investigative agencies of various countries to analyse the procedures and systems followed in those countries. **For this purpose, Market Analysis and Risk Management division which may be created in SFIO. Sectoral studies and trend analysis may also be taken up. This division may also take up information sharing and coordination with other enforcement and regulatory agencies, banks, financial institutions and the MCA 21 database, etc.**

Information gathered by this Division may be analyzed and risk management strategies evolved to record unusual behaviour on the part of a company or a group of companies. This would enable development of Risk Based Management System which after evaluating various parameters could throw up possible signals of fraud. The value of this analytical work would be to identify aberrant behaviour, the modus operandi adopted and investigation experience in different situations.

10.2.3 The **“Investigation Division”** of SFIO which, indeed, would comprise major part of the organization, may consist of a number of Units, each including officers from diverse disciplines and organizations. These Units may be assigned the job of investigation as required. Number of such Units may be decided depending upon the workload. During the course of investigation by the Units of this Division, necessary assistance may be provided to these Units by various other divisions. Officers in Investigation Division may be drawn from such organizations, which are involved in investigative work, viz., Indian Police Service, Indian Revenue Service (Income Tax, Customs and Excise), Central Bureau of Investigation, Intelligence Bureau, Enforcement Directorate and such other organizations.

10.2.4 SFIO may also include a **“Technical Analysis Wing”** responsible for helping the investigating team in examination of the documents, unraveling and discovering data hidden by companies behind complex computer programmes and codes, assist in forensic audit of financial information relating to the company, provide technical inputs in cracking the computerized accounting systems and their processes adopted by companies. It is imperative to have an adequately equipped Cyber Forensics Division in SFIO so that this office is not found wanting in this area, whenever an investigation is assigned. Necessary action to recruit and train required manpower in this field may also be initiated.

10.2.5 **“Legal Assistance and Prosecution Division”** which has been recently created may be strengthened and should function as a unit independent of investigation division. At present prosecution is being handled by officers from investigation and other

divisions. This division may engage lawyers in addition to officers of Indian Legal Service and Indian Company Law Service who provide in-house legal inputs. This division may be responsible for providing legal assistance during the course of investigation to "Investigation Division" and also filing of prosecution after completion of investigation and their follow-up in the Court. This Division may also look after the MLAT being entered by SFIO with the authorities of other countries. Such Prosecution Division in the SFIO may be created headed by an Additional/ Joint Director (Law) with 4-5 officers of the rank of Assistant Director, which may be obtained on deputation from various organizations if need be.

10.2.6 Human resource development should be a continuous , ongoing effort in the SFIO. The "**Administration Division**" of the SFIO, besides being responsible for administrative work relating to the operations of the SFIO, financial administration, budgeting and service matters of the officers and staff of the SFIO, should also be developed to address the specialized training and capacity building requirements of the officers of SFIO.

10.2.7 In SFIO, investigations are assigned to a group of officers headed by Additional/ Joint Director. The other members of the team are Sr. Assistant/Assistant Directors, who are required to scrutinize the documents and other records, record the statements for the purpose of investigation to unearth the fraud. The officers at this level being the mainstay of investigation are expected to be the best in their field. SFIO at present has 59 posts at this level in PB 2 (plus grade pay of Rs. 4800). **In order to attract the best talent available across different departments like Customs and Central Excise, Income Tax, Enforcement Directorate, Intelligence Bureau, C & AG, and other ministries and departments, it is recommended that these posts may be upgraded and grade pay be raised.**

10.2.8 In addition to the above permanent structure, **it is recommended that Director SFIO may be empowered to outsource the services of experts like Chartered Accountants, Cost Accountants, Legal Experts, and Experts in the field of Cyber**

Forensics and Computers etc. at the rates prescribed by their respective institutes / governing bodies. Director SFIO may make suitable panels for each category and experts may be selected out of the panel as per requirement suiting to a particular investigation. In doing so issues relating to confidentiality, protection against misuse of confidential data or privileged position and conflict of interest would also need to be addressed.

Organisational Sustainability

10.3 Currently SFIO is manned entirely by officers drawn on deputation from other government agencies and departments. **To provide continuity, which is very essential for an organization of this kind where institutional memory needs to be built up to contribute to the available knowledge and expertise in the subject, in addition to extremely sensitive matters and records to be kept and maintained, it is recommended that a structure comprising of permanent and tenure based officers be created.** The permanent cadre could be to the extent of 25% of total posts in various selected divisions except Administration division, where this could be 50%. This permanent cadre could comprise officers recruited by SFIO from time to time. There should also be provision for lateral entry and permanent absorption as well. Rest of the posts, not less than 50% in each division, may be filled up on tenure basis. Some of the posts in case of Investigation Division could be considered for encadrement, in other cadre controlling authorities such as Central Bureau of Investigation, Enforcement Directorate, Income Tax, Intelligence Bureau, Customs & Central Excise etc. Balance posts in this division may continue to be filled up on deputation or recruitment basis so that fresh and new talent is available. Similarly, Legal Assistance and Prosecution Division could also have some (25%) of the posts encadred in respective cadres of Ministry of Corporate Affairs and Ministry of Law. Balance 50% of the posts in all these divisions may continue to be filled up on deputation or recruitment. To provide promotional avenues to the proposed permanent cadre, it would be necessary to earmark some posts of Deputy Directors and Joint Director.

10.3.1 Since 50% of the posts in SFIO are proposed to be filled up by deputation, it is essential that the terms and conditions and remuneration package attached to these posts are so designed to attract the best talents available. **It is hence recommended that the officers joining SFIO on deputation from other departments like CBI, IB, ED, SEBI and Banks etc. are ensured protection of their existing pay, allowances and perks. In addition, all the officers posted to SFIO should be granted Investigation Allowance at the same rate and terms as applicable to officers in CBI and National Investigation Agency.**

10.4 Organisational Structure: The organizational structure of the SFIO should not be excessively rigid or hierarchical. Rather SFIO should have a flat structure so that it may constitute teams of experts quickly under team leaders to carry out investigations. The investigation team to investigate a corporate fraud may be constituted by Director SFIO with officers from different disciplines as per the requirement of investigation. In addition SFIO may also set up regional offices in selected locations across the country. This would improve the speed of response, coordination of investigation and prosecution with local authorities.

Training of the Officers of SFIO for skill Development

10.5 SFIO as an organization is engaged in the investigation of complex nature of cases relating to fraud which involve highly technical skills and knowledge of financial transactions, capital market, auditing and account etc. Therefore, officers of this organization are required to be trained in such fields from time to time. The investigation of fraud in India is a very new concept and, therefore, specialized training in such field is not readily available in other organizations or institutes dealing with or imparting training in investigation of crime. As informed to the Committee, certain officers of this organization were trained in CBI Academy at the time of formation of this organization.

10.5.1 Training in forensic auditing and other accounting frauds is being imparted in certain institutes and organizations in overseas countries. As informed to the Committee, necessary correspondence is being exchanged by the SFIO with such institutes and organizations for developing a training programme for the officers of SFIO. It is suggested that a comprehensive training programme for training of the officers of SFIO in investigation of fraud may be developed in association with the institutes/organizations engaged in investigation of crime either in India or abroad.

10.5.2 Besides training at foreign institutes, possibility could also be explored of organizing training on Fraud Investigation Techniques etc. in India in collaboration with leading training institutes in this field. Similarly, skill updation programmes could be organized in the field of banking, capital market, intelligence gathering, investigation and prosecution etc. either in India or in concerned training institutes in other developed countries. SFIO should have regular interaction with other fraud investigating agencies of the world like SFO UK, FBI USA etc. for skill development and capacity building of the investigating teams.

10.5.3 As recommended by the Irani Committee, SFIO, set up by the Central Government, should serve as a Nodal Agency for development of such expertise and its dissemination to the State Governments, who may also be encouraged to set up similar organizations and provide requisite specialization as a part of their action against economic offences.

Administrative and Financial Autonomy

10.6 Necessary financial and administrative autonomy to SFIO may be considered so that day to day functions of SFIO are carried out smoothly. For smooth functioning of SFIO full powers need to be delegated to Director/SFIO especially in the following areas:

- a) Hiring of best legal counsels for assisting the investigation, vetting of report and for prosecution. Director SFIO should be empowered to hire counsels even at special rates if need be.
- b) Outsourcing of manpower requirement whether in the field of computer experts like in areas of cyber forensics, Data Entry Operators or programmers or Chartered Accountants in the field of Forensic Audit or capital Market or Cost accounting or bankers etc.
- c) Purchase of computer hardware or software

Annexure I

F.No.2/1/2004-CL.V
Government of India
Ministry of Company Affairs

'A' wing, 5th Floor, Dr. R.P. Road
Shastri Bhavan, New Delhi – 110001.
Dated: 23rd February 2006

ORDER

Sub: Constitution of an Expert Committee to advise the Government on issues concerning the Serious Fraud Investigation Office.

The Serious Fraud Investigation Office [SFIO}, established to investigate corporate fraud, has been constituted to function under the Ministry of Company Affairs since its establishment. The SFIO has gained experience by investigation of cases involving corporate fraud referred to it. It is now proposed to consider measures to strengthen the organization and to further streamline its functioning with a view to making it more effective.

2. It has, therefore, been decided to constitute an Expert Committee consisting of the following to examine various issues relating to the SFIO as per the Terms of Reference indicated below and make recommendations to the Government:-

<u>Sl.No.</u>	<u>Name of Person/Institution</u>	<u>Position</u>
1.	Shri Vepa Kamesam, Ex-Dy. Governor, RBI	Chairman
2.	Shri M.M.K. Sardana, Member, MRTP Commission	Member
3.	Shri B. Swarup, IRS [Retd.], Member, Income Tax Settlement Commission.	Member
4.	Shri G. Anantharaman, Whole-time Member, SEBI.	Member
5.	Shri O.P. Verma, Deputy Government Counsel,	Member

M/o Law and Law and Justice

6. Representative of Central Bureau of Investigation* Member
7. Shri Jitesh Khosla, Joint Secretary, MCA Member-Secretary

3. The Terms of Reference of the Expert Committee referred to in para 2 above are:-

To make recommendations to the Government on:-

- a) Assessment of the need for and details of a separate statute to govern the constitution and functioning of SFIO;
- b) The nature and details of the legislative changes as may be required in existing laws, to enable effective functioning of SFIO including prosecution of offences detected by it;
- c) The mechanism for referral of cases to SFIO and coordination of activities of SFIO with other agencies/organizations of the Central and State Governments, including investigating;
- d) Powers of SFIO and its investigation officers;
- e) Specification of offences and penalties to enable effective conduct of investigation agencies and the need for Special Courts for trial of corporate fraud cases; and
- f) Other matters consequential to or in pursuance of the above.

4. Secretarial assistance to the Committee will be provided by the Ministry of Company Affairs.

5. The Committee will submit its report to the Ministry within 3 months from the date of its constitution.

Sd.....
[L.M. Gupta]
Director [Inspection & Investigation]

Copy to:-

Chairman and all Members of the Committee.

PS to Minister, Company Affairs/All Officers in MCA
*** Sh. Navneet Ranjan Wasan**

Annexure III

i) Extract from Sl.No.176, Para No.10.85 of JPC

Another related problem is the issue of 'financial frauds'. During the year 2000-01, RBI in its report on Trend and Progress of Banking in India (2000-01) reported 50 cases of large value frauds (Rs.1 crore and above) involving Rs.506.34 crore. The major factors facilitating the perpetration of frauds include non-observance of laid-down systems and procedures of bank functionaries, nexus or collusion of bank staff with the borrowers/depositors, negligence on the part of the dealing officials/ branch managers, failure of internal control systems, inadequate appraisal of credit proposals and ineffective supervision. During the course of the present examination, similar irregularities were noticed in the case of private as well as co-operative banks. **Moreover, there is no separate Act under which scamsters can be booked and even in cases where criminal proceedings are launched cases drag on for years together in Courts, with the result that the perpetrators of frauds are seldom punished.** The Committee were informed that in 1991, the Ghosh Committee was set up to enquire into various aspects relating to frauds and malpractices in banks. The Committee had made about 125 recommendations, most of which were accepted by RBI and implemented. However, with a view to examining certain legal aspects including attempting a definition of Financial Fraud and laying down procedural guidelines to deal with financial fraud, recently another Committee under the Chairmanship of Dr. L.N. Mitra was set up. The recommendations of the Mitra Committee are in two parts – Part I deals with recommendations which can be implemented without any legislative changes and are preventive in nature and Part II requires legislative changes for implementation. Some of the important recommendations contained in Part II include a separate Act to deal with financial fraud, making financial fraud a criminal offence, placing special responsibility on the regulator, setting of a separate institution for investigation, special courts for trying cross-border financial frauds as well as all offences under the proposed Financial Fraud Act. Though as reported by the RBI, all the recommendations under Part I have been accepted and instructions issued on 3/5/2002, the recommendations under Part II are yet to be implemented. **The Committee desire that since these recommendations have an important bearing on the sound functioning of our financial system, the same should be implemented expeditiously.** The Committee express regret at the tardy manner in which the issue of financial fraud has been addressed by the RBI although the Ghosh Committee (1991) and the L.N. Mitra Committee (2001) have highlighted this issue. Despite the recommendations of the L.N. Mitra Committee in September, 2001, no effective mechanism has been put in place including the enactment of proposed Financial Fraud Act to deal with this problem.

ii) Extract from Sl.No.199, Para No.12.80 of JPC

The Committee find that human resource constraint has been almost a perennial problem in the CBI, as during the course of the enquiry of the earlier JPC also, the same problem was spelt out. The Committee are, however, concerned to note that the situation has not improved even after a lapse of almost a decade, since even at present about 50% vacancies

exist in the CBI, including its Economic Offences Wing, which is a crucial arm of the investigative agency. Though it is imperative that a premier investigative agency like the CBI should not be allowed to remain incapacitated for want of both men and material, but at the same time the Committee find that basically CBI is a police organization and is not fully equipped with competent and qualified personnel for investigating into intricate financial matters. This handicap has also been expressed quite explicitly by the representatives of the CBI before the Committee. Taking into account, the new technological innovations where electronic modes are likely to be adopted for undertaking various types of financial transactions, it is imperative that persons investigating the economic offences are fully qualified and trained to handle the complex and diverse nature of transactions with a sense of competence and necessary acumen. The Committee find that the expert Committee on Legal Aspects on Bank Frauds set up under the Chairmanship of Dr. N.L. Mitra in their report submitted on 31.8.2001 to RBI have also, after having delved deep into the matter, observed that on account of involvement of CBI in multifarious activities, it would be prudent to have a separate multi-faculty investigative institution to deal with financial frauds. The Committee are given to understand that the Government is also seriously pondering over the issue and setting up a separate Serious Fraud Office on similar lines as in the United Kingdom (U.K.). The Committee are inclined to agree with this current thinking and recommend that a separate body be set up to investigate into all incidents of serious frauds and necessary legislation in this regard be enacted. Besides, the jurisdictional powers of such an organization should not be limited to conducting investigation against the employees of the Central Government/Public Sector Undertakings of the Government of India but should be comprehensive, covering offences committed even by the employees of the State Governments/organizations as well as those who are in the private sector.

Annexure IV

Copy of Order dated 2.7.2003 of SFIO

(TO BE PUBLISHED IN THE GAZATTE OF INDIA, PART-1, SECTION 2)

Government of India
Ministry of Finance
Department of Company Affairs

5th Floor, "A" Wing, Shastri Bhavan
New Delhi – 110 001, July 02, 2003

RESOLUTION

The Government of India has set up a Serious Fraud Investigation Office (SFIO) in the Department of Company Affairs. It will investigate corporate frauds. The SFIO will consist of a multi-disciplinary team which includes experts in the field of accountancy, forensic auditing, taxation, information technology, capital markets, financial transactions etc. The SFIO will function within the existing legal framework and carry out investigations under Sections 235 to 247 of the Companies Act, 1956.

The SFIO will only take up investigation of frauds characterised by : (a) complexity, and having inter-departmental and multi-disciplinary ramifications; (b) Substantial involvement of public interest to be judged by size, either in terms of monetary misappropriation, or in terms of the persons affected, and (c) the possibility of investigations leading to, or contributing towards, a clear improvement in systems, laws or procedures.

The SFIO would be headed by Director (of the level of Joint Secretary/ Additional Secretary) as Head of the Department for all financial and administrative purposes.

Sd/-
[SHEELA BHIDE]
Joint Secretary to the Govt. of India
Tel. : 2338 1226

No.45011/16/2003-Admn.

New Delhi, dated the 02nd July, 2003

ORDER

1. Ordered that a copy of the resolution be communicated to all Ministries/Departments of the Govt. of India/all State Governments/Union Territory Administrations/Director, Intelligence Bureau/Director, Central Bureau of Investigation, Delhi.

2. Ordered also that the Resolution be published in the Gazette of India for general information.

Sd/-
[SHEELA BHIDE]
Joint Secretary to the Govt. of India
Tel. : 2338 1226

To

The Manager,
Government of India Press
FARIDABAD (HARYANA) – (with Hindi Version)

