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CONTENTS

A Development Reading of India’s Cases in the World Trade Organization
Dr. Pallavi Kishore ................................................................. 1

When 90% Of The Loans Are Exceptions To The Rule, There Is No Rule: Navigating Through Post-Financial Crisis Regulation And Wall Street’s Caveat Emptor Defense
Eve Mizerak ........................................................................ 23

A Competition Act by India, for India: The First Three Years of Enforcement Under the New Competition Act
Dorothy Shapiro ................................................................. 59

Enrico Baffi ................................................................. 100
A Development Reading of India’s Cases in the World Trade Organization

Dr. Pallavi Kishore

ABSTRACT

The World Trade Organization (WTO) agreements contain certain distinct provisions for developing countries called Special and Differential Treatment (S&DT) that allow for increased market access for developing country exports and some protection for their markets. Therefore, the WTO aims to achieve development by these two methods. Indeed, India has been following the same economic policy evident from an analysis of its five year plans.

One of the principal organs of the WTO is the Dispute Settlement Body (DSB). This article mainly looks at the cases involving India as complainant with a focus on the reports issued by the DSB. It analyses the interpretations of the agreements by the DSB in these reports to find out whether and how they correspond with the objectives of the WTO (and of India) including S&DT.

CONTENTS

I. INTRODUCTION
II. ANALYSIS OF CASES
III. CONCLUSION

1 This is a modified version of the paper A Critical Analysis of the WTO DSS in the Light of India’s Cases that was presented at the Sixth International Conference on International Law in the Contemporary World, Indian Society of International Law, New Delhi, India, 1-4 February 2009 and appeared in the Sixth International Conference on International Law in the Contemporary World Conference Proceedings, Indian Society of International Law, 359-374 (2009).
2 Assistant Professor and Assistant Director, Centre for International Trade and Economic Laws, Jindal Global Law School, O.P. Jindal Global University, Sonipat, India.
I. INTRODUCTION

“… [R]elations in the field of trade and economic endeavour should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, and expanding the production of and trade in goods and services, while allowing for the optimal use of the world’s resources in accordance with the objective of sustainable development, seeking both to protect and preserve the environment and to enhance the means for doing so in a manner consistent with their respective needs and concerns at different levels of economic development,

… [T]here is need for positive efforts designed to ensure that developing countries, and especially the least developed among them, secure a share in the growth in international trade commensurate with the needs of their economic development,…”

This is an extract from the Preamble to the Agreement establishing the World Trade Organization (WTO).\(^3\) The Preamble sets out the goals of the WTO and also provides a definition of development. The aim of the WTO is to work towards the achievement of the goals stated in the Preamble. For this, the WTO agreements contain some distinct provisions for developing countries called Special and Differential Treatment (S&DT). These provisions allow for increased market access for developing country exports and some protection for their markets. Therefore, the WTO aims to achieve development by these two methods i.e. by increased market access and protection.

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\(^4\) A country is defined as a developing country based on self-selection.
India has been following the same economic policy which is evident from an analysis of its foreign trade policy (five year plans) from 1947 onwards. This policy is also reflected in India’s relations with the WTO.

Since this article looks at India’s cases in the WTO, a brief description of the role of the Dispute Settlement System (DSS) follows. The Dispute Settlement Understanding (DSU) has been touted as one of the most significant achievements of the Uruguay Round (UR). The DSS steps in only if the members do not fulfil the obligations they have undertaken in the negotiations. The DSS’ role is, therefore, very important because it tries to get the members to implement their commitments regarding market access. The DSS has to interpret the legal provisions in a manner which is consistent with the advancement of goals as defined in the law. Therefore, the DSS has a huge responsibility.

The DSU has resulted in greater legalisation of the dispute settlement (DS) process,\(^5\) thus leading to the expectation that developing countries could derive more benefit from it. The use of the DSS is greatly dependent on the resources of each member country. Therefore, one would think developing countries do not make much use of this mechanism. But India belies this claim. India is a big developing country member of the WTO and plays an important role in DS not only as a party but also as a third party. The legalisation of the DSS has contributed to India becoming an active litigant. It pursues and defends various kinds of systemic and commercial interests. India has challenged and has been challenged by the most powerful members of the WTO i.e. the United States (US) and the European Communities (EC). Increasingly though, there have been cases involving other developing countries also.

Moreover, there are cases in which India is a joint complainant with other members, including developed and developing country members.

This article examines the issue of development through the lens of DS involving India by analysing how India uses the DSS. The Preamble to the WTO Agreement talks of development so the DSS must help achieve development as must all other organs of the WTO. Consequently, the issue being considered is – to what extent does the DSS fulfil India’s developmental goals through litigation? This article mainly looks at the cases involving India as complainant though it will also dwell briefly on cases in which India was a respondent. Some cases are pending and some have been settled with the help of a mutually agreed solution. This article examines a number of these cases but the focus is on the reports issued by the panels and Appellate Body (AB). It analyses the interpretations of the agreements by the DSS in these reports to find out how these interpretations correspond with the objectives of the WTO (and of India) including S&DT and whether or not these interpretations further development as mentioned in the Preamble to the WTO Agreement and stated by panels in cases such as the EC – Tariff Preferences case. In other words, it examines whether the panels and AB in India’s cases have applied the WTO agreements to promote development which is the goal India hopes to achieve. If India has to file cases to get market access commitments enforced and is not always successful, what would be the condition of other less powerful developing countries? Moreover, an examination of India’s arguments illustrates India’s legal strategy in the DSS and the quality of its legal analysis and arguments.

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6 Of course, as one Delegate from the Indian Mission to the WTO clarified, the DSS is only one of the components to achieve India’s objectives in the WTO.

7 WT/DS246 European Communities — Conditions for the Granting of Tariff Preferences to Developing Countries.
Interviews in the WTO revealed that the DSS was not viewed as an instrument of development. Development primarily meant S&DT provisions and the preambular language was not considered obligatory. One expert, though, felt that the link between market access and the DSS was the latter’s ability to compel members to implement commitments undertaken in the negotiations.

There is diverse literature on developing countries (including India) and the WTO (including the DSS). Most of this literature does not relate to the substantive interpretations of the WTO agreements. In two separate studies for the International Centre for Trade and Sustainable Development (ICTSD), Shaffer and Qureshi explicitly state that the DSS can contribute to development. Shaffer links market access to the DSS thus recognising the latter’s role in enforcing market access commitments. His central thesis is the improvement of the DSS in favour of developing countries to get their WTO rights enforced. Hence, it is clear that the WTO DSS has an important role to play in development.

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8 One expert also stated that market access does not always lead to development even though there is a presumption in the WTO that liberalisation and market access lead to development.
Thus, some of the literature touches upon DSS and development but it does not do so taking India’s cases as a base. The basic premise of the WTO is liberalisation of markets for freer trade i.e. increase in exports especially those from developing countries. As stated above, the DSS must contribute in achieving the goals of the WTO and therefore an analysis of the DSS’ contribution to enforcing market access commitments would be useful. Moreover, this would contribute to the study of the efficacy of one of the principal mechanisms of the WTO i.e. the DSS in the case of a large developing country i.e. India.

II. ANALYSIS OF CASES

There have been a number of reports of the panels and AB involving various agreements in cases of market access. An analysis of the findings of the DSS in each case shows that there are instances where the interpretation may not necessarily lead to enhancement of market access or development even though India might have won the case.

One of the cases directly relevant to differential market access is the EC – Tariff Preferences case. In this case, the European Generalised System of Preferences (GSP) scheme included five arrangements for granting preferences. The EC granted additional preferences to eleven countries through arrangements meant to combat drug production and trafficking. In 2001, the EC added Pakistan to this list. As a result, India’s textiles exports to the EC declined. India tried bilateral consultations but when they failed, it filed a complaint as a last resort because of the important systemic implications of this case. According to an expert from the Advisory Centre on WTO Law (ACWL), the twelve beneficiaries were going against all other developing countries by taking advantage of being on a closed list and India was actually taking into account the interests of all other developing countries. India’s argument preempted any defence the EC could take because it claimed a violation of the Most Favoured
Nation provision and the exception (Enabling Clause) i.e. India claimed a violation of footnote 3 of the Enabling Clause.\footnote{This footnote reads as follows: “As described in the Decision of the CONTRACTING PARTIES of 25 June 1971, relating to the establishment of "generalized, non-reciprocal and non discriminatory preferences beneficial to the developing countries" (BISD 18S/24),” Differential And More Favourable Treatment Reciprocity And Fuller Participation Of Developing Countries Decision of 28 November 1979 (L/4903).} Even though discrimination is commonly understood to mean unjustified differentiation, India argued that any distinction (even between different categories) was discriminatory. India's argument was counterproductive because it might have greater needs and so require greater preferences but it said that needs were not to be taken into consideration and equal preferential treatment should have been granted to all beneficiaries. The reason for taking this line of argument was that market access benefits had been shifted from India to Pakistan and India had lost its textiles exports to the EC due to additional preferences granted to Pakistan. The AB held that it was possible to include non-discriminatory conditions (as defined in the Agreement establishing the WTO or in international instruments\footnote{Paragraph 163, WT/DS246 EC – Tariff Preferences AB Report.} in GSP schemes as long as identical preferences were granted to similarly-situated beneficiaries.

Because the AB reaffirmed paragraph 3(c) of the Enabling Clause\footnote{This paragraph reads as follows: “Any differential and more favourable treatment provided under this clause: (c) shall in the case of such treatment accorded by developed contracting parties to developing countries be designed and, if necessary, modified, to respond positively to the development, financial and trade needs of developing countries,” Differential And More Favourable Treatment Reciprocity And Fuller Participation Of Developing Countries Decision of 28 November 1979 (L/4903).} i.e. the AB stated that it was enforceable, there will now be constraints on conditionalities. India had a sweeping victory at the panel stage because the Panel said that no differentiation was allowed. Compared with this, the AB ruling might not appear that good. But compared with the contention that there are no restrictions on the right of preference givers to include
conditionalities in their GSP,
the AB ruling looks good. Theoretically, India could get preferences based on its specific needs but only on the fulfilment of certain conditions which are AB-legal. If countries are unable to fulfil these conditionalities, they will lose out on additional preferential market access. Therefore, the extent to which the AB’s criteria responds to a need (paragraph 3(c) of the Enabling Clause) and enhances market access is a debateable issue. Moreover, the use of international instruments is recognition of the entry of non-trade values in the WTO to which India is opposed as they might hamper market access.

In US - Shrimp, India argued that the respective needs and concerns at different levels of economic development of different countries should be taken into consideration as stated in the Preamble to the WTO Agreement. But, the AB chose to refer to “sustainable development” instead of “respective needs and concerns at different levels of economic development” in the Preamble. It held that the import prohibition on shrimps from the complainant countries was in accordance with article XX(g) of the General Agreement on Tariffs and Trade (GATT) but violated the chapeau of article XX. The US was asked to make the prohibition non-discriminatory. Whether or not the prohibition was non-discriminatory was indeed important for market access in this case. In fact, when the US changed its measure to make it non-discriminatory, the complainant countries could not challenge it any more.

The right to impose trade restrictive measures in accordance with article XX involves a lot of discretion because each country decides the values that are important to it and therefore the

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15 WT/DS58 United States — Import Prohibition of Certain Shrimp and Shrimp Products.
16 It should be noted that the complainants had claimed a violation of articles I(1), XI(1), and XIII(1) not justified by articles XX(b) and (g) of GATT.
decision is subjective. Can developing countries afford this kind of liberty? Not really.\textsuperscript{17} It is obvious that a WTO-compliant measure could actually be used to create obstacles to the achievement of perfectly legitimate goals such as market access. In such a case, much depends on the interpretation of the law by the DSS.\textsuperscript{18} Even though the Preamble to the WTO Agreement mentions the importance of sustainable development, it should be remembered that the hundred and fifty-seven members of the WTO\textsuperscript{19} are at different levels of development which need to be taken into account while interpreting WTO law. To say that the American measure is justified under article XX(g) means that the AB recognises the extraterritorial exercise of subjective discretion by the US.

Another important point in this case was the acceptance of amicus curiae briefs by the AB in complete disregard of the DSU. India had opposed this, stating that this would allow powerful business interests to participate in the DSS. Also, countries have to respond to amicus curiae submissions which create additional obligations for them. The creation of these additional obligations is not a function of the DSS. Developing countries do not have the resources to indulge in this sort of activity, especially when these briefs emanate from developed country non-governmental organisations supporting social causes the protection of which may be achieved in a different way in developing countries.\textsuperscript{20} Thus, the DSS has to keep in mind the interest of all parties to the dispute.

\textsuperscript{17} See WT/DS332 Brazil — Measures Affecting Imports of Retreaded Tyres in which the EC successfully challenged Brazil's environmental measures affecting European exports to Brazil.

\textsuperscript{18} Developed countries have the resources to implement such measures. Therefore, the panels and AB have an even greater responsibility to take into account the viewpoints of other members while interpreting the law.


\textsuperscript{20} Badri Narayanan G, \textit{Questions on Textile Industry Competitiveness}, 40(9) \textit{ECONOMIC AND POLITICAL WEEKLY}, 905 (2005). Also, India stated that turtles were well protected in India due to the Indian culture of harmony between man and nature.
What is worse is that shrimps were targeted once again by the US in another case i.e. US – Customs Bond Directive.21 In this case, India claimed a violation of the GATT, the Anti-dumping Agreement (ADA) and the Agreement on Subsidies and Countervailing Measures. According to the AB, the application of the Enhanced Continuous Bond Directive by the US was illegal in this case due to lack of requisite evidence. Even though the AB set forth strict criteria for its application, the US could bring sufficient evidence in the future and thus block further imports. Therefore, this ruling does not have a favourable impact on prospective market access.

In these cases, India may have won the case but not the interpretation. In fact, India itself was inconsistent in its approach claiming in US – Shrimp that needs of members should be considered and claiming otherwise in EC – Tariff Preferences.

One of the most important export industries in India is the textiles industry. Its exports have been targeted by different kinds of measures. India has challenged restrictive measures on its textiles exports under the GATT, the Rules of Origin Agreement (ROA), the Agreement on Textiles and Clothing (ATC), and the ADA.

In Turkey – Textiles,22 India claimed a violation of articles XI(1) and XIII(1) of the GATT23 and article 2(4) of the ATC24 not justified by article XXIV of GATT.25 Fortunately, India got a

21 WT/DS345 United States — Customs Bond Directive for Merchandise Subject to Anti-Dumping/Countervailing Duties.
22 WT/DS34 Turkey — Restrictions on Imports of Textile and Clothing Products.
23 These articles read as follows:
XI(1) “No prohibitions or restrictions other than duties, taxes or other charges, whether made effective through quotas, import or export licences or other measures, shall be instituted or maintained by any contracting party on the importation of any product of the territory of any other contracting party or on the exportation or sale for export of any product destined for the territory of any other contracting party.”
XIII(1) “No prohibition or restriction shall be applied by any contracting party on the importation of any product of the territory of any other contracting party or on the exportation of any product destined for the territory of any other contracting party, unless the importation of the like product of all third countries or the exportation of the like product to all third countries is similarly prohibited or restricted.”
ruling in its favour from both the Panel and the AB. In fact, Turkey, before imposing the impugned measure, had suggested negotiations which India refused stating that quantitative restrictions (QRs) were contrary to WTO law.

What is noticeable is that in Turkey – Textiles, US – Shrimp, and EC – Tariff Preferences cases, India claimed a violation of the law not justified by the exception. This was probably done to prevent the respondent from relying on the exception as a defence. This reflects the sophistication of the Indian legal technique.

In US – Textiles Rules of Origin, the complaint was that the US Rules of Origin (RO) were commercial barriers to trade. India claimed that the US wanted to protect its industry and favour imports from the EC. The case was about the use of RO with respect to textile quotas which, the US conceded, aimed to protect its domestic industry during the transition period. The Panel made it clear that members had a lot of liberty regarding RO during the ten year transition period. While interpreting article 334 of the US Uruguay Round Agreements Act which India had challenged, the Panel stated that the fact of using RO to make quotas all the more tight was not unjustified as it aimed to enhance the efficiency of US

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24 Relevant parts of article 2 read as follows:

“1. All quantitative restrictions within bilateral agreements maintained under Article 4 or notified under Article 7 or 8 of the MFA in force on the day before the entry into force of the WTO Agreement shall, within 60 days following such entry into force, be notified in detail, including the restraint levels, growth rates and flexibility provisions, by the Members maintaining such restrictions to the Textiles Monitoring Body provided for in Article 8 (referred to in this Agreement as the "TMB"). Members agree that as of the date of entry into force of the WTO Agreement, all such restrictions maintained between GATT 1947 contracting parties, and in place on the day before such entry into force, shall be governed by the provisions of this Agreement…

4. The restrictions notified under paragraph 1 shall be deemed to constitute the totality of such restrictions applied by the respective Members on the day before the entry into force of the WTO Agreement. No new restrictions in terms of products or Members shall be introduced except under the provisions of this Agreement or relevant GATT 1994 provisions. Restrictions not notified within 60 days of the date of entry into force of the WTO Agreement shall be terminated forthwith.”

25 This article deals with Customs Unions and Free-trade Areas.


commercial policy. But, quotas, by nature restrictive, if tightened will lead to a greater decline in imports. Additionally, according to the Preamble to the ROA, RO are supposed to facilitate international trade instead of creating unnecessary obstacles to it.

The US stated that article 405 of the US Trade and Development Act had been introduced to solve a dispute with the EC but the Panel stated that it was not possible to hold a law illegal simply because it favoured one member. However, this is not required by the law of the WTO. What is required is a loss of advantage to the complainant. Moreover, the Panel even stated that the fact of creating exceptions in favour of products from the EC did not prove that these exceptions aimed to favour imports from the EC as compared with those from other members. Additionally, the Panel asked India to prove that the US had favoured the EC by means of article 405. The Panel was, in a way, asking India to prove the intention of the US to favour EC. Clearly, it is impossible to access markets in such a case. Under WTO law, the complainant is not required to prove the respondent’s intentions; it is only required to prove a violation of WTO law. The AB in US – Offset Act (Byrd Amendment) said that the Panel was not supposed to refer to intentions of the legislator. India could have taken this argument had it appealed in the RO case.

The RO were same for India and EC for products not important to the EC but important to India and quotas were to apply to these products. Products important for EC had different RO and were not subject to quotas. India said that these rules modified the conditions of competition for India’s products at the point of entry into the US. It proved the trade effects (distortion of conditions of competition) of the US measure. Even the RO determination favoured EC. The US measure was indeed WTO-inconsistent because it gave better access to

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30 Section 405 amended section 334 to create certain exceptions to the general rules on determining origin for fabrics and made-up articles.
EC products even though Indian products were like products. The Panel was not convinced by India’s arguments even when it did provide proof. The Panel also enunciated a “same” products standard which India could have appealed. Had India appealed and lost, it would, in a way, have reinforced the US law potentially causing other members to refrain from challenging it.

The Preamble to the ROA aims at increased liberalisation and expansion of world trade, but the Panel achieved the opposite in this case. In fact, the Preamble has noble “intentions” as it proclaims that clear, transparent, and neutral RO would not infringe members’ rights under the GATT. But, it is up to the adjudicating bodies to interpret the ROA in the light of its Preamble.

An interesting point in this case was India’s stand on article 2(d) of the ROA.33 Regarding the concept of discrimination, it stated that there must be unjustifiable differential treatment of goods from different countries. However, it completely changed its stand in the EC - Tariff Preferences case.

As regards the ATC, the US has made use of the safeguard clause indiscriminately as a pressure mechanism against developing countries. It imposed safeguard measures thrice against India and withdrew them when India decided to take the US to the DSS. In US – Wool Shirts and Blouses,34 the Panel held in India’s favour. Given that the textiles industry

33 This article reads as follows:
“2. Until the work programme for the harmonization of rules of origin set out in Part IV is completed, Members shall ensure that: …
(d) the rules of origin that they apply to imports and exports are not more stringent than the rules of origin they apply to determine whether or not a good is domestic and shall not discriminate between other Members, irrespective of the affiliation of the manufacturers of the good concerned…”
34 WT/DS33 United States — Measures Affecting Imports of Woven Wool Shirts and Blouses from India.
employs millions of people in India and contributes heavily to the export earnings, these interpretations of the panels and AB are more than welcome from the point of view of development. In fact, the US safeguard measures were also held to be illegal in two other cases brought by Costa Rica and Pakistan in which India was a third party.

In another case, EC – Bed Linen, the EC practice of zeroing to calculate anti-dumping (AD) duties on Indian linen was struck down. It is significant that the EC then challenged the US for the use of this methodology against EC exports in US – Zeroing (EC) and US – Continued Zeroing wherein it was held illegal. The Panel in EC – Bed Linen also held that the EC failed to explore the possibilities of constructive remedies thus violating article 15 of the ADA. The EC did not even appeal this finding because article 15 creates no concrete obligations. Moreover, it is not clear how a favourable article 15 ruling can be implemented. In EC – Unbleached Cotton Fabrics, immediately preceding EC – Bed Linen, India highlighted the back to back dumping investigations and the fact that the EC did not establish dumping and injury from Indian imports. However, no panel was established in this

37 WT/DS192 United States — Transitional Safeguard Measure on Combed Cotton Yarn from Pakistan.
38 WT/DS141 European Communities — Anti-Dumping Duties on Imports of Cotton-type Bed Linen from India.
40 WT/DS350 United States — Continued Existence and Application of Zeroing Methodology.
41 This article reads as follows:
"It is recognized that special regard must be given by developed country Members to the special situation of developing country Members when considering the application of anti-dumping measures under this Agreement. Possibilities of constructive remedies provided for by this Agreement shall be explored before applying anti-dumping duties where they would affect the essential interests of developing country Members."
42 WT/DS140 European Communities — Anti-Dumping Investigations Regarding Unbleached Cotton Fabrics from India.
case and according to Davey, India did not pursue the case because the EC did not impose AD duties.\textsuperscript{43} Evidently, the barriers in these cases were wilful.

The most frequently-used barrier to India’s exports is the imposition of AD duties. We have already seen its use by the EC in the textile industry and by the US in the shrimps industry. The US has also made use of it in the form of a law applicable generally. In US–Offset Act (Byrd Amendment), the AB disagreed with the Panel’s opinion that the Continued Dumping and Subsidy Offset Act (CDSOA) encouraged producers to file complaints as it would amount to giving too large an interpretation to the word “against” in article 18(1) of the ADA.\textsuperscript{44} But this analysis ignores the reality because the CDSOA, by making foreign producers finance their American competitors, made them stop dumping on the US market (thus effectively blocking India’s access to the US market) and encouraged American producers to file complaints. This is just another example of the textual approach. In fact, the AB agreed that the encouragement to file complaints was indeed a consequence of the CDSOA but said that it was not to be taken into consideration. In this case, the US law was struck down. But if the US law had been held to be WTO-legal, the AB’s observations would have severely impacted exporters because they would have had to continue to pay AD duties which would be used to finance their competitors. In such a case, the exporters would stop exporting to the US. Additionally, the US was using CDSOA to protect its market. Users of imports were compelled to use domestic products so that the CDSOA also functioned as a local content condition.

\textsuperscript{43} William J. Davey, \textit{Implementation of the Results of WTO Trade Remedy Cases}, in Mitsuo Matsushita, Dukgeun Ahn and Tain-Jy Chen (Eds.), \textit{The WTO Trade Remedy System: East Asian Perspective}, 33-61(2006).

\textsuperscript{44} This article reads as follows:
“No specific action against dumping of exports from another Member can be taken except in accordance with the provisions of GATT 1994, as interpreted by this Agreement.”
Moreover, when India, along with Indonesia, invoked article 15, the Panel, adopting a textual approach, rejected their argument that the CDSOA discouraged price undertakings. Article 15 is not a very effective provision; its effectiveness depends all the more on its interpretation. According to the Congressional Budget Office, price undertakings protect producers whereas the CDOSA protects and compensates them. Given this choice of the best amongst the worst, it is clear that the Panel’s interpretation has important consequences for India’s access to US markets. The US continued to disburse compensation to its producers and also claimed that it had complied with the AB ruling. A Delegate from the Indian Mission to the WTO stated that the real problem is that small countries cannot retaliate against big countries, which shows the imbalance in the WTO system.

The ADA does not prohibit but instead regulates dumping. Certain members overstep the bounds of the ADA. Can the DSS really regulate this improper use of WTO agreements?

In US – Steel Plate, the Panel stated that neither the US administrative practice nor the US customs law obliged the US to violate its WTO commitments. It also stated that an administrative practice was not a measure that could be challenged. This stance ignores the effects of the operation of the practice or law. However, it is these effects that actually impact market access. India argued that the US should not have rejected all the information supplied by Steel Authority of India Limited (SAIL) simply because some of it was defective. The Panel stated that the domestic authorities had no obligation to examine each piece of information separately. Moreover, these different elements of information were frequently connected so that the absence of any one element could have consequences for the entire investigative process. It even held that elements of information which would satisfy

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46 WT/DS206 United States — Anti-Dumping and Countervailing Measures on Steel Plate from India.
paragraph 3 of Annex II of ADA if considered separately could be rejected if other elements did not satisfy paragraph 3. In this case, the Panel favoured India stating that the US had illegally rejected sales price information. However, what is important is the reasoning behind it. Even though there is no stare decisis in WTO law, panels and AB frequently quote and rely on previous reports adopted by the Dispute Settlement Body (DSB). This proves the importance of development-friendly interpretations.

This case also provides a glimpse of the hollowness of S&DT. India claimed a violation of article 15 of the ADA because the US had not taken into consideration the particular situation of SAIL, an enterprise from a developing country. According to the Panel, article 15 refers to developing country members and not their enterprises. However, SAIL being a public company through which the Indian Government operates, represents India. Therefore, the utility of article 15 will only be theoretical if it is not applied to such companies. The Panel also stated that the first sentence of article 15 did not impose any obligation on members. But, in fact, it does impose an obligation to take into account the special situation of developing members. Of course, it is an ambiguous obligation.

India also claimed that the US had not explored possibilities of constructive remedies. The Panel recalled that the EC – Bed Linen Panel had said that the idea of exploring did not really mean arriving at a particular result. This demonstrated the futility of S&DT. The present Panel did conclude by saying that the developed country should actively and openly explore possibilities to arrive at a positive result. But it did not interpret article 15 in favour

47 This paragraph reads as follows:
“All information which is verifiable, which is appropriately submitted so that it can be used in the investigation without undue difficulties, which is supplied in a timely fashion, and, where applicable, which is supplied in a medium or computer language requested by the authorities, should be taken into account when determinations are made. If a party does not respond in the preferred medium or computer language but the authorities find that the circumstances set out in paragraph 2 have been satisfied, the failure to respond in the preferred medium or computer language should not be considered to significantly impede the investigation.”
of development when it was time to do so. Again, it is obvious that the effectiveness of article 15 depends on its interpretation.

Even though this article does not analyse in great detail all the cases in which India was a respondent, a look at the interpretations of the adjudicating bodies in some of these cases leads to some significant findings. Developed countries achieved their current levels of economic development by protecting their markets. Even if protection is not the principal means of achieving development, it is certainly one of them. Morally and historically speaking, India has the right to protect its markets because the industrialised countries did it. The fact that the WTO lets developing countries protect their markets (for example, by granting them longer transition periods) proves that the WTO believes in the moral force of the argument that developing countries should be allowed to shield their markets like developed countries did while pursuing their development. However, India has not won any of the cases in which it was the respondent. Given that the application of the provisions regarding protection has been overturned by the DSS, one could say that S&DT relating to protection is not entirely effective. Despite the WTO agreements allowing protection, the DSS is not very favourable to it when India invokes the provisions pertaining to protection. Protection was granted for limited purposes where developed countries felt it would not disadvantage them and India is unable to make use of it even for those limited purposes.

India’s cases as respondent mainly involve the GATT (articles XI and XVIII) and the TRIPS. In India – Quantitative Restrictions, India maintained QRs for balance of payments (BoP).

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49 For example, the ten years transition period granted for product patents in pharmaceuticals was subject to the mailbox and exclusive marketing rights exceptions as defined in articles 70(8) and 70(9) of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS).

50 This article deals with Governmental Assistance to Economic Development.

51 WT/DS90 India — Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products.
reasons. The Panel held that these restrictions violated the GATT and the Agreement on Agriculture. The AB went further and said that the QRs were not necessary for stabilising the BoP. India found this interpretation too strict. According to Flory and Ligneul, developing countries should not be allowed to take the defence of article XVIII to avoid fulfilment of their obligations. Given the strict surveillance exercised by developed countries, it is difficult to imagine a developing country like India avoiding fulfilment of its obligations.

In another case, India – Autos, the Panel went much further than the textual interpretation of a law, resulting in a finding against India. Because the Indian law stated that importers should have equivalent exports and a maximum limit on exports existed in practice, the Panel saw it as restriction on imports. A comparison of this case with US – Offset Act (Byrd Amendment), where the AB refused to consider the fact that the Byrd Amendment led to a higher number of complaints because it did not oblige the manufacturers to complain, brings out the inconsistency in the technique of interpretation. The adjudicators did not apply the textual approach in the former case but did so in the latter.

After losing these cases, India found new means to achieve its aim of protecting its markets. In April 1998, the Directorate General of Anti-Dumping and Allied Duties was constituted within the Department of Commerce in India to initiate inquiries and give necessary relief and protection to domestic producers against dumping of goods and articles from other parts of the world. According to one WTO expert, despite not having the resources to conduct AD enquiries, the absence of the possibilities to increase tariffs after the UR or impose QRs after losing the QRs case made India impose AD measures in order to protect its markets.

53 WT/DS146 India — Measures Affecting the Automotive Sector.
This led to three complaints against India by the EC, Chinese Taipei, and Bangladesh, the last one of which was settled with the help of a mutually agreed solution.

III. Conclusion

Looking at these interpretations, one wonders how developing countries with their meagre resources are supposed to fight powerful trading partners. One cannot help but think of Shaffer’s argument that the interpretations of the panels and AB have been shaped by economic powers because they have the resources to convince the panellists and AB members.

Nevertheless, there have been instances where the panels and AB have upheld the interests of developing members. One could say there is a mixed bag of findings in cases in which India is a complainant because it does, at times, achieve market access or favourable interpretations. However, it never achieves protection as a respondent even though some of it has been legalised through S&DT.

The main problem with the DSS is that it cannot compel compliance by developed members. Also, the technicalities of the WTO agreements including the DSU are difficult for developing countries to handle. These countries are still trying to adapt to a legalised DSS and India is in the same position. It is dependent on expensive lawyers, law firms, and the

55 WT/DS304 India — Anti-Dumping Measures on Imports of Certain Products from the European Communities.
56 WT/DS318 India — Anti-Dumping Measures on Certain Products from the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu.
57 WT/DS306 India — Anti-Dumping Measure on Batteries from Bangladesh.
58 Supra note 5, at 59.
59 Supra note 5.
ACWL. Moreover, India is not able to fully defend its development interests in the WTO DSS. The fact that India is still learning in DS impacts the achievement of its goals.

Apart from the interpretations themselves, an analysis of these reports leads to certain subsidiary findings:

1. India has to handle a diversity of cases involving different WTO agreements.
2. India is an active user of the DSS and a supporter of the rules-based system. This has been stated by India in DSB meetings and its frequent use of the DSS is proof of the same.
3. India’s legal strategy is consistent or inconsistent depending on the goals it wants to achieve in the cases. But it is quite consistent in invoking S&DT whether as complainant or respondent. According to a WTO expert, this is more to make a political point but according to a Delegate from the Indian Mission to the WTO, developed countries should understand why developing countries need S&DT.

A pertinent question that arises is whether India always aims to achieve protection in cases in which it is a respondent. The goal of protection depends on each case and the measures and obligations at issue. According to an ACWL lawyer, a government may use QRs even when it is trying to liberalise the economy because they are needed. Also, some feel that the TRIPS cases were not really about protection.\(^{60}\) Sometimes there is genuine disagreement and the respondent sincerely thinks it is not protecting its market. Furthermore, one could protect markets, consumers or the environment to give a few examples.

Two striking conclusions are also obvious from India’s cases:

1. The sheer number of cases proves that there are numerous obstacles in accessing other countries’ markets.

\(^{60}\) Interview with a Professor and an ACWL lawyer in Geneva.
2. The sheer diversity of the agreements involved proves that countries use different methods to target exports from the same industry especially when it is a competitive industry.

This leads to the conclusion that DSS interpretations need to be made more development-friendly. Thus, it is important to strike a balance between the interpretation of the WTO agreements and the special position of developing countries. WTO agreements should be interpreted by the DSS to promote the aims and objectives defined in those agreements and in the Agreement establishing the WTO. These aims include market access and protection for developing countries whether through general provisions or through provisions on S&DT.

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61 However, a large number of cases relate to AD measures.
When 90% Of The Loans Are Exceptions To The Rule, There Is No Rule: Navigating Through Post-Financial Crisis Regulation And Wall Street’s Caveat Emptor Defense

Eve Mizerak*

ABSTRACT

The United States is currently recovering from the failure of the residential mortgage backed security (RMBS) market and the consequent Great Recession. In response to the 2007 financial crisis, the Securities and Exchange Commission adopted new regulations, pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, to address the lax regulation that created the environment leading up to the financial crisis. This Note explores the collapse of the RMBS market as one of the main drivers of the financial crisis and addresses the inadequacies of the newly adopted regulations. First, this Note provides background to the mechanics of subprime mortgages and discusses the subprime market meltdown. This Note then provides an overview of the current litigation occurring between Wall Street firms and institutional investors. This Note concludes by discussing the newly adopted regulations and arguing that the downfall of the Dodd Frank Wall Street Reform and Consumer Protection Act is the unaddressed issues that create the potential for a similar future crisis.

* J.D. Candidate, 2013, Villanova University School of Law; M.B.A. Candidate, 2013, Villanova University School of Business; B.A., 2010, Rutgers University.

23
I. INTRODUCTION

“[T]he crisis was a result of human mistakes, misjudgments, and misdeeds that resulted in systemic failures for which our nation has paid dearly . . .

The greatest tragedy would be to accept the refrain that no one could have
seen this coming and thus nothing could have been done. If we accept this notion, it will happen again."^{62}

In 2007, the residential mortgage backed security (RMBS) market failed, causing the United States economy to experience a major financial crisis.^{63} This crisis is commonly referred to as

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Investors suing the financial institutions have attempted to bring claims under SEC Rule 10b-5, but have been blocked by the heightened pleading standard required to succeed on a 10b-5 claim. See Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308 (2007) (discussing scienter requirement under 10b-5); Lawrence v. Cohn, 325 F.3d 141, 147-49 (2nd Cir. 2003) (providing that in order to prove defendant violated § 10(b) and Rule 10b-5, plaintiffs must prove (1) material misrepresentation or omission by defendant; (2) scienter; (3) connection between misrepresentation or omission and purchase or sale of security; (4) reliance upon misrepresentation and omission; (5) economic loss; and (6) loss causation); In re American Intern. Group, Inc. 2008 Sec. Litig., 741 F. Supp. 2d 511, 528 (S.D.N.Y. 2010) (describing heightened pleading standards for securities fraud and Section 10(b) claims); Plumbers & Steamfitters Local 773 Pension Fund v. Canadian Imperial Bank of Commerce, 694 F. Supp. 2d 287, 299-300 (S.D.N.Y. 2010) (holding that investor failed to adequately plead facts giving rise to inference of scienter); In re MBIA, Inc., Sec. Litig., 700 F. Supp. 2d 566, 586-90 (S.D.N.Y. 2010) (holding that although plaintiff adequately alleged defendants made materially misleading statements, investor failed to show that defendant’s alleged misstatements were materially misleading when they were made and investor failed to plead facts giving rise to inference of scienter).

Others have been faced with retaliating the adage caveat emptor. See, e.g., Dealbook, The Goldman Defense: Caveat Emptor, N.Y. Times, (Apr. 19, 2010) available at http://dealbook.nytimes.com/2010/04/19/the-goldman-defense-caveat-emptor/ (discussing Goldman, Sachs & Co.’s caveat emptor defense). Other investors have brought claims for negligent misrepresentation, common law fraud, and for violations of Sections 11, 12(a) (2), and 15 of the
the Great Recession, and is generally thought of as the longest and deepest economic crisis since the Great Depression of the 1930s. Many scholars blame the Securities and Exchange Commission (SEC) for failing to properly regulate the financial services sector and corporate governance policies amongst financial institutions. Other theorists blame the lack of economic analysis concerning low interest rates and the unprecedented rise in housing prices. Some scholars even describe the actions of the financial services industry as a ‘moral-cultural malaise.’ In partial response to these criticisms, the SEC adopted new regulations, pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 1933. See, e.g., Compl. at 12, Fed. Hous. Fin. Agency v. J.P. Morgan Chase & Co., Case No. 1:2011cv06188 (S.D.N.Y. filed Sept. 2, 2011) (listing actions Federal Housing Finance Agency brought against J.P. Morgan Chase & Co. and Bear Stearns & Co., among others).

See Chris Isidore, The Great Recession, CNN Money, (Mar. 25, 2009) available at http://money.cnn.com/2009/03/25/news/economy/depression_comparisons/ (“[T]he longest post-Depression economic decline before the Great Recession was 16 months, which occurred in both the 1973-75 and 1981-82 recessions.”). The financial crisis underlying the Great Recession broke in mid-August 2007 when a series of debilitating events unfolded in the United States financial market. See Id. (Discussing the Great Recession). The crisis was first precipitated in 2001 by the Federal Reserve, who in an effort to prevent a 2001 recession (based on the after-effects of the tech bubble burst and the tragic events of 9/11) gradually reduced its target federal funds rate, eventually reaching 1% in 2003. See Historical Changes of the Target Federal Funds and Discount Rates, Fed. Reserve Bank of N.Y. available at http://www.newyorkfed.org/markets/statistics/dlyrates/fedrate.html (last visited Sept. 20, 2011) (listing target federal funds and discount rates since 1971). Seeking for ways to gain a higher return, investors began demanding higher yielding investments, such as collateralized debt obligations and asset-backed securities. See William Poole, Essay, Causes and Consequences of the Financial Crisis of 2007-2009, 33 HARV. J.L. & PUB. POL ’Y 421, 424 (2010) (commenting that low interest rates and memories of dot-com crash caused investors to search for higher yielding investments). In addition, the Bush Administration and Congress, in an attempt to get every American in a home, began pushing Fannie Mae and Freddie Mac to purchase subprime mortgages (thereby increasing the demand for subprime mortgages and encouraging subprime lending). See Russell Roberts, How Government Stoked the Mania, Wall St. J., (Oct. 3, 2008) at A21 (commenting on role of politicians and policy makers during financial crisis). Consequently, many lenders began originating mortgages to undeserving borrowers who were at high risk of default. See William D. Cohan, How Wall Street Hid Its Mortgage Mess, N.Y. Times, (Oct. 14, 2010) available at http://opinionator.blogs.nytimes.com/2010/10/14/how-wall-street-hid-its-mortgage-mess/ (providing data reported by Clayton Holdings that revealed amount of mortgages that deviated from underwriting guidelines). These loans were then securitized into RMBS and collateralized debt obligations. See Id. (Discussing how investors invested in subprime loans after they were securitized). Moreover, the expansion of the housing market contributed to the financial crisis because the models securitizing subprime mortgages were built around the expectation that housing prices would continue to rise. See Roberts (arguing that Washington caused housing prices to rise to unprecedented levels).


See, e.g., Poole, Supra note 3, at 425-26 (discussing conditions leading to crisis).

See Jackson, Supra note 4, at 736 (discussing moral-cultural aspects of financial crisis).
(the Dodd-Frank Act), to address the calamity of the financial crisis and limit the risk of future similar failures.\(^6^8\)

This Note explores the collapse of the RMBS market as one of the main drivers of the financial crisis. It suggests that a significant basis for the critical failure in the performance of subprime securitization, and in fact also some prime securitizations, was rooted in the stark truth that the underwriting guidelines touted in the prospectuses were misreported. Furthermore, this Note argues that although the SEC correctly adopted Rule 193 and New Item 1111 of Regulation AB, these new regulations fail to completely address all of the inadequacies present in pre-financial crisis regulations regarding RMBS disclosures.\(^6^9\)

Part II of this Note provides background to the mechanics of subprime mortgages and RMBS offerings in order to emphasize the complexity of a RMBS and stress the importance of providing data on the underlying assets in a RMBS.\(^7^0\) Part III discusses the occurrences of the financial crisis focusing specifically on the subprime market meltdown.\(^7^1\) Part IV then provides an overview of the faulty disclosures and a discussion of the litigation between investors and Wall Street firms, while arguing that investors, even sophisticated investors, were deceived by the disclosures.\(^7^2\) Part V discusses the new regulations provided through Section 945 of the Dodd-Frank Act and argues that the regulation leaves critical components to issuers’ good intention rather than mandatory requirements.\(^7^3\) Part VI concludes by arguing that the Dodd-Frank Act lacks the type of regulation needed to prevent a similar financial crisis from occurring.\(^7^4\)

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\(^6^8\) For the full text of the Dodd-Frank Act, see H.R. 4173, 111th Cong. (2010).
\(^6^9\) For the full text of Rule 193 and new Item 1111 of Regulation AB, see 17 C.F.R. § 230.193 (2011) and 17 C.F.R. § 229.1111 (2011) respectively.
\(^7^0\) See Infra notes 14-72 and accompanying text.
\(^7^1\) See Infra notes 73-91 and accompanying text.
\(^7^2\) See Infra notes 92-117 and accompanying text.
\(^7^3\) See Infra notes 118-78 and accompanying text.
\(^7^4\) See Infra note 179 and accompanying text.
II. BACKGROUND TO SUBPRIME MORTGAGES: THE DEVIL IS IN THE DETAILS

The United States mortgage market today is a complex web comprised of originators, borrowers and the secondary mortgage market where mortgages are securitized into investments. The introduction of subprime mortgages into RMBS offerings introduced a substantial amount of risky investments into the mortgage market by creating a myriad of product choices largely determined by borrower credit history. Many factors have contributed to the growth of subprime mortgage lending. Primarily, “it became legal.” In addition, market changes such as high interest rates in the 1990s and a subsequent decrease in prime lending ignited the search for a new, profitable venture. In 1995, demand for RMBS offerings backed by subprime loans increased when RMBS offerings with subprime collateral became more attractive to investors. Since then, the RMBS market has risen to $6.6 trillion.

76 See Id. at 31-32 (same).
78 See Chomsisengphet, Supra note 14, at 38 (discussing changes in lending laws). The ability to charge high rates and fees to borrowers was not possible until the adoption of the Depository Institutions Deregulation and Monetary Control Act in 1980 (which preempted state interest rate caps) and the Alternative Mortgage transaction Parity Act in 1982 (which permitted the use of variable interest rates and balloon payments)). See Id. (same). These laws created a fundamental change in lending practices and consequently allowed for the creation of subprime mortgage lending. See Id. (adding that subprime lending did not truly gain popularity until the Tax Reform Act of 1986). “The TRA increased the demand for mortgage debt because it prohibited the deduction of interest on consumer loans, yet allowed interest deductions on mortgages for a primary residence as well as one additional home. This made even high-cost mortgage debt cheaper than consumer debt for many homeowners.” Id.
79 See Id. (commenting that mortgage brokers and mortgage companies responded to drops in prime mortgage market by looking to subprime market to maintain volume and business).
80 See Id. at 41 (commenting that number of subprime fixed-rate-mortgages and adjustable-rate-mortgages originated was approximately 62,000 and 21,000 respectively in 1995 compared to number of subprime fixed-rate-mortgages and adjustable-rate-mortgages peaking at approximately 780,000 and 866,000 respectively since then).
A. Mechanics of Subprime Mortgages

Prime mortgages are typically awarded to credit-worthy borrowers. Whether a borrower is credit-worthy depends on a variety of factors. Such factors include the borrower’s FICO rating, the borrower’s debt-to-income (DTI) ratio, the borrower’s depth of credit, the amount of assets the borrower has on reserve and the loan-to-value (LTV) ratio. Borrowers awarded prime mortgages thus optimally have a high FICO score, a low DTI ratio, an

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83 For an in depth discussion of such factors, see infra note 23.
84 See generally About credit scores, myFICO, available at http://www.myfico.com/crediteducation/creditscores.aspx (last visited Oct. 12, 2011) (providing that lenders use FICO scores to assess future risk based solely on credit report data). A FICO score allows lenders to assess a borrower’s credit worthiness by taking into consideration a borrower’s payment history, current level of indebtedness, types of credit the borrower has used in the past and the length of the borrower’s credit history. See Id. (discussing FICO scores); See also Lisa Smith, Too Much Debt For A Mortgage, Investopedia.com, (Mar. 3, 2009) available at http://www.investopedia.com/articles/07/debt_to_income.asp#axzz1Wj6xUETd (providing that DTI ratio indicates how much borrower’s income will be spent per month on his or her mortgage payment). For example, if a borrower has a DTI ratio of forty percent, forty percent of his or her income will be spent on his or her monthly mortgage payment. See Id. (explaining DTI ratio). A borrower with a lower DTI ratio is considered a safer borrower because less of his or her monthly income is spent on the mortgage payment, leaving him or her with more disposable income or savings. See Id. (providing that lower DTI ratio is better); See also Credit Writing Guidelines, Mortgage Underwriters, available at http://www.mortgageunderwriters.com/creditg.html (last visited Oct. 3, 2011) (providing that depth of credit equals amount of credit experience borrower possesses and providing that queries made in analysis of borrower’s depth of credit include: How many credit cards are in borrower’s name; What is borrower’s track record of repaying debt; and What other loans does borrower currently possess); See also Underwriting Guidelines for the Average Mortgage, Credit Infocenter, (May 25, 2011) available at http://www.creditinfocenter.com/mortgage/guidelines.shtml (providing that lenders consider borrowers possessing larger number of assets on reserve safer than borrowers with smaller number of assets on reserve); See also Justin Pritchard, Loan To Value Ratio, About.com, available at http://banking.about.com/od/loans/g/loantovalue.htm (last visited Oct. 3, 2011) (providing that LTV ratio indicates amount of equity the borrowers will bring to the transaction). For instance, if the borrower wants to buy a house costing $100,000 and the bank lends them a loan for $100,000, the LTV ratio is 100%: the bank has supplied the total amount of money necessary to buy the house and the borrower has not contributed any money towards the house. See Id. (providing similar example). In contrast, if the borrower wishes to buy a house costing $100,000 and the borrower has savings of $10,000 to contribute to the price of the house, the borrower will only need to take out a loan for $90,000, making the LTV ratio ninety percent. See Id. (providing similar example). The lower the LTV, the safer is the loan because the borrower has more money invested and is thus more likely to repay their mortgage. See Id. ("[H]igher loan value ratios mean higher risk for the lender.").
extensive prior borrowing history, a large amount of assets on reserve and a low LTV ratio. The benefit of a prime mortgage is the low interest rate.

In contrast, subprime mortgages are generally awarded to those borrowers with little to no credit-worthiness. Subprime borrowers typically have a low FICO score, a high percentage of their monthly income directed towards their mortgage payment, weak prior borrowing history, a small amount of savings and a small down payment. Subprime lending thus expands the pool of available credit to borrowers who otherwise would not qualify for a mortgage.

In order to compensate for the high risk that the borrower will default on a loan, the loan originator will charge a much higher interest rate to subprime borrowers than they would charge to prime borrowers. In addition, lenders also differentiate subprime from prime borrowers through fixed rate mortgage (FRM) and adjustable rate mortgage (ARM) programs. Lenders use a process known as risk-based pricing to calculate subprime borrowers’ mortgage rates and terms.

87 See Ashcraft, Supra note 24, at 14-22 (providing that borrowers who display credit risk characteristics typically receive subprime mortgages).
88 See Id. 14-16 (discussing subprime mortgage characteristics).
89 See Chomsisengphet, Supra note 14, at 31 (“Two of the major benefits of [subprime] lending, then, are the increased numbers of homeowners and the opportunity for these homeowners to create wealth.”).
90 See Id. at 32 “[B]ecause poor credit history is associated with substantially more delinquent payments and defaulted loans, the interest rates for subprime loans are substantially higher than those for prime loans.”).
91 See Kimberly Amadeo, Fixed Rate Mortgage, About.com http://useconomy.about.com/od/glossary/g/fixed_rate.htm (last visited Oct. 12, 2011) (“The interest rate on a [FRM] stays the same throughout the life of the loan.”). A FRM is a loan accompanied by an interest rate that remains constant throughout the time of the loan (typically thirty years). See Id. (describing a FRM). In contrast, an ARM is a loan accompanied by an interest rate that typically begins at a low rate and then rises over the time of the loan.
B. Matrix

Lenders utilize risk-based pricing through a risk-based pricing matrix. Before the financial crisis, there were several different kinds of subprime mortgage structures available. When an originator gave a borrower a mortgage, the originator was required to follow certain guidelines, organized into a risk matrix. Included in the matrix was a list of lending programs that were available to borrowers based on several lending guidelines and factors. Such factors included the borrower’s FICO rating, the borrower’s debt to income ratio, the purpose of the loan, the amount of the borrower’s assets on reserve and the LTV ratio. Each lending program contained variations on these five borrower characteristics and each program possessed varying requirements with respect to each lending guideline. These characteristics are referred to as “matrix guidelines” and can be seen in the risk-based pricing matrix.


92 See Lisa Smith, Subprime Lending: Helping Hand Or Underhanded?, Investopedia.com, available at http://www.investopedia.com/articles/basics/07/subprime basics.asp#axzz1Y2DyPt6k. (“The worse your credit, the more expensive the loan.”).

93 For an example of a matrix, see Eligibility Matrix, FANNIE MAE (Aug. 30, 2011).


95 See Id. (showing matrix).

96 See Id. (same).

97 For a description of each lending criteria, see Supra note 23.

98 See, e.g., Supra note 32 (providing matrix with programs and lending guidelines).

99 See, e.g., Supra note 32 (showing matrix).
In addition, lenders considered “core guidelines” when determining whether or not to lend to a borrower. Thus, the risk matrices allowed originators to lend responsibly to borrowers by indicating which loan program was appropriate for each borrower according to the borrower’s evaluation under the matrix and core guidelines. Violations of either matrix guidelines or core guidelines could be equally detrimental to the repayment likelihood of the loan.

C. Securitization of Subprime Mortgages: What Happens to a Mortgage After the Borrower Signs the Dotted Line

The initial step in creating a RMBS is the generation of the loans by the loan originators. A sponsor of a RMBS then pools these loans into groups. After pooling the loans, the sponsor then transfers them to the depositor (which is typically a special-purpose affiliate of the sponsor) to receive and pass on the rights to the pools of loans. After the depositor receives the pool of loans, the loans are then transferred to an issuing trust. In order for the rights to the cash flows from the pool of loans to be sold to investors, the depositor then securitizes the pool in the issuing trust.

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100 See generally 12 C.F.R. § 365.2 (2000) (listing real estate lending standards). Core guidelines contain information regarding whether the borrower has experienced a bankruptcy in the past seven years; how many months worth of mortgage payments the borrower possesses on reserve; how many other types of debt the borrower possesses; and whether the borrower has a prior mortgage that is delinquent. See Kurt Eggert, Article, The Great Collapse: How Securitization Caused the Subprime Meltdown, 41 Conn. L. Rev. 1257, 1268-1276 (referring discussing lending guidelines).


103 See Id. (providing that Wall Street investment banks sponsor RMBS offerings).

104 See Id. (describing role of sponsor in mortgage securitization).

105 See Id. at 10 (“Upon acquisition, the depositor transfers, or deposits, the acquired pool of loans to an ‘issuing trust.’ The depositor then securitizes the pool of loans in the issuing trust so that the rights to the cash-flows from the pool can be sold to investors.”).

106 See Id. (describing depositor’s duty during securitization process).
Next, the tranches are established.\textsuperscript{107} Then, the issuing trust passes the securities back to the depositor, who then passes the securities to underwriters.\textsuperscript{108} The underwriter provides information about the loans and the securities that potential investors . . . use to decide whether to purchase the securities. \textsuperscript{109} Therefore, the cash flow from the pool of loans of a securitization is the source of payment to holders of the securities.

The credit quality of the security depends directly upon the credit quality of the loans in the pool.\textsuperscript{110} Importantly, the originator making the initial loan maintains the most important information about the credit quality of the underlying loans.\textsuperscript{111} Investors are not given access to the loan files but instead must rely upon the representations made by the investment firms in the security offering materials.\textsuperscript{112}

\textsuperscript{107} See \textit{Id.} (providing that securitization divides securities into different levels of investments called tranches). The securitization transactions are structured such that the risk of loss is divided among different levels of investment, or “tranches.” Tranches consist of multiple series of related securities offered as part of the same offering, each with a different level of risk and reward. Any losses on the underlying loans – whether due to default, delinquent, or otherwise – are generally applied in reverse order of seniority. As such, the most senior tranches of [RMBS] receive the highest credit ratings because they are the least risky. Junior tranches, being less insulated from risk, typically obtain lower credit ratings, but offer greater potential returns.

\textsuperscript{108} See \textit{Id.} (describing what happens to loans after creation of tranches).

\textsuperscript{109} \textit{Id.}

\textsuperscript{110} See \textit{Id.} at 11 (explaining that credit quality of securities particularly depends “on the likelihood that mortgage holders will make their mortgage payments”).

\textsuperscript{111} See \textit{Id.} (arguing that loan originator possesses information important to investors in originator’s loan files). For residential mortgage loans, each loan file normally contains documents including the borrower’s application for the loan; verification of the borrower’s income, assets, and employment; references; credit reports on the borrower; an appraisal of the property that will secure the loan and provide the basis for measures of credit quality, such as LTV ratios; and a statement of the occupancy status of the property. The loan file also typically contains the record of the investigation by the loan originator of the documents and information provided by the borrower, as well as the detailed notes of the underwriter setting forth the rationale for making each loan.

Traditionally, mortgage originators financed their mortgage business by retaining ownership of the loans they originated and through monthly mortgage payments.\textsuperscript{113} Therefore, the originator was incentivized to lend only to creditworthy borrowers.\textsuperscript{114} However, mortgage loan securitization caused a shift in the mortgage business to a new, current model where originators sell the mortgages to investment banks and firms, thereby shifting the risk of non-payment to investors.\textsuperscript{115} Securitization thus incentivized originators to increase the number of mortgages they issued regardless of credit quality because they no longer bore the risk that borrowers would default on the underlying loans.\textsuperscript{116} In fact, in their report on the financial crisis, the Financial Crisis Inquiry Commission (FCIC) concluded: “The originate-to-distribute model undermined responsibility and accountability for the long-term viability of the mortgages and mortgage-related securities and contributed to the poor quality of mortgage loans.”\textsuperscript{117} The real dangers associated with the originate-to-distribute model and low-quality mortgage loans became apparent in the financial crisis.\textsuperscript{118}

D. Due Diligence

Due diligence in the context of mortgage securitization is a loan review process conducted for the purpose of assisting investors in understanding loan-level risks when buying an RMBS offering.\textsuperscript{119} Due diligence typically involves an understanding of accurate and updated

\textsuperscript{113} See Id. at 12 (explaining originate-to-hold model).
\textsuperscript{114} See Id. (“When an originator held a mortgage through the term of the loan, the originator also bore the risk of loss if the borrower defaulted and the value of the collateral was insufficient to repay the loan.”).
\textsuperscript{115} See Id. at 12-15 (describing new originate-to-distribute model).
\textsuperscript{116} See Id. at 13 (providing that originate-to-distribute model allowed originators to obtain most of their income from transaction and loan-servicing fees, rather than from monthly mortgage streams).
\textsuperscript{118} For a description of the complaints brought by investors and the nation in general were hurt by the originate-to-distribute model, see \textit{Infra} notes 73-117 and accompanying text.
loan data. Due diligence firms also offer quality control services, which is a loan level review, conducted in order to confirm, “whether loans have been underwritten to risk tolerances, to guideline and program requirements . . . [and] whether [the loans] comply with federal and state regulations.”

E. Original Regulation AB

Original Regulation AB was published on September 7, 2005 as a principles-based set of disclosure items designed to form the basis for disclosure in both Securities Act of 1933 (Securities Act) registration statements and Exchange Act reports. Original Regulation AB was intended to add substantial disclosure requirements relating to the background, experience, performance and roles of various parties involved in an RMBS offering. Instead of drafting detailed disclosure guides for each asset type that may be securitized, the SEC identified various types of disclosure concepts and provided examples. Thus, the SEC decided that original Regulation AB would not provide a list of risk factors that may be common to many RMBS transactions.

See Id. (same). Loan data review includes origination data, seller data, servicer data, and updated data (including credit or valuation data from third party providers. See Id. (same). The loan data is collected from the loan file and includes re-calculations of LTV and DTI ratios. See Id. (same). The loan data review is concluded with reports such as “[d]ata discrepancy reports which identify, by loan, any variances between the provided electronic data and the data as collected by [due diligence firms].” Id.

See Id. (same). Insight into a loan’s credit quality includes an examination of the “loan’s credit quality at its origination or its current state . . . [and a determination of a loan’s] layered risk, a borrower’s ability to perform, or [an assessment of] a loan’s compliance to original programs and guidelines.” Products & Services, Clayton Holdings LLC, available at http://www.clayton.com/ProductsServices.aspx (last visited Oct. 13, 2011)

Id.

For full text of original Regulation AB, see 17 C.F.R. § 229.1100 (2005).

See generally Asset-Backed Securities, 70 Fed. Reg. 1506 (discussing final rules for asset-backed securities). Parties include the sponsor, the depositor, the servicer and the trustee. See id. at 1511 (discussing parties involved in final rules).

See Id. at 1531 (explaining SEC’s belief that “it would be impractical to provide an exhaustive list of disclosure items”).

See Id. at 1533 (“[A]ny such list would result in boilerplate and generic disclosures in all prospectuses even if not applicable to the particular transaction.”).
In addition, the regulation required no due diligence by issuers but instead only requested information on the entire pool such as yield, cash flows, interest rate sensitivity, total rate of return, and the financial impact of losses. Furthermore, original Regulation AB also did not require the rating agency rating the security to disclose information such as the pool data it relied on when rating the security. Additionally, original regulation AB required disclosure of static pool information only if material to the transaction. Such required information included delinquency data, loss data and prepayment data.

Unfortunately, the financial crisis exemplified the inadequacies of original Regulation AB. For example, original Regulation AB focused on disclosures regarding the repayment record of the obligations placed in a pool being securitized. A consequence of this focus was the failure of the regulation to take into consideration many factors that precipitated default in the financial crisis, such as the fluctuating interest rates in ARMs.

III. FINANCIAL CRISIS: SUBPRIME MARKET MELTDOWN

In order to prevent a 2001 recession after the stock market peak of 2000 and the events of September 11, 2001, the Federal Reserve began cutting the federal funds rate to historically


128 See Id. (arguing that original Regulation AB failed “to deal with the rating that is a key element of every securitization.”).

129 See Supra note 63, at 1538 (“In particular, we proposed to require static pool data with respect to the delinquency and loss experience of the sponsor’s overall portfolio for the past three years . . . ”).

130 See Id. (describing static pool data disclosure requirements).

131 See Richard E. Mendales, Article, Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix It, 2009 U. ILL. L. REV. 1359, 1383 (2009) (indicating it would have been better to follow examples set by Ginnie Mae regulations for RMBS offerings based on pools of large numbers of residential mortgages). The SEC attempted to deal with the regulation of RMBS based on its experience regulating disclosure by operating businesses and thus left it susceptible to the complexities involved in RMBS offerings. See Id. (discussing original Regulation AB).

132 See Id. at 1383 (discussing original Regulation AB’s failure).

133 See Id. (discussing original Regulation AB’s failure to account for problems that occurred during the collateralized debt obligation meltdown).
low levels until it arrived at 1% in 2003. As a result, the economy and the real estate market began to expand and housing prices began to rise. At the same time, the rate on a thirty-year FRM was at a forty-year low.

As a result, homeowners and investors took advantage of a cheap source of equity, i.e., mortgages. Moreover, with interest rates at a low, investors began looking for investments yielding higher returns. Consequently, investors (such as insurance companies, hedge, mutual and pension funds) turned to RMBS offerings and collateralized debt obligations (CDOs) backed by subprime mortgages.

Un fortunately, quality of the mortgage-related securities had deteriorated from a lack of adequate due diligence and a waiver of underwriting standards by the firms securitizing the mortgages. This change in underwriting standards was never disclosed to investors. Therefore, investors continued to invest in the instruments, without knowledge as to the true amount of risk associated with these securities.

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134 See Kimberly Amadeo, The Federal Funds Rate and How it Works, About.com available at http://useconomy.about.com/od/monetarypolicy/a/fed_funds_rate.htm (last visited Oct. 12, 2011) (“A higher fed funds rate means banks are willing to borrow money to keep their reserves at the mandated level. This means that they will lend less money out . . . When the fed funds rate is decreased, the opposite occurs.”).


138 See Poole, *Supra* note 3, at 424 (discussing conditions leading to financial crisis).


140 See *Supra* note 1, at 187 (“Potential investors were not fully informed or were misled about the poor quality of the mortgages contained in some mortgage-related securities.”).
Tellingly, the United States mortgage market began seeing an increase in the number of foreclosures in 2006. In early 2007, reports issued by financial institutions such as New Century Financial, NovaStar Financial and HSBC Finance indicated that rising default rates were causing them to lose millions of dollars. As a result of similar reports from other financial institutions and reports indicating that the housing market would weaken even further, stocks began falling in March 2007. A decrease in housing prices was also reported, with the median price of a new home dropping by the largest amount on record in May 2007.

Additionally, Freddie Mac reported its decision to no longer buy the most risky subprime mortgages and mortgage-related securities. In June 2007, Wall Street firms began to show their wounds as firms such as Goldman, Sachs & Co. and Bear Stearns & Co. reported flat profits and decreased net income. In the summer of 2007, Standard and Poor’s (S&P) and

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Moody’s Investor Services (Moody’s) downgraded over 100 bonds backed by second-lien subprime mortgages and S&P placed 612 securities backed by subprime residential mortgages on a credit watch.\footnote{See The Financial Crisis A Timeline of Events and Policy Actions, Federal Reserve Bank of St. Louis, available at http://timeline.stlouisfed.org/index.cfm?p=timeline (last visited Oct. 3, 2011) (describing events occurring during the financial crisis).} In September 2007, the SEC began an investigation into whether the credit rating agencies improperly rated mortgage-related securities.\footnote{See Stephen Labaton, S.E.C. Inquiry Looks for Conflicts in Credit Rating, N.Y. Times, (Sept. 27, 2007) available at http://www.nytimes.com/2007/09/27/business/27credit.html?ref=creditcrisis ("[R]ating agencies have come under renewed scrutiny by regulators and lawmakers.").} Also in September 2007, the Fed began to cut the federal funds rate, finally reducing it to three percent in June 2008.\footnote{See Historical Changes of the Target Federal Funds and Discount Rates, Fed. Reserve Bank of N.Y., available at http://www.newyorkfed.org/markets/statistics/dlyrates/fedrate.html (last visited Oct. 3, 2011) (displaying changes in target federal funds rate and discount rates from 1971 to present).} In March 2008, major Wall Street firms began to fail.\footnote{See Poole, Supra note 3, at 422 (providing that Bear Stearns & Co. failed first and was ultimately bailed out by the Federal Reserve and then bought by J.P. Morgan Chase & Co). Soon after, Lehman Brothers Holdings Inc. realized significant losses but was not bailed out by the Federal Reserve. See \textit{Id.} at 423 (describing the failure of Lehman Brothers Holdings Inc.). Next was the failure of American International Group, which was also bailed out by the Federal Reserve. See \textit{Id.} (describing the failure of American International Group).} Then in August 2008, real signs of a recession emerged when the Labor Department reported that 4,000 jobs were lost from July to August.\footnote{See David Leonhardt & Jeremy W. Peters, Unexpected Loss of Jobs Raises Risk of Recession, N.Y. Times, (Sept. 8, 2007) available at http://www.nytimes.com/2007/09/08/business/08econ.html?ref=creditcrisis (describing increases in unemployment in 2007).} As a result of low unemployment, high default rates and the failure of major financial institutions, the United States economy suffered a severe credit crunch, putting pressure on consumers and businesses and causing a decline in economic activity.\footnote{See Michael J. de la Merced, Companies Under Pressure, N.Y. Times, (Sept. 26, 2008) at C1 (discussing harmful effects of expensive credit on businesses).} The result was the Great Recession.

\textbf{IV. SOPHISTICATED INVESTORS V. WALL STREET}

\textit{Investors were not given sufficient information to make the decisions that they needed to make to see if they were going to buy these securities . . . They...}
should have been given loan-level detail for every pool for which securities were issued . . . Instead, they got vague, boilerplate language about ‘underwriting,’ and that there were ‘substantial exceptions,’ . . . Why weren’t investors given that information which was in the hands of the people that were selling the securities?”\footnote{Cowan, Supra note 20.}

As the financial crisis turned into the Great Recession, an outraged public began placing blame on everyone from government regulators to Wall Street investment bankers to the average American citizen.\footnote{See Ben Steverman & David Bogoslaw, The Financial Crisis Blame Game, Bloomberg Businessweek, Oct. 18, 2008, available at http://www.businessweek.com/investor/content/oct2008/pi20081017_950382.htm (summarizing individuals and entities to blame for financial crisis).} In particular, there has been much litigation attributed to the argument between sophisticated investors and financial institutions.\footnote{See Koppel, Supra note 11 (commenting that Morgan Stanley, American International Group, Fannie Mae and Merrill Lynch were being sued in September 2008); Compl. at 1-3, MBIA Ins. Corp. v. Bank of Am. Corp. (Cal. Super. Ct. June 21, 2010) (describing MBIA Insurance Corp.’s action against Bank of America Corp. over alleged fraud perpetrated by Countrywide Financial Corp. and its executives that included Countrywide’s sale of MBS to MBIA Insurance Corp.’s insureds); Gretchen Morgenson, Mortgage Investors Turn to State Courts for Relief, N.Y. Times, (July 11, 2010) at BU1 (providing that Cambridge Place Investment Management is suing fifteen banks for misrepresenting billions of dollars of MBS); Louise Story & Gretchen Morgenson, A.I.G. to Sue Bank on Loss in Fiscal Crisis, N.Y. Times, (Aug. 8, 2011) at A1 (discussing American International Group suit against Bank of America Corp. over MBS offerings); Supra note 15, at 2-12 (containing the Federal Housing Finance Agency’s suit against J.P. Morgan Chase & Co. over the offer and sale of MBS offerings to Fannie Mae and Freddie Mac); Mark Jewel, Allstate Sues Goldman Sachs Over Toxic Investments, The Huffington Post, (Aug. 11, 2011) available at http://www.huffingtonpost.com/2011/08/16/allstate-sues-goldman-sachs-over-toxic-investments_n_928550.html (providing that Allstate Insurance Co. sued Goldman, Sachs & Co. over toxic investments including more than $123 million in mortgage backed securities).} The arguments injured parties are bringing focus mainly on Wall Street’s alleged misrepresentations with respect to the sale of RMBS offerings.\footnote{See generally Compl., MBIA Ins. Corp. v. Bank of Am. Corp. (Cal. Super. Ct. June 21, 2010) (discussing MBIA Insurance Corp.’s causes of action against Bank of America Corp.). MBIA Insurance Corp. also argued that Countrywide Financial made false statements regarding their business in 2003 and 2004, 2005, 2006, and the first part of 2007. See Id. (same). In addition, in its complaint against Goldman, Sachs & Co. Allstate Insurance Co. alleged that Goldman, Sachs & Co. made misrepresentations in its offering materials regarding underwriting standards and practices, due diligence results, owner-occupancy statistics, LTV and combined LTV ratios, the sufficiency of borrower income, credit ratings, credit enhancement and underwriting exceptions. See generally Supra note 41 (discussing Allstate Insurance Co.’s causes of action against Goldman, Sachs & Co.). Similarly, the Federal Housing Finance Agency sued J.P. Morgan Chase & Co., Bear Stearns & Co., Washington Mutual, and Long Beach arguing the falsity of statements in the registration statements and prospectus supplements (specifically...}
Disclosure of the characteristics of the underlying assets is generally of interest to RMBS investors. The lack of due diligence and underwriting reports contained in the disclosures for the RMBS in the years leading up to the financial crisis deprived investors of information needed to make informed, rational decisions. The disclosures presented to investors with respect to the RMBS offerings possessed three flaws that proved disastrous to investors.

First, the disclosures failed to include due diligence reports containing a review of the underlying loans. Second, the disclosures did not indicate the amount of exceptions granted to guidelines contained in the pool of underlying loans, i.e., exception loans. Third, the disclosures lacked information regarding the reasoning behind the granting of the exception loans.

The need for regulating disclosures regarding underwriting guidelines and exceptions was made clear in the aftermath of the 2008 financial crisis. For example, in its suit against the falsity of the owner-occupancy data and the loan-to-value data. See generally Supra note 2 (discussing Federal Housing Finance Agency’s causes of action against J.P. Morgan Chase & Co, Bear Stearns & Co., Washington Mutual, and Long Beach). The seriousness of including exception loans into securities is evidenced in the catastrophic losses these securities experienced once borrowers began defaulting on their loans. For example, a forensic loan review conducted in late 2007 “revealed that approximately 91% of the defaulted or delinquent loans in the Countrywide securitizations that were reviewed by MBIA show material discrepancies from the underwriting guidelines that Countrywide represented it would follow.” Compl., MBIA Ins. Corp. v. Bank of Am. Corp. (Cal. Super. Ct. June 21, 2010).


For an analysis of the inadequacies in the disclosures, see infra notes 103-17 and accompanying text.

For a discussion of the insufficient disclosures required under original Regulation AB, see Supra note 62-71 and accompanying text.


See Id. (commenting that prospectuses included language like exceptions accounted for substantial or significant portions of the loans); Eggert, Supra note 39, at 1306 (commenting that use of exceptions appeared to be increasing beginning in 2005).

See Supra note 1, at 169-70 (questioning usefulness of mortgage-related securities disclosures due to lack of “disclosure made to the investors with regard to the quality of the files they were purchasing”).

See Id. at 165-70 (discussing quality control issues in disclosures and due diligence as causes of the financial crisis).

The integrity of the market depended on two critical checks. First, firms purchasing and securitizing the mortgages would conduct due diligence reviews of the mortgage pools, either
Countrywide Financial Corp. (Countrywide), MBIA Insurance Corp. (MBIA) argued that beginning in 2003, Countrywide altered the type and quality of the mortgage loans it originated and pooled into MBS offerings, did not disclose this change to the public and “kept this change hidden from the public through material misrepresentations and omissions in its public statements.”

Furthermore, the FCIC concluded that firms “failed to perform adequate due diligence on the mortgages they purchased and at times knowingly waived compliance with underwriting standards.” The FCIC further concluded, “[p]otential investors were not fully informed or were misled about the poor quality of the mortgages contained in some mortgage-related securities.”

Because the loans backing the securities were not properly characterized in the disclosures, the investors could not have possibly understood the risk associated with the securities.

‘Each misrepresentation and omission created an additional, hidden layer of risk well beyond that known to be associated with an ‘adjustable rate mortgage’ or a ‘home equity loan’ in the abstract.”

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Id. at 165.

164 Compl. at 14, MBIA Ins. Corp. v. Bank of Am. Corp. (Cal. Super. Ct. June 21, 2010). MBIA argues that one of Countrywide’s “fraudulent schemes” was its “consistent and pervasive misrepresentation of its credit and underwriting standards to convince the public between 2004 and 2007 to invest in its securities backed by loans it had originated.” Id. at 1. The depth of Countrywide’s abandonment of its underwriting standards and misrepresentations about its underwriting “infected all of Countrywide’s securities offerings during those three years.” Id.

165 Supra note 1 at 187.

166 Id.

167 See Supra note 41, at 16 (providing examples of how securities were improperly characterized in disclosures provided by Goldman, Sachs & Co.). For example, in its complaint Allstate Insurance Corp. alleged that Goldman, Sachs & Co.:

(1) overstated how many loans were owner-occupied (owner-occupied properties have lower risks), (2) understated the loan pool’s average LTV and CLTV ratios (suggesting the borrowers had more of an equity ‘cushion’ than they did), (3) misrepresented the loans’ adherence to standard underwriting practices, and (4) failed to inform investors such as Allstate that high numbers of defective loans were ‘waived’ into the mortgage pools (making representations regarding the quality of the underwriting process even more misleading).

168 Id. at 16.

169 Id. at 16-17.
In addition to a lack of due diligence reporting, the disclosures generally inadequately and inaccurately described the underlying assets. Moreover, the broad language used in the disclosures about the inherent risk associated with these types of securities changed little as the banks adopted riskier lending practices. Additionally, the prospectuses discussing exceptions to the underwriting guidelines only mentioned that such exceptions would be granted to borrowers if there were “favorable compensating factors present.” Furthermore, the disclosures that mentioned loan exceptions did not mention whether the banks were making case-by-case or bulk exceptions to the underwriting guidelines. This is important to an investor because “[a] disclosed guideline is factually irrelevant – and indeed misleading – from a risk-analysis perspective if large numbers of loans were peremptorily excused from those standards.”

It is clear that the originator banks made irresponsible lending decisions based on the fact that most of the loans that started out with high AAA or AA ratings have now all been

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169 See Bajaj, Supra note 99 (discussing disclosures regarding underlying loans).
170 See Supra note 103, at 35 (“[T]he broad language written in prospectuses about the risky nature of these securities changed little in recent years, even as due diligence reports noted that the number of exception loans backing the securities was rising.”).
171 Id. at 41 (discussing prospectus supplements for Countrywide CWHEQ 2005-E note offering). This statement was misleading because at Countrywide, for example, exceptions to the underwriting guidelines “were made as a matter of course through the Exception Processing System, which was a system designed to ensure acceptance of loans regardless of their quality.” Id. at 43. Additionally, “Goldman represented that it made only case-by-case exceptions to the disclosed underwriting standards, based on compensating factors that balanced out the risks of a loan application and thereby improved the quality of a loan application.” Supra note 41 at 29. For example, the Offering Materials for GSAMP Trust 2006-HE5 and GSAMP Trust 2006-HE7 stated that “[i]n certain instances, compensating factors demonstrated by a prospective borrower may warrant [Goldman Sachs Mortgage Company] to make certain exceptions to these [underwriting] guidelines.” Id. However, “[t]hese representations were false and misleading. Loans were routinely granted outside of the stated guidelines, without regard to whether there were any purported ‘countervailing features’ justifying a lending or underwriting exception.” Id. at 29-30.
172 See Supra note 1, at 169 (discussing problems with disclosures). “Only a small portion – as little as 2% to 3% - of the loans were in any deal were sampled, and evidence from Clayton shows that a significant number did not meet stated guidelines or have compensating factors.” Id.
173 Supra note 41, at 29.
downgraded to ‘junk” by the rating agencies.\textsuperscript{174} In addition, the securities that were supposed to be long-term, stable investments have experienced payment problems well beyond what should have occurred for properly underwritten loan pools.\textsuperscript{175} Findings that the issuers failed to disclose both their underwriting practices and that of originators is also evident in the due diligence reports conducted by third party firms such as Clayton Holdings or The Bohan Group.\textsuperscript{176} As the FCIC report concluded: “many prospectuses indicated that the loans either met guidelines outright or had compensating factors, even though Clayton’s records show that only a portion of the loans were sampled, and that of those that were sampled, a substantial percentage of Grade 3 Event loans were waived in.”\textsuperscript{177} The FCIC further concluded that “[p]rospectuses for the ultimate investors in the mortgage-backed securities did not contain this information, or information on how few of the loans were


From 2000 to 2007, Long Beach and WaMu together securitized tens of billions of dollars in subprime loans, creating mortgage backed securities that frequently received AAA or other investment grade credit ratings. Although AAA securities are supposed to be very safe investments with low default rates of one to two percent, of the 75 Long Beach mortgage backed security tranches rated AAA by Standard and Poor’s in 2006, all 75 have been downgraded to junk status, defaulted, or been withdrawn. In most of the 2006 Long Beach securitizations, the underlying loans have delinquency rates of 50% or more.

\textit{Id.} at 55.

\textsuperscript{175} See \textit{Supra} note 41, at 30 (explaining five Goldman, Sachs & Co. securities payment problems). As Allstate Insurance Co. illustrated “approximately 36.79% of the Mortgage Loans underlying the [securities] that Allstate invested in have already had to be written off, and approximately 32.40% of the remaining loans are currently 30, 60, 90 or more days delinquent – all within a few years of when the loans were made.” \textit{Id.} note 41, at 30.

\textsuperscript{176} See \textit{Id.} at 40 (describing third party due diligence firms’ role in securitization process). Third party due diligence firms were tasked with reviewing whether the loans met banks’ standards. See \textit{Id.} (same). Most Wall Street firms conducted due diligence to determine whether the mortgage loan complied with their underwriting guidelines. See \textit{Id.} (same). To make these determinations, the banks employed third party firms “who reviewed a sample of the purchased loans to confirm that they both conformed to the representations made by the originators and complied with the company’s own credit policies.” See \textit{id.} (same). “For each loan pool it was hired to review, [the due diligence firms] checked for: (1) adherence to seller-credit underwriting guidelines and client-risk tolerances; (2) compliance with federal, state local regulatory laws; and (3) the integrity of electronic loan data provided by the seller to the prospective buyer.” \textit{Id.}

\textsuperscript{177} \textit{Supra} note 1, at 167. Grade 3 Event loans failed to meet guidelines. See id. at 166 (discussing Grade 3 Event loans).
reviewed, raising the question of whether the disclosures were materially misleading, in violation of the securities laws. 178

V. STILL NOT THERE: POST-FINANCIAL CRISIS REGULATIONS ARE ONLY STEPPING STONES TO TRANSPARENT DISCLOSURES

One argument posed is that securitization caused the subprime crisis. 179 Scholars following this argument believe that securitization has structural flaws in that it created subprime lenders, amplified the effect of rising loan defaults and encouraged a degradation of the underwriting process. 180 Although securitization may possess structural flaws, it was not securitization in general that caused the financial crisis. 181 Instead, it was the lack of regulation over the RMBS market. 182

Because of lax regulation regarding the inclusion of underwriting guidelines in the disclosures, the underwriting culture on Wall Street became an environment where overall loan volume became more important than creditworthiness. 183 Without any sort of

178 Id. at 170.
179 See Eggert, Supra note 39, at 1311-12 (arguing that securitization caused subprime meltdown because it allowed and encouraged “each step of the lending and securitization process to be done at the margins, at the highest level of risk tolerance permitted;” “encouraged brokers and sales agents to push borrowers to borrow the maximum possible;” and “allowed originators to bargain down the quality standards of other market participants, including their due diligence in examining loans, the effectiveness of the rating agencies and the level of credit enhancements needed to create a large percentage of AAA-related securities.”).
180 See Id. (discussing flaws of securitization).
181 See Cowan, Supra note 20, at 6-7 (discussing benefits of securitization). There are many benefits of securitization such as more available and low-cost credit, a dispersion of capital to areas that may otherwise be deprived of credit options, and the relocation of risk from financial institutions to investors. See supra note 20, at 6-7 (discussing these benefits).
182 See Mendales, Supra note 66, at 1415 (attributing problems in financial services industry to problems in securities regulation.)
183 See generally Supra note 103, at 14 (discussing changes in Countrywide Home Loans’ originating practices from 2003 to 2007). For example, prior to 2003, Countrywide Home Loans originated loans each year that were mainly “traditional long term, fixed rate, first lien mortgage loans to prime borrowers that met the guidelines for sale to Fannie Mae and Freddie Mac.” Supra note 103, at 14. However, two changes occurred in the late 1990s and early 2000s that were catalysts for dramatic shifts in Countrywide Financial Corp.’s lending practices. See Id. (discussing lending practice changes). First, the market experienced an increase in demand for securitizations, which required increased loan origination to generate the loans behind the MBS. See Id. (same). Second, Countrywide Financial
regulation requiring Wall Street to disclose their precise underwriting guidelines and the amount of exception loans, there was never any protection for the public. Banks were free to include as many loan exceptions as possible without warning the public that the securities were backed by loans belonging to borrowers that were quite the opposite of the ideal borrower described in the guidelines.

Corp. decided to lend to different types of borrowers using various types of lending programs in order to expand market share and capitalize on this increased demand. See Id. (same). The result was a “culture change” starting in 2003 where Countrywide Financial Corp. began lending riskier loans and began an initiative to increase its market share from 13% in 2003 to an unprecedented 30%. See Id. (same). MBIA claims that “Countrywide Financials desire to expand its already enormous market share during the mortgage lending boom from 2004 to 2007 led to a systematic pattern and practice of secretly abandoning its own underwriting guidelines in pursuit of loan origination and market share at all costs.” Compl. at 16, MBIA Ins. Corp. v. Bank of Am. Corp. (Cal. Super. Ct. June 21, 2010). In fact, senior management at Countrywide Financial Corp., particularly David Sambol, former President and Chief Operating Officer of Countrywide Financial Corp., who ran Countrywide Financial Corp.’s loan production “sent a clear message to loan origination and underwriting employees that overall volume was far more important than creditworthiness.” See Id. at 17 (discussing Mr. Sambol’s role changing Countrywide Financial Corp.’s culture).

Moreover, in its complaint against Goldman, Sachs & Co., Allstate Insurance Co. argued that originators “systematically abandoned their stated guidelines” by:

- Coaching borrowers to falsely inflate their income on loan applications to appear to quality for mortgage loans that the borrowers could not afford to repay
- Falsely inflating a prospective borrower’s income to quality the borrower for a loan he or she could not afford to repay;
- Steering borrowers to loans that exceeded their borrowing capacity;
- Encouraging borrowers to borrow more money than they could afford by guiding them to “stated income” loans – loans on which the borrowers could simply make up, or “state,” inflated incomes that would not be verified;
- Approving borrowers based on “teaser rates” for loans, despite knowing that the borrower would not be able to afford the payment when the loan rate adjusted; and
- Allowing non-qualifying borrowers to be approved for loans they could not afford under exceptions to the underwriting standards based on so-called “compensating factors” when such “compensating factors” did not in fact exist or did not justify approving the loans

Supra note 41, at 47-48.

See Mendales, Supra note 66, at 1414-15.

[The problem with securities regulation began] with the development of securities . . . that became so complex that investors could not rely on securities law disclosure concerning their payment characteristics. This void was filled by the [credit] rating system, although the latter was largely outside the scope of securities regulation. The result was that securities were bought, sold, and used as the basis for derivative agreements solely on the strength of ratings that, as the housing bubble swelled, became progressively further removed from reality.

Id. See Supra note 103, at 17 (discussing Countrywide Financial Corp.’s culture change).

Countrywide Financial and Countrywide Home Loans knowingly: (1) loaned billions of dollars to borrowers who could not afford to repay the loans; (2) approved loans for borrowers who made gross misstatements in their loan applications regarding their income and ability to pay, often with the assistance and encouragement of Countrywide Home Loans’ employees and brokers; and (3) approved borrowers who otherwise did not satisfy the basic risk criteria for prudent and responsible lending that Countrywide Financial and Countrywide Home Loans claimed to use.

Id.
Furthermore, investors justifiably relied on the banks’ false representations and misleading omissions when they decided to invest in the securities or recommend the securities as investments to third parties.\textsuperscript{186} The public was not in a position to assess the banks’ loan-origination processes or appreciate the true risk inherent in these investments.\textsuperscript{187} In addition, the complexity of RMBS offerings prevented investors from analyzing the underwriting of the underlying loans.\textsuperscript{188} Because the loans were packaged into securities and bought and sold countless times, it was nearly impossible for an investor to locate each underlying loan in the security they were buying an interest in and then review the underwriting guidelines under which the loan was given.\textsuperscript{189} As a result, many investors did not conduct an independent analysis of their own due diligence, but instead relied on the rating agencies’ analysis or the disclosures in the product offering materials provided by the investment firms.\textsuperscript{190} Furthermore, the prospectuses and other offering materials were often hundreds of pages long, leaving little time for investors to thoroughly read the offering materials and sort through the complexity of RMBS offerings.\textsuperscript{191}

\textsuperscript{186} See \textit{Id.} at 197 (arguing that if MBIA Insurance Corp. had known “the true facts regarding the underwriting practices and quality of the loans” at Countrywide Financial Corp. they would not have purchased loans).

\textsuperscript{187} See Eggert, \textit{Supra} note 39, at 1304 (identifying relationships between popularity of securities market, high value of securities and consequent consumer trust in securities).

\textsuperscript{188} See \textit{Id.} (discussing complexity of RMBS offerings).


\textsuperscript{190} See \textit{Supra} note 1, at 119 (“Many investors . . . relied on credit ratings because they had neither access to the same data as the rating agencies nor the capacity or analytical ability to assess the securities they were purchasing.”).

\textsuperscript{191} See Schwarcz, \textit{Supra} note 128, at 383 (indicating effects of lengthy prospectuses); See id. at 405 (discussing how complexity can deprive investors and other market participants of information needed for efficient markets). “Investors were not given information that could have alerted them to the decline in underwriting that occurred in the subprime market in the years leading up to the subprime crisis, and so they kept investing in securities backed by those loans.” Eggert, \textit{Supra} note 39, at 1307 (referencing Randall S. Krasner, Governor, Bd. of Governors of the Fed. Res. Sys., Improving the Infrastructure for Non-Agency Mortgage-Backed Securities, Speech at the Federal Reserve System Conference on Housing and Mortgage Markets (Dec. 4, 2008), available at http://www.federalreserve.gov/newsevents/speech/kroszner20081204a.htm (“The paucity and inaccessibility of data about the underlying home loans was, in my opinion, one of the reasons that private-label MBS was able to expand so rapidly in 2005 and 2006 despite a deterioration in underwriting and prospective credit performance.”).
Another reason investors relied on the securities is because securitization protects investors from credit risk through sequential tranches.\textsuperscript{192} Those investors who were extremely risk-averse (and who thus believed they were covering their bases) purchased AAA tranches, which were thought to possess the most reliable underlying assets.\textsuperscript{193} The AAA tranche is also retired first, thus assuring a AAA investor that their investment will be returned to them should the security begin to lose value.\textsuperscript{194}

In addition, credit agencies historically rated subprime offerings with a conservative risk assessment.\textsuperscript{195} In other words, investors may have believed that their holdings actually deserved a higher credit rating than S&P and Moody’s gave them, providing investors with a false sense of security.\textsuperscript{196} Moreover, securities are understood to be diversified investment instruments in that they contain loans from borrowers with different geographical backgrounds, credit risk, and prepayment risk, which may also have provided investors with a false sense of security.\textsuperscript{197}

A. Post-Financial Crisis Regulations

\textit{“The challenge for the Commission is to develop a rule that addresses these twin problems: 1) that the asset reviews that were conducted were inadequate to reveal the extent of problems with assets underlying the securities; and 2) that, where problems were uncovered by the reviews, they were neither}

\textsuperscript{193} See Id. (same).
\textsuperscript{194} See Supra note 1, at 71-74 (providing in-depth discussion of tranches).
\textsuperscript{195} See Id. at 2055 (providing that S&P’s reports for 2003 through 2006 expressly provided data demonstrating that S&P tended to overestimate credit risk of senior subprime tranches and upgrades outnumbered downgrades until 2006).
\textsuperscript{196} See Supra note 1, at 221-23 (discussing downgrades in 2007). In hindsight, it is clear that the holdings were actually much worse than what S&P and Moody’s rated them. See Id. (same).
\textsuperscript{197} See Engel, Supra note 131, at 2057 (“Diversification is another means by which securitization reduces investor’s risk . . .”).
rectified nor clearly disclosed to investors. To solve these problems, the Commission must counteract the strong incentives investment banks and others in the securitization supply chain have to under-invest in due diligence and to hide potential problems from investors.”

The SEC adopted two regulations attempting to rectify the financial crisis. First, the SEC adopted Rule 193. Second, the SEC adopted amendments to Item 1111 of Regulation AB.

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199 For the full text of Rule 193, see 17 C.F.R. § 230.193 (2011).

An issuer of an “asset-backed security,” as that term is defined in Section 3(a)(77) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(77)), offering and selling such a security pursuant to a registration statement shall perform a review of the pool assets underlying the asset-backed security. At a minimum, such review must be designed and affected to provide reasonable assurance that the disclosure regarding the pool assets in the form of prospectus filed pursuant to § 230.424 of this chapter is accurate in all material respects. The issuer may conduct the review or an issuer may employ a third party engaged for purposes of performing the review. If the findings and conclusions of the review are attributed to the third party, the third party must be named in the registration statement and consent to being named as an expert in accordance with § 230.436 of this chapter.

200 For the full text of Rule 193, see 17 C.F.R. § 229.1111 (2011).

Id.

For the full text of Rule 193, see 17 C.F.R. § 229.1111 (2011).

Describe the pool assets, including the information required by this Item 1111 . . . In addition to presenting the number, amount and percentage of pool assets by distributional group or range, also provide statistical information for each group or range by variables, to the extent material, such as, average balance, weighted average coupon, average age and remaining term, average loan-to-value or similar ratio and weighted average standardized credit score or other applicable measure of obligor credit quality.

(a) Information regarding pool asset types and selection criteria. Provide the following information: . . .

(7)(i) The nature of a review of the assets performed by an issuer or sponsor . . . including whether the issuer of any asset-backed security engaged a third party for purposes of performing the review of the pool assets underlying an asset-backed security; and

(ii) The findings and conclusions of the review of the assets by the issuer, sponsor, or third party described in paragraph (a)(7)(i) of this section . . .

(8) If any assets in the pool deviate from the disclosed underwriting criteria or other criteria or benchmark used to evaluate the assets, or any assets in the sample or assets otherwise known to deviate if only a sample was reviewed, disclose how those assets deviate from the disclosed underwriting criteria or other criteria or benchmark used to evaluate the assets and include data on the amount and characteristics of those assets that did not meet the disclosed standards. Disclose which entity (e.g., sponsor, originator, or underwriter) or entities determined that those assets should be included in the pool, despite not having met the disclosed underwriting standards or other criteria or benchmark used to evaluate the assets, and what factors were used to make the determination, such as compensating factors or a determination that the exception was not material. If compensating or other factors were used, provide data on the amount of assets in the pool or in the sample that are represented as meeting each such factor and the amount of assets that do not meet those factors. If multiple entities are involved in the decision to include assets
i. Rule 193

Effective March 28, 2011 the SEC adopted Rule 193 in order to implement Section 945 of the Dodd-Frank Act and Section 7(d) of the Securities Act in an attempt to address the lack of information regarding a RMBS offering disclosed to investors.201 The SEC ultimately decided to include a reasonable assurance minimum review standard in Rule 193 requiring that the review be designed and affected to provide reasonable assurance that the disclosure in the prospectus regarding the assets is accurate in all material respects.202 When choosing to adopt Rule 193, commentators voiced mixed feelings regarding the inclusion of a reasonable assurance minimum review standard.203 In fact, commentators possessed mixed feelings despite not having met the disclosed underwriting standards, this should be described and each participating entity should be disclosed.

Id. 201 See generally Supra note 96 (containing review of proposed rules, comments on proposed rules and final rules). “Section 945 of the Dodd-Frank Act was created because due diligence practices in [RMBS] offerings eroded.” S. Rep. No. 111-176, at 133 (2010).

202 See Supra note 96, at 4234-35 (describing reasonable assurance standard). The reasonable assurance standard “encompasses the full range of reviews an issuer may perform to ensure that its review is designed and effected to provide reasonable assurance that the prospectus regarding the pool assets is accurate in all material respects.” Id. at 4235. “Thus, for example, if the prospectus disclosed that the loans are limited to borrowers with a specified minimum credit score, or certain income level, the review, as designed and effected, would be required to provide reasonable assurance that the loans in the pool met this criterion.” Id. at 4234.


The reasonable assurance standard could provide a workable approach [because] any issuer of securities registered under the [Securities Act], is already liable for any misstatement of a material fact in its disclosure, and for any omission necessary to make the statements it does make in that disclosure not misleading in any material respect. Therefore, every issuer already should be taking appropriate steps to ensure the accuracy of its disclosure in order to avoid potential liability for material misstatements or omissions.

Id.: But see Comment from Tom Deutsch, Executive Director, American Securitization Forum, at 4-5 (Nov. 15, 2010), available at http://sec.gov/comments/s7-26-10/s72610-44.pdf (File No. S7-26-10) (expressing dislike for reasonable assurance standard). [The reasonable assurance minimum review standard] . . . is inappropriate and unnecessary . . . [because] the new requirements mandated by [the Dodd-Frank Act] should address a review of the assets, not a review of the disclosure about the assets . . . Issuers already have strict liability for any untrue statement of a material fact in the prospectus or any omission to state a material fact required to be stated therein or necessary to make the statements made not misleading. Effectively, the “reasonable assurance” standard if applied to Rule 193 would require issuers to describe what they did to get comfortable that they met their disclosure obligations. This disclosure requirement could expose issuers to liability for failing to have used procedures that provided such “reasonable assurance”, or for not having accurately described the nature of the procedures and their findings and conclusions, even if there was no material error or omission as
about including a minimum review standard at all in Rule 193 due to the fact that "[RMBS] do not lend themselves to a one-size-fits-all approach to asset reviews." Moreover, Rule 193 permits the sampling of assets as a way to satisfy the asset review requirement. Issuers are also required to disclose in the registration statement whether they relied on a third party’s assistance in conducting a review and the name of that third party.

**ii. Amendments to Item 1111 of Regulation AB**

Also effective on March 28, 2011 was the decision to adopt the amendments to Item 1111 of Regulation AB in order to satisfy Rule 193. Under New Item 1111(a)(7), an issuer is required to disclose the findings and conclusions of the review performed by the issuer or by a third party who conducted the review. Furthermore, under New Item 1111(a)(8) of Regulation AB, issuers are required “to disclose how the assets in the pool deviate from the disclosed underwriting criteria and include data on the amount and characteristics of those assets that did not meet the disclosed standards.” Importantly, the amendment requires issuers to disclose the entity responsible for determining that such assets are included in the pool, despite the deviation from the disclosed underwriting standards, and what factors were used to make the determination. Moreover, for loans granted with the use of compensating

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Id.  
204 See Roper, Supra note 137, at 6 (noting that it would be near impossible “to write a detailed, prescriptive rule outlining exactly how asset reviews should be conducted in each circumstance”).  
205 See Supra note 96, at 4235 (discussing allowance of sampling).  
206 See Id. at 4236-37 (discussing requirements for third party reviews).  
207 See Id. at 4237 (stating SEC’s purpose in amending Item 1111 was to ensure disclosures provide clear pictures for investors of review undertaken and results of such review).  
208 See Id. at 4237-38 (providing that new Item 1111(a)(7) of Regulation AB requires issuers of RMBS offerings to disclose nature of review it conducts to satisfy Rule 193). New Item 1111(a)(7) requires disclosure as to “whether the issuer has hired a third-party firm for the purpose of reviewing the assets . . . a description of the scope of the review . . . and what kind of sampling technique was employed . . .”). Id.  
209 Id. at 4238.  
210 See Issuer Review of Assets in Offerings of Asset-Backed Securities, 76 Fed. Reg. 4231, 4238 (providing that this explanation “could include compensating factors, such as those included in an issuer’s waiver policies for
or other factors, New Item 1111(a)(8) requires issuers to provide data on the amount of assets in the pool or sample “that are represented as meeting each factor and the amount of assets that do not meet those factors.”

B. Analysis of New Regulations

In response to critics of the reasonable assurance standard, it is correctly argued that a minimum standard of review is necessary to “reintroduce due diligence” into the securitization process. A minimum review standard is essential to regulating RMBS offerings because allowing issuers to satisfy the statutorily required review without following a proscribed minimum standard, “potentially could undercut the statutory purpose by erroneously suggesting that due diligence was conducted.” Hence, it is unfortunate that the SEC did not write Rule 193 to require the issuer to conduct a specific type of review.

including in the pool loans that fail to meet the disclosed underwriting criteria, or a determination that the exception was not material.”

We also believe that this information will help provide investors with a more complete understanding of the quality and extent of the issuer’s review of the assets (through hiring a third-party or otherwise) and how that relates to a determination to either include a loan in the pool or exclude it from the pool.

Indeed, if issuers’ and underwriters’ responsibility to ensure accurate disclosures were adequate to discipline this process, it should have worked in the past. The fact that it did not should serve as sufficient reason not to rely on it to do so now. Similarly, investors’ inability to force more extensive or more timely disclosures with regard to asset-backed securities strongly suggests that they will be similarly unable to exert sufficient market power to improve the quality of asset reviews absent a Commission requirement that those reviews meet some minimum standard.

First, a credit review examines the sample loans to ascertain whether they have been originated in accordance with the originator’s underwriting guidelines. This would include a review of whether the loan characteristics reported by the originator are accurate and whether the credit profile of the loans is acceptable to the sponsor. A second type of review could be a compliance review, which examines whether the loans have been originated in compliance with applicable laws, including
The SEC should have mandated a minimum review standard of the assets underlying RMBS transactions. In fact, as one commentator correctly noted, “[i]n order to make a review of underwriting guidelines meaningful, it is imperative that issuers be required to disclose the applicable underwriting to investors.” Although the SEC did not mandate an inclusion of a credit review in the adoption of Rule 193, it did suggest that an asset review at a minimum should include information regarding credit quality. Nevertheless, without a mandatory credit review, the disclosures following the adoption Rule 193 may potentially defeat the goal of the new regulation.

Furthermore, by failing to require a specific review for RMBS offerings, the SEC left the door open for Wall Street to manipulate the review to their desire. The only requirement the issuer is now obligated to follow is to include “material” facts and conduct the review in a way that provides “reasonable assurance.” Thus, all Rule 193 has done is perpetuate the “notoriously slippery concept” of materiality and create potential new litigation surrounding predatory lending and Truth in Lending statutes. Third, a valuation review entails a review of the accuracy of the property values reported by the originators for the underlying collateral. This could include a review of each original appraisal to assess whether it appeared to comply with the originator’s appraisal guidelines, and the appropriateness of the comparables used in the original appraisal process.

Id. at 4235.

For example, in order to comply with Section 945 on RMBS transactions, the review of the assets should include the following: (i) verification of data (i.e., confirmation that the information on the mortgage loan schedule matches what appears in the actual mortgage loan files), (ii) credit re-underwriting to the loan requirements set forth in the originator’s underwriting guidelines, (iii) compliance with underwriting guidelines (including noting exceptions made to underwriting guidelines and describing compensating factors), (iv) compliance with the originator’s property valuation guidelines, and (v) compliance with applicable consumer protection laws and noting any violations thereof. For seasoned loans, a review of compliance with underwriting guidelines should not be required. Instead, a review of borrower payment history should be conducted.

Comment from Steven Cohen, Senior Vice President and General Counsel, Clayton Holdings LLC, at 9 (Nov. 15, 2010), available at http://sec.gov/comments/s7-26-10/s72610-42.pdf (File No. S7-26-10).

Id.

See Supra note 149, at 4235 (“The minimum review standard we are adopting will necessarily include credit quality and underwriting of the assets . . . ”).

Id. at 32 (indicating SEC’s goal was to “increase investor protection”).

See Id. at 4235-35 (discussing final issuer review requirement rule under Rule 193).
the meaning of reasonable assurance. The Supreme Court has warned against a bright-line rule. Nevertheless, a determination of what to include in the disclosures should not rely solely on “delicate assessments of the inferences a ‘reasonable shareholder’ would draw from a given set of facts and the significance of those inferences to him.” With respect to RMBS disclosures, it seems apparent that reasonable investors would benefit from a bright-line rule requiring issuers to disclose due diligence reports on asset reviews and the amount of exception loans contained in the RMBS offerings. Therefore, a materiality-based disclosure is no longer appropriate and the SEC has faultily kept the materiality scapegoat alive for issuers.

The SEC should also have required a minimum percentage of loans be reviewed for different asset classes or require the samples satisfy a specific statistical confidence interval. Permitting issuers to review and report on only a sample of the underlying assets contributed to the problem surrounding the financial crisis.

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221 See Basic Inc. v. Levinson, 485 U.S. 224, 232 (1988) (“Where . . . the event is contingent or speculative in nature, it is difficult to ascertain whether the ‘reasonable investor’ would have considered the omitted information significant at the time.”).

222 See Basic Inc. v. Levinson, 485 U.S. at 236 (“A bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances. But ease of application alone is not an excuse for ignoring the purposes of the Securities Acts and Congress’ policy decisions.”)

223 For examples of investors’ complaints over inadequate reporting of due diligence reports and sampling, see supra notes 98-117 and accompanying text.


225 See, e.g., Supra note 2, at 153 (providing that J.P. Morgan Chase & Co., Bear Stearns & Co. and Washington Mutual were informed that 27 percent, 16 percent, 27 percent, and 9 percent of loans reviewed by [third party due diligence firms] for J.P. Morgan Acquisitions, EMC, Washington Mutual Bank, and Washington Mutual Securities, respectively, were not underwritten according to represented underwriting standards). Instead of increasing the sample size to see why the sample deviated from the underwriting standards, the investment firms “continued to carry on with their own poor internal underwriting and work with problematic originators.” Id. at 154. Had there been a regulation requiring these firms to sample a minimum amount of assets or to increase the sample size when confronted with a sample that was inconsistent with their underwriting standards, it would have been more difficult
Next, the SEC also mistakenly permitted issuers to rely on third party reviews in conducting the asset review.\textsuperscript{226} Allowing an issuer to engage a private third party creates a conflict of interest similar to the conflict of interest that was apparent between the issuers and the credit rating agencies prior to 2008.\textsuperscript{227} One protection Rule 193 offers in response is the requirement that third parties consent to expert liability in accordance with Section 7 and Rule 436 of the Securities Act, which would provide accountability and thus create stronger incentives by the third parties to perform high-quality reviews.\textsuperscript{228}

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\textsuperscript{226} See \textit{Supra} note 149, at 4236-37 (discussing requirements for third party reviews).

\textsuperscript{227} See, e.g., Elliot Blair Smith, ‘Race to Bottom’ at Moody’s, S&P Secured Subprime’s Boom, Bust, Bloomberg (Sept. 25, 2008), available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ax3vfya_Vtdo (discussing adjustment of rating requirements for securities conducted by Moody’s and S&P in order to block threat of losing business from Wall Street banks). The third parties are incentivized to produce faulty reviews and report inaccurate findings by perhaps overlooking deviations from the guidelines in order to maintain the issuers as continuous clients. See \textit{Id.} (same).

\textsuperscript{228} See \textit{Supra} note 149, at 4236 (discussing requirement under Rule 193 that issuers may rely on third-party’s review provided third party is named in registration statement and consents to expert status).

In response to this requirement, commentators voiced their opinion that requiring third party due diligence firms to consent to expert liability would deter these third parties from conducting the review for the issuers. See, e.g., Rubin, \textit{Supra} note 142, at 5-6 (expressing American Bar Association’s belief that third party due diligence firms will not consent to being named experts). This, commentators argue, would be harmful to investors because less experienced firms would then be left to conduct the reviews. See \textit{Id.} (“If any third party due diligence provider were required to be named as an expert, that requirement would significantly increase the likelihood that review of the pool assets will be performed only internally by the issuer and, accordingly, decrease the likelihood of independent review. We believe that this result would not be beneficial for investors.”); See also Comment from Christeena G. Naser, Assistant General Counsel, American Bankers Association Securities Association, at 2 (Nov. 16, 2010), available at http://sec.gov/comments/s7-26-10/s72610-49.pdf (File No. S7-26-10) (“[It is] likely that few third-party due diligence providers would be willing to subject themselves to such liability but would rather withdraw their services in such instances.”);

Even if issuers were able to engage skilled third parties who were willing to consent to be named as experts . . . such third parties would likely be inclined to perform a far more limited, “check the box” style review than they would perform if incurring expert liability was not a concern. Alternatively, the quality of loan review by existing providers of these services could be maintained, but at a much higher cost reflecting additional procedures required in order to operate under the higher liability standard, which would result in higher costs of credit to be borne by borrowers. It is also possible that the industry could see an influx of newly formed Third Party Diligence Providers who would be thinly capitalized and therefore more willing to take on expert liability. Such reviews would likely be substantially poorer in quality than those performed by the skilled and experienced providers currently active in the market.

Deutsch, \textit{Supra} note 142, at 6-7.
One alternative to requiring third party due diligence firms to accept expert liability as a solution to the conflict of interest concern that has been recommended is to require the third party due diligence firms to provide a certification stating that they were not involved in a conflict of interest. However, including a certification in the disclosures or disclosing that the issuer pays the third party is not adequate protection for investors. Requiring only these toothless options as a solution to the conflict of interest problem is to mitigate the unethical choices members of the rating agencies and the issuers made prior to the financial crisis.

There are other options to the conflict of interest problem. For example, the SEC could audit the third party due diligence providers or conduct due diligence reviews itself so as to ensure the reviews are truthfully reported. However, this would require the SEC to acquire a higher level of examination and enforcement power than even the recent authority granted to the SEC through the Dodd-Frank Act. Auditing the third parties would encourage the third parties to conduct thorough, truthful and complete reviews due to the threat of a potential audit.

229 See Deutsch, Supra note 142, at 9 (discussing alternatives to third party due diligence problem).
230 We propose that Third Party Diligence Providers . . . hired by issuers to perform the review required by proposed Rule 193 be required to provide a certification stating that (i) the Third Party Diligence Provider was not subject to any coercion or duress that either limited the scope of the review or limited the provider’s ability to conduct an independent and thorough review and (ii) the review was conducted in accordance with specified loan-level review standards provided by the party engaging the Third Party Diligence Provider (which could be the standards of the rating agencies or of the underwriter, or the sponsor’s underwriting standards or those of the originator). This is similar to the certification currently provided by Third Party Diligence Providers to rating agencies on RMBS transactions.

231 See Rubin, Supra note 142, at 7 (“[T]o the extent that there are any conflict of interests issues for hired due diligence providers, disclosure of the conflict should be a sufficient cure.”).
233 See Examinations by the Securities and Exchange Commission’s Office of Compliance Inspections and Examinations (Feb. 2011), available at http://www.sec.gov/about/offices/ocie/ocieoverview.pdf (discussing expansions of SEC’s examination authority to include several additional types of entities/persons).
Moreover, many commentators argued that a mandated disclosure of the findings and conclusions of the review is not mandated by Section 945 of the Dodd-Frank Act.\textsuperscript{234} Nevertheless, the SEC was correct in requiring that the issuer disclose the findings and conclusions of a review in its registration statement.\textsuperscript{235} Disclosure of the findings and conclusions of the review is necessary to provide investors with a clear picture of the security.\textsuperscript{236} Absent a report on the findings of the asset reviews, issuers could be incentivized ‘to conduct the review themselves to avoid making publicly available the findings and conclusions of any review of the assets underlying the [RMBS].’\textsuperscript{237} Additionally, a reporting of the findings of the review will provide investors with useful information and will ‘help elicit information in areas that became problematic in the recent financial crisis.’\textsuperscript{238} In order to solve the problem of investor ignorance as to the underlying assets, the ‘asset reviews themselves [need to be] sufficient to reveal the existence and extent of problem assets.’\textsuperscript{239}

\section{VI. Conclusion}

New regulation should ‘not take away from the citizen his inalienable right to make a fool of himself. It [should] simply [attempt] to prevent others from making a fool of him.’\textsuperscript{240} It is not until investors possess all necessary information to make informed decisions that

\textsuperscript{234}See Rubin, \textit{Supra} note 142, at 8 (discussing American Bar Association’s view that Congress could have required disclosure of findings and conclusions of issuer’s due diligence review but chose to not make this requirement); Naser, \textit{Supra} note 167, at 2-3 (‘[I]t is inappropriate for the Commission to substitute its judgment and impose a requirement to disclose due diligence findings under the Securities Act.’). But See Roper, \textit{Supra} note 137, at 4 (applauding SEC’s decision to require disclosure of asset review findings).

\textsuperscript{235}See Supra note 149, at 4238 (discussing SEC’s intention “to make clear that disclosure of the findings and conclusions necessarily requires disclosure of the criteria against which the loans were evaluated, and how the evaluated loans compared to those criteria along with the basis for including any loans not meeting those criteria”).

\textsuperscript{236}Roper, \textit{Supra} note 137, at 4.

\textsuperscript{237}Id. (approving SEC’s disclosure proposal because the disclosures will provide information to investors regarding deviation from disclosed underwriting criteria, number and characteristics of assets that do not meet disclosed criteria and entity responsible for determining that such assets should be included).

\textsuperscript{238}Id.

\textsuperscript{239}Id.

investors can be blamed for their investment choices and the defense of caveat emptor be employed.

As outlined in this Note, the shortfall of post-financial crisis regulations is the door left open. Issuers are still permitted to perform sample reviews with all the dangers of under-disclosure that accompanies sampling. The new regulations also leave a murky pool of uncertainty as to how to ensure deal transparency. Moreover, the great unanswered question in the Dodd-Frank Act is how to ensure that issuers do not exert undue influence on due diligence providers without retribution from a strong audit requirement either by its corporate auditors or a SEC with sufficient resources to adequately police issuers and protect investors.

These are the imperative, unaddressed issues in the Dodd-Frank Act that have the ability to recreate the financial crisis in the future. No suitable answers have been posed. It seems predictive that true financial reform is destined to be iterative as underlying flaws in the current legislation are uncovered and then subsequently addressed in future legislation.
A Competition Act by India, for India: The First Three Years of Enforcement Under the New Competition Act

Dorothy Shapiro

ABSTRACT

In 2002, India unveiled its new Competition Act. The Act substantially improves upon the previous competition regime, which regulated and condemned dominance even absent culpable conduct. Despite improvements, provisions of the Act have proven difficult for the fledgling Competition Commission (“the Commission”) to implement. For one, the Act overwhelmingly prefers rule of reason analysis to per se illegality for horizontal and vertical agreements. While this approach gives the Commission the flexibility to conduct a nuanced inquiry, the economic analysis required is challenging. So far, the Commission has struggled when applying basic antitrust economics in the hundred or so orders that it has issued. Going forward, the Commission should develop systematic approaches grounded in economic principles in order to create clear rules and precedents that will support a competitive market place and promote economic growth. It may be necessary to train the Commission members or replace them with individuals who have a background in antitrust economics. After the Commission has addressed limitations on resources and staff expertise, it should develop enforcement priorities and interpret its guiding statute in a way that is congruent with India’s unique economic situation. Most importantly, the Commission should focus on cartel abuses, which would beneficially affect a broad base of consumers.

CONTENTS

I. INTRODUCTION

II. HISTORY OF INDIAN COMPETITION POLICY

A. MRTP Act
B. Raghavan Committee
C. The Competition Act
   i. Delay in Enforcement
   ii. The Commission

III. THE STRUCTURE OF THE COMPETITION ACT

A. Section 3: Vertical and Horizontal Agreements
B. Section 4: Abuse of Dominance
C. Sections 5 and 6: Combinations
D. Implementation Challenges

IV. ENFORCEMENT OF THE ACT TO DATE

A. MCX and Market Definition
B. Arriving at Abuse of Dominance in MCX
C. DLF and Abuse of Dominance – Ghosts from the MRTP era?
D. Lack of Enforcement in Cartel Cases

V. HOW TO BUILD A ROBUST COMPETITION INSTITUTION IN INDIA?

A. Training
B. Corruption
C. Precedents
D. Carving out Enforcement Priorities
   i. Enforcement Priority: Hard Core Cartels
   ii. State Owned Enterprises and Liberalization

VI. CONCLUSION: AN ANTI TRUST REGIME BY INDIA, FOR INDIA
I. INTRODUCTION

In 2002, the Indian government demonstrated its commitment to aligning its antitrust enforcement regime with that of the western world. Since then observers have wondered what principles would drive the Competition Commission’s enforcement agenda. This paper attempts to summarize and evaluate the evolution of India’s competition policy thus far.

In 2002, India unveiled its new Competition Act, which the OECD has called “close to state-of-the-art.”242 The Act incorporates statutory elements from the U.S., the EU, the UK, Australia, and Canada, and creates a watchdog agency with jurisdiction over abuses of dominance and horizontal and vertical agreements. It also sets forth merger analysis procedures to be enforced by the agency. The Act substantially improves upon the previous competition regime, which regulated and condemned dominance even absent culpable conduct.

Despite these improvements, the provisions of the Act may be difficult for the fledgling Competition Commission (“the Commission”) to implement. For one, the Act overwhelmingly prefers rule of reason analysis to per se illegality for horizontal and vertical agreements. While this approach gives the Commission the flexibility to conduct a nuanced inquiry, the economic analysis required is challenging. Capacity issues at the top of the Commission exacerbate this issue. Since creation, the Commission has been short-staffed and operating with a tight budget. As of August 2011, 50 out of 144 sanctioned posts at the Commission and half of the posts at the Director General’s office were unfilled. Further, the majority of the members of the Commission, who select cases for investigation and write the orders, have no background in antitrust economics or competition policy. And the members are not rigorously trained in competition law.

242 OECD Economic Surveys: India 14 OECD, 109 (New Delhi, 2007).
So far, the Commission has struggled when applying basic antitrust economics in the hundred or so orders that it has issued. Many decisions lack concrete economic analysis and are instead supported by conclusory statements about market competitiveness. Other orders suggest that the members may be interpreting their mandate to protect consumer welfare by selecting cases that resemble contractual disputes. Further, the Commission has developed a pattern of refraining from making a decision or imposing a penalty when the option is available, which suggests that the members are insecure over their own abilities.

The Commission should develop systematic approaches grounded in economic principles before doling out violations (and imposing hefty fines). Without using economic analysis in the orders that it generates, the Commission runs the risk of penalizing competitive behavior, which would stifle the competitiveness of India’s vibrant economy. Alternatively, if the Commission is too timid to take on naked abuses *suo moto*, it will fail to promote market competitiveness and economic growth. Further, the lack of economic analysis in the orders issued has prevented the Commission from establishing clear rules and precedents. And absent clear guidance, the Commission may chill the business community from engaging in pro-competitive behavior with the fear that such behavior would subject it to scrutiny by the Commission.

In order to correct these problems, the foundation of the Commission must be altered. The members should be trained or replaced with individuals who have a background in antitrust economics. In addition, the Commission should alter its enforcement priorities and focus on straightforward abuses, such as naked restraints. Naked restraints, such as horizontal price-fixing, seriously impact consumer welfare in India. A number of studies have alleged that cartels, both within India and internationally, have artificially inflated prices of Indian goods, including diet staples. By taking a hard line against cartels, the Commission would
demonstrate its commitment to promoting consumer welfare at its broadest base, which would generate public support for the agency. And focusing on clear violations would provide opportunities for the Commission to refine its skills and develop capacity with a relatively low margin for error.

Part two of this paper provides a brief history of the Competition Act and its predecessor, the Monopolies and Restrictive Trade Practices (“MRTP”) Act. Part three describes the structure of the Competition Act and highlights differences from United States competition law. Part four discusses the Commission’s enforcement to date, focusing on several landmark cases. Notably, the paper discusses a lack of cartel enforcement despite compelling evidence of concerted behavior and cartelized sectors of the economy. Part five offers recommendations for building a robust competition institution within India.

II. HISTORY OF INDIAN COMPETITION POLICY

A. MRTP Act

Before the Competition Act was enacted, the Monopolies and Restrictive Trade Practices Act formed the backbone of Indian competition law. The Act was created in 1969 following a government inquiry into private sector concentration. The inquiry produced a report demonstrating that over 85% of industrial areas had a “high concentration of economic power.” The Committee ultimately passed the Monopolies and Restrictive Trade Practices Bill (MRTP) with the goal of limiting market concentration by industry.

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The MRTP Act was enacted in December of 1969 and it came into force the following year. The MRTP Commission was charged with investigating the conduct of entities suspected of engaging in monopolistic, restrictive, or unfair trade practices. If the MRTP Commission concluded that illegal action had taken place, it could direct the firms to discontinue the practice. The Act also required all large companies (whose assets exceeded INR 20 crore) or “dominant” companies (whose assets exceeded INR one crore and whose share of the market exceeded 25%) to obtain licenses or permits before engaging in mergers or takeovers, establishing new ventures, or substantially expanding old ones. Firms with assets of more than INR 100 crore were prohibited from expanding into sectors not selected by the government. In 1977, unfair trade practices, such as false or misleading advertising, were included in the list of prohibited activities.

The MRTP Act was amended in 1984 to prohibit monopolistic trade practices, which were defined quite broadly. An inquiry could be ordered if the monopolistic company was “unreasonably” limiting competition or if the firm was “unreasonably maintaining or increasing prices and limiting investment.” And in 1991, the MRTP Act was amended to eliminate the requirement for government approval prior to conducting a merger or acquisition, which the government believed “had become a hindrance to the speedy implementation of industrial projects.”

The MRTP Act ultimately failed for several reasons. First, the MRTP Act’s licensing requirement and strict regulation of growth punished efficiency. If a large company wanted to increase production, it would need to apply for a license or permit from the government.

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245 A crore is a unit equal to ten million.
246 See Dr. S. Chakravarthy, MRTP ACT METAMORPHOSES INTO COMPETITION ACT, 10 (2005).
247 Unfair trade practices were removed from the scope of the MRTP by the Consumer Protection Act of 1986.
248 1991 Amendment Bill.
Second, the MRTP Commission lacked the power to impose substantial penalties for violations. Its primary tools were cease and desist orders, which were often ignored.

The act was also excessively vague. It failed to define many of the anti-competitive acts that it intended to prohibit and the definitions that it included were too general. For example, the broad definition of “unfair trade practices” invited complaints that resembled consumer or contractual disputes. Thus, the MRTP Commission spent much of its limited resources responding to claims about the production of defective goods, deficient services, and related claims that did not allege an injury to competition.249 The broad language also allowed the MRTP Commission to take on a regulatory gap-filling role. For example, complaints about residential property predominated during this time, which was likely due to the fact that the housing industry is not regulated in India. By contrast, the MRTP Commission was not interested in pursuing cartels. Only seven cartel cases were resolved from 1991 to 2007, and almost all resulted in dismissals because of a lack of evidence of an agreement.250

B. Raghavan Committee

In 1991, India began a project of economic liberalization. This move away from “command and control” economic principles culminated in an overhaul of the competition laws. In his 1999 budget speech, the finance minister explained, “The MRTP Act has become obsolete in certain areas in the light of international economic developments relating to competition laws. We need to shift our focus from curbing monopolies to promoting competition.”251 The Indian government appointed a High Level Committee on Competition Policy and Law, known as the Raghavan Committee, to evaluate the MRTP Act. The Committee’s report

249 See Aditya Bhattacharjea, India’s New Antitrust Regime: The First Two Years of Enforcement, ANTITRUST BULLETIN (Publication Forthcoming).
250 Id., at 6.
251 Abir Roy & Jayant Kumar, COMPETITION LAW IN INDIA 44-45 (2008).
found the MRTP to be inadequate “for fostering competition in the market...and reducing...anti-competitive practices...” The Committee made a series of recommendations, which prompted the Indian government to replace the MRTP Act with an entirely new act. Notably, the Committee recognized that substantial expertise would be necessary to institute an effective competition regime. The report explained, “...If the Competition Law Authority is to monitor mergers in India, it will have to be suitably equipped with adequate staff with relevant expertise in law, commerce, economics, and other relevant disciplines. Such expertise will inevitably take time to be developed as we are already seeing in the case of the new regulatory authorities that have been set up recently in the various infrastructure sectors.”

C. The Competition Act

i. Delay in Enforcement

The Indian Parliament enacted the Competition Act (“the Act”) in December 2002 and it received Presidential assent in January 2003. While the Act was enacted in 2002, Sections 3 and 4 were not ratified or enforced until 2009 and the Commission’s first orders under Section 3 and 4 were not announced until February 2010. Sections 5 and 6, which pertain to mergers and acquisitions, were delayed further--two drafts of implementing regulations were notified and then withdrawn in the face of vehement criticism. A third set of regulations was notified in May and the merger provisions were finally given effect in June 2011.

The Act was initially blocked by a lawsuit that challenged the constitutional validity of its provisions. A writ petition filed in the Supreme Court of India claimed that the head of the Commission must be a member of the judiciary because the Commission would exercise

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252 Report of the High Level Committee on Competition Policy and Law, GOVERNMENT OF INDIA, para. 2.9.7 (2000).
253 Id., at para. 4.7.9.
judicial powers. Despite its discomfort with the appointment of a retired civil servant as the head of the agency, the Supreme Court refrained from passing a definitive judgment because the government stated that it would amend the Act. Accordingly, the Act was amended in 2007 in order to create a substantial role for the judiciary. The 2007 amendments created the Competition Appellate Tribunal (CAT), a three-member quasi-judicial body that must be led by a former judge of the Supreme Court or the Chief Justice of a High Court. In addition, the Chief Justice of the Supreme Court would have primary responsibility in selecting the members of the Committee.

The CAT has two primary responsibilities. First, any individual who wishes to contest an order made by the Commission must appeal to the CAT. Rulings made by the CAT can only be appealed to the Supreme Court. Second, the CAT determines compensation after a violation has been established.

ii. The Commission

Section 7 of the Act creates the Competition Commission of India, the national agency charged with investigating complaints. Unlike the U.S., the Commission has both investigative and adjudicatory functions. It may inquire into violations *sua moto* or can choose to pursue complaints that it receives. Any individual, trade association, or state government body is able to file a complaint with the Commission for a nominal fee. However, unlike the U.S., there is no private cause of action for competition abuses. Thus, the Commission must bear the full brunt of investigating and litigating competition violations without any help from private litigants. Due to its limited resources, the


255 §53A of the Competition Act.

256 Indian competition law distinguishes between penalty and compensation. While the compensation is paid to the Commission, the winning party may only seek compensation from the CAT. So unless the CAT upholds the Commission’s order, there will be no payment of the award.
Commission has been unable to investigate all of the complaints that are filed, which means potentially meritorious claims may never be investigated or resolved.

The Commission consists of six members and one chairperson. Together, the Commission reviews complaints and decides which are worthy of further investigation. Once the Commission decides that a prima facie case exists, the members order the Director General to conduct an enquiry. The Director General heads the investigative arm of the Commission. After a period of time, the Director General submits a report on the facts and law, including his recommendation for further action. The parties involved are given an opportunity to respond, after which the Commission can choose to close the matter, order further investigations, or pronounce an order that directs the guilty party to “cease and desist” from their anticompetitive conduct or pay a fine (not exceeding 10% of the average turnover during the preceding three years). The Commission can also levy a higher fine against cartels, taking three times their illegal profits if this number is greater than 10% of their annual turnover. In addition, the Commission can order the dissolution of a dominant firm. This provides substantial leverage during negotiations with dominant firms who engage in anticompetitive practices.

All competition offenses are treated as civil offenses. Jail time may only be imposed (by an independent magistrate’s court) if an individual refuses to comply with the Commission’s orders.

Since creation, the Commission has been short-staffed and operating with a tight budget. As of August 2011, 50 out of 144 sanctioned posts at the Commission and half of the posts at

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257 The Commission receives an annual budget from the Ministry of Corporate affairs. The total amount for 2010-2011 was originally INR 4403 lakh (or about $8.9 million), but was further reduced by the Ministry to INR 3306 lakh ($6.7 million). *Competition Commission of India Annual Report*, 41 (2010-2011).
the Director General’s office were unfilled. In a 2006 report by IIM-Bangalore, professors and researchers recommended that the Commission have a support staff of 200, consisting of 40% finance professionals and 40% economists. However, in January 2012, I was informed by one of the members that the Commission is staffed by less than 80 people in total.

III. THE STRUCTURE OF THE COMPETITION ACT

The Competition Act covers four enforcement areas: 1) Anti-competitive agreements, 2) Abuse of dominance, 3) Combination regulation, and 4) Competition advocacy (which will not be addressed in this paper). The language of the Act is taken from competition law from around the world, and provides much more specific guidance than the MRTP Act. For the most part, it defines technical terms and actually lists criteria that the Commission must use when deciding cases.

A. Section 3: Vertical and Horizontal Agreements

Section 3 prohibits both horizontal and vertical agreements. Section 3(3) prohibits four categories of horizontal agreements between enterprises in the same industry (with exemptions for efficiency enhancing joint ventures). These include agreements that i) lead to price fixing, ii) limit or control quantities, iii) share or divide markets, and iv) result in

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259 Id.

260 Id.

261 The Ministry of Corporate Affairs sanctioned 187 posts in January 2009, including 122 professionals (90 at the Commission and 32 in the DG’s office) and 63 support staff positions. 27 out of the 32 professional positions in the DG’s office were vacant in December 2009. It seems as though the agency employees are too overburdened to concentrate on their duties as well as hiring. As R. Prasad explained during our meeting, “hiring takes more work.”

261 Note that a “joint venture” is not defined in the act.
bid-rigging. Unlike the United States, these horizontal agreements are not per se illegal, and instead are presumed to have an “appreciable adverse effect on competition” (AAEC) that can be rebutted. In other words, the burden of proof is shifted for horizontal offenses, but otherwise, there is no real difference between horizontal agreements and other offenses.262

Section 3(4) identifies vertical agreements that are subject to review under a rule of reason test. The Act requires the Commission to determine whether the vertical agreement will lead to an AAEC. By instituting this version of a rule of reason test, India has bypassed the U.S. common law evolution for vertical agreements. Section 3(4) specifically includes ties, exclusive supply and distribution agreements, refusals to deal, and resale price maintenance as within the Commission’s jurisdiction. And Section 3(5) lists exemptions from the application of Section 3, which include conditions that protect intellectual property rights and export cartels (where the harm to competition is inflicted on foreign entities).

B. Section 4: Abuse of Dominance

Section 4 prohibits abuse by dominant entities. The Act uses the EC’s United Brands definition for dominance: a “dominant position” is “a position of strength, enjoyed by an enterprise, in the relevant market, in India, which enables it to i) operate independently of competition forces prevailing in the relevant market; or ii) affect its competitors or consumers in the relevant market in its favor.” So far, the Commission has read this test broadly to include relationships characterized by a contractual lock-in.263

262 The Commission’s analysis in FICCI - Multiplex Association of India v. United Producers/ Distributors Forum & Ors., confirms that the Commission will use a rule of reason test even when evaluating cartel cases. See infra note 60.

263 See the DLF case, Part IV.C, infra.
Section 4(2) lists five categories of exclusionary behavior that will be considered abusive: (i) unfair or discriminatory pricing (including predatory pricing); (ii) limiting or restricting production, (iii) denying market access; (iv) making a contract subject to obligations unrelated to the subject of the contract; and (v) using a dominant position in one market to enter or protect another market. Section 19(4) directs the Commission to consider “any or all” of thirteen factors during a dominance inquiry. These include, “relative advantage, by the way of contribution to economic development” by the dominant enterprise and “social obligations and social costs,” as well as “any other factor which the Commission may consider relevant for the inquiry.”

The drafters of Section 4 declined to require that the Commission demonstrate an adverse affect on competition when evaluating an abuse. Section 19 lists factors for the Commission to consider when deciding whether or not a company is dominant, but the Act does not require the Commission to prove that conduct in question is harming market competitiveness. This allows the Commission to condemn exploitative abuses, such as excessive pricing, in addition to exclusionary abuses.264

C. Sections 5 and 6: Combinations

Sections 5 and 6 regulate “combinations,” which includes mergers, amalgamations, and acquisitions.265 Combinations that cause or are likely to cause an AAEC in India are prohibited. Any combination that exceeds the monetary threshold limits specified in the Act

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264 Article 102 of the Treaty on the Functioning of the European Union (TEFU) includes exploitative abuses in its abuse of dominance test. The United States limits abuse of dominance to exclusionary abuses.

265 Acquisition is defined as “acquiring or agreeing to acquire, i) shares, voting rights, or assets of an enterprise or (ii) control over management or control over the assets of an enterprise.” See §2(a) of the Competition Act. The definition of combination includes “acquiring of control by a person over an enterprise.” Thus, a merger can be a combination between two existing companies but also the absorption of one company by another.
must file a premerger notification with the Commission. The Act uses a size of the entity test, measuring the combined size of the acquirer and the target against the threshold, which differs from the U.S., which uses a size of the transaction test. The Act also exempts transactions that take place entirely outside India with an insignificant local nexus and effect on Indian markets, acquisitions where the buyer holds no more than 15% of the enterprise for investment purposes, and intra-group reorganizations. The Act was also altered to include an additional threshold for Commission scrutiny based on the size of the acquired entity. No filing is required if the size of the target enterprise has less than INR 2.5 billion in assets in India and 7.5 billion in turnover in India.

Any entity whose combination meets the thresholds must give the Commission notice of its proposed transaction. After filing, the Commission may approve the combination, or it may propose modifications or block the combination entirely. The Commission has 210 days to conduct its investigation or the combination will be considered approved.

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266 A transaction is required to be notified only if the combined size of the acquirer and the acquired enterprise, upon completion of the transaction, meets the following jurisdictional monetary thresholds (at a conversion ratio of 1 USD = INR 53.12 approximately):
(a) Where the parties to the transaction have a cross-border presence,
   (i) Globally: At least 3 billion dollars in assets 9 billion dollars in turnover on a group-wide basis, or at least 750 million dollars in assets or 2.25 billion dollars in turnover on an enterprise-wide basis and
   (ii) In India, at least 141 million dollars in assets or 423 million dollars in turnover on a group-wide or enterprise-wide basis.
(b) In purely domestic transactions: At least 1.12 billion dollars in assets or 3.38 billion dollars in turnover on a group-wise bases, or at least 282 million dollars in assets or 847 million dollars in turnover on an enterprise-wide basis.

“Group” is defined to include all controlling entities, controlled entities, and all entities under common control. The definition of “enterprise” includes subsidiaries.

267 This local nexus requirement for cross-border mergers was introduced in a 2007 amendment to the Competition Act.

268 Because this change was accomplished through exemption notification instead of an amendment to the act, the exemption will only be available for five years. Rahul Singh, India’s Tryst with ‘The Clayton Act Moment’ and Emerging Merger Control Jurisprudence: Intersection of Law, Economics and Politics, (Publication Forthcoming).
While Sections 3 and 4 were ratified in 2009 (following the litigation over the composition of the Commission), Section 5 became effective in July 2011. The delay was the product of aggressive lobbying by the business community. International entities were concerned that the notification and review procedures would impose an onerous burden on foreign firms with small investments in India. The International Bar Association and the American Bar Association each issued memoranda expressing their concerns.

The revised merger regulations include contradictions that are a product of aggressive and uncoordinated lobbying from the business community. The Competition Act’s treatment of “groups” provides an amusing example. The Competition Act requires a group of enterprises in common control to have their assets considered in aggregate when evaluating whether the combination meets the Act’s asset or turnover thresholds. Groups that exceed the thresholds are subject to premerger notification requirements. The original legislation defined a group to be two or more enterprises in a position to control 26% or more of the voting rights in the other enterprise. This ensured that all entities within a group would be accounted for when calculating the jurisdictional threshold. However, the business community lobbied the Ministry of Corporate Affairs, the sponsoring ministry of the Commission, to raise this threshold. The Ministry assented, clarifying that a group exercising less than 50% of voting rights was exempt from the calculation of jurisdictional monetary thresholds in the 2011 regulations.

269 A draft of the merger regulations was issued in February 2011, but were revised and finalized in May 2011. See Joint Comments of the American Bar Association Section of Antitrust Law and Section of International Law on the Draft CCI (Procedure in Regard to the Transaction of Business Relating to Combination) Regulations (March 21, 2011), available at http://meetings.abanet.org/webupload/commupload/IC906787/relatedresources/sal_sil_comments_on_india_draft_combination_regulations_final.pdf.

270 Many Indian corporate entities exist as a group, or a collection of parent and subsidiary corporations that function as a single economic entity. For example, Tata Group, which is one of the largest conglomerates in India by market capitalization and revenue, comprises of 114 companies and subsidiaries. Thus, while the assets of Tata motors may be small under a stand-alone test, Tata group still accounts for a large share of the Indian market.
At the same time, lobbyists for the business community pushed the Commission to exempt intergroup mergers from scrutiny. The final regulations provide a safe harbor for acquisition of control, shares, voting rights, or assets by an enterprise within the same “group.” Consequently, under the new regulations, a subsidiary of a corporation would be exempt from seeking the Commission’s approval for intergroup acquisitions (unless an independent third party could prove that there would be an AAEC). However, while intergroup mergers are exempt from scrutiny, fewer entities will be given the exemption: the safe harbor will only apply to groups who reach the 50% threshold. As Professor Singh explains, the business lobbies, “through their hectic lobbying endeavors aimed at having their cake and eating it too, appear to have shot themselves in the foot.”

The 2011 merger regulations include additional compromises between the government and the corporate community. The original notification thresholds were increased to one and a half times their original size, exempting most transactions from scrutiny. The law does not allow the Commission to voluntarily scrutinize mergers that fall below the thresholds, thus, the regulations deprive the Commission of the authority to review a number of transactions that might have harmful effects on the Indian economy. Perhaps realizing the error of this compromise, the Government of India has proposed to amend the Competition Act in order to raise the thresholds or eliminate them entirely for certain sectors. For example, the Indian government has recently decided that all pharmaceutical mergers should be subject to the

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274 Of course, if the Commission were given unlimited discretion, this would lead to substantial uncertainty within the business community.
premerger notification requirement.275 However, the legal validity of this extension of the Commission’s jurisdiction is subject to debate.276 And the government has simultaneously decided to exempt all bank mergers from the pre-merger notification requirements.277 Paradoxically, both the inclusion and exclusion of these mergers have been justified on the grounds of consumer welfare.278

The Commission also responded to widespread concern that the 210-day waiting period places an undue burden on the parties to the transaction.279 The Commission issued a final set of regulations in 2011, clarifying that it would approve a transaction within 30 days if it concluded that there would be no adverse competitive effect. Further the Commission explained that if it had not communicated with a party within 30 days the merger would be considered cleared. The Commission could only take longer than 30 days if it issued a show-cause notice stating that a prima facie case exists that the merger would generate adverse competitive effects in India.

275 Recently, several Indian pharmaceutical firms were acquired by multinational corporations. These transactions were not reviewed by the Commission. This has prompted criticism of the thresholds, and attempts by the government to amend the competition laws to impose reduced thresholds for certain sectors. See generally, CCI Efficacy to Clear Pharma Deals Doubtful: Experts, BUSINESS STANDARD (October 17, 2011), available at http://www.cuts-ccier.org/Media-CCI_efficacy_to_clear_pharma_deals_doubtful_Experts.htm; Shruti Shrivastava, CCI gets mandate to approve all pharma M&As, THE INDIAN EXPRESS (October 11, 2011), available at: http://www.indianexpress.com/news/cci-gets-mandate-to-approve-all-pharma-m&as/858266/0.


279 In the US, the waiting period is 30 days. See, Hart-Scott-Rodino Antitrust Improvements Act of 1976, Public Law 94-435. In the EU, a phase I decision is reached within 25 days. Phase II decisions, which tend to involve complex transactions) are issued in 90 days.
So far, the Commission has met the 30-day deadline for the 17 mergers that it has cleared.\textsuperscript{280} And the decisions thus far have not revealed a nationalist sentiment: the Commission has not provided enhanced scrutiny for the combinations involving international actors.\textsuperscript{281} However, the bulk of the mergers have been intergroup mergers, which do not require complicated analysis.

\section*{D. Implementation Challenges}

The drafters of the Competition Act sought to correct many problems that the MRTP Act had created. In many ways, the Act is a substantial improvement. The Competition Act excludes “unfair” trade practices from the Commission’s jurisdiction (such claims are now under the jurisdiction of the Consumer Protection Act) and does not try to restrict the size of firms or ownership concentration. The Act does not focus on dominance as a basis for investigation, and instead directs the Commission to evaluate conduct. The Act further allows the Commission to impose substantial fines and other penalties. And unlike the MRTP Act, the Competition Act gives the Commission power to investigate and punish activities outside of India that have a substantial affect on the Indian economy.\textsuperscript{282} Thus, the Commission will be able to “pass such orders as it may deem fit” to combat international cartels.

\begin{footnotesize}
\textsuperscript{280} The Commission has passed final orders regarding mergers within 24 calendar days. See, Rahul Singh, \textit{India’s Tryst with ‘The Clayton Act Moment’ and Emerging Merger Guidance: Intersection of Law, Economics, and Politics}, (Publication Forthcoming).

\textsuperscript{281} \textit{Id.} He notes that 8 out of the 9 merger orders issued before December 28, 2011 involved foreign acquirers and this has not impacted the Commission’s analysis.

\textsuperscript{282} This is in stark contrast to the MRTP Act, which did not allow the MRTP Commission to reach extraterritorial abuses. In 2002, the Supreme Court removed all foreign conduct from the purview of the MRTP Act in Haridas Exports v. All India Float Glass Manufacturers’ Association, 6 Supreme Court Cases (2002). A summary of the case appears in Aditya Bhattacharjea, \textit{Export Cartels: A Developing Country Perspective}, 38(2) \textit{Journal of World Trade} 331, 342-44 (2004).
\end{footnotesize}
However, the application of the law may prove to be challenging for a fledgling agency. For one, in certain sections, key terms have not been defined. It remains to be seen how the Commission will quantify an “appreciable” effect on competition\(^{283}\) or what will count as “control” in an acquisition. Further, the Act’s attempt to guide the Commission’s market definition analysis may have backfired. The Act asks the Commission to consider the “relevant product market” and the “relevant geographic market” when engaging in market definition.\(^{284}\) It further clarifies that the relevant product market is dependent upon interchangeable goods and services, and the relevant geographic market is determined by the homogeneity of the conditions of competition and whether these conditions are distinguishable from those found in neighboring areas.\(^{285}\) This language attempts to guide the members’ analysis and serve as a baseline from which to begin a more rigorous analysis. Instead, the members have relied on the statutory language to justify their own intuitions about the relevant market and have refrained from utilizing a formal test, such as a SSNIP test, that would help the Commission understand buyer preferences and the degree of product substitution.\(^{286}\)

Further, the Act overwhelmingly favors an unstructured rule of reason approach for horizontal and vertical agreements. As mentioned, horizontal agreements are not illegal *per*
se, but are instead presumed to have an AAEC under Section 3. This presumption can be rebutted by a demonstration that there are offsetting benefits to the agreement.

By applying a rule of reason framework for horizontal restraints, the Act applies a more lenient standard than the United States. Despite the added flexibility, a rule of reason test poses a greater challenge for the fledgling agency. Rule of reason tests require more sophisticated economic analysis and have a larger margin for error than a per se rule. The benefits of a clear rule would be especially great for an agency with limited experience and resources. Horizontal agreements between unrelated entities are not likely to have a pro-competitive purpose. And because the rule of reason approach may generate underdeterrence (especially when applied by a fledgling agency), a per se prohibition should be used. Further, the lack of clear rules and bright-line tests will contribute to legal uncertainty in the business community.

Section 19(3) of the Act, which was modeled after Article 101(3) of the Treaty of the Functioning of the European Union (“TEFU”), provides additional loopholes. Section 19(3) requires the Commission to have “due regard” to six factors when determining whether an agreement has an AAEC. The Act specifies both “aggravating factors” and “mitigating

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287 Naked restraints are per se illegal in the United States. Horizontal agreements that fix prices, limit outputs, divide markets, and set up boycotts are also per se illegal. However, the courts will do a quick look rule of reason test before applying the per se rule in certain circumstances (for example, if the agreement advances the pro-competitive purposes of a productive business collaboration). BMI v. CBS, 441 U.S. 1 (1979).


“Most developing countries have insufficient resources to run their competition offices. They are short of staff, especially staff members who are economics experts. This suggests that brighter-line rules might be needed, whether they tip in the direction of more or less aggressive enforcement. The kind of analysis suggested, for example, by the U.S. Supreme Court in California Dental Association, might be too complex and of uncertain application. Yet the focused analysis suggested by Justice Breyer’s dissenting opinion – relying on experience and theory that rules against advertising discounts raise prices – might prove more appropriate.”

289 Article 101(3) requires that an agreement share the benefits with consumers, not involve restrictions that are unnecessary to attaining the efficiency objective, and not substantially eliminate competition.
Mitigating factors include benefits to consumers, improvement of production of goods and provision of services, and the promotion of development. The Act does not require that the benefits be balanced against the losses to other parties. For example, section 19(3) can be used to protect agreements that promise dynamic efficiencies but it does not make clear that the efficiencies must exceed adverse affects.

The Act also includes a list of criteria for the Commission to consider when determining whether a combination is likely to have an AAEC. Surprisingly, an efficiency defense is not included. Instead, Section 20(4) asks the Commission to consider “whether the benefits of the combination outweigh the adverse impact of the combination, if any.” While the Act does not clarify which benefits may count, it does at least specify that the benefits must exceed potential adverse effects.

The exclusion of a competitive effects test in Section 4 is also worrisome. By not requiring proof of an AAEC, the Commission preserves the opportunity to condemn exploitative behavior (such as excessive pricing) as abusive. But if an abuse can occur without proof of a corresponding effect on competition, the Act gives the Commission substantial authority to render “abusive” conduct *per se* illegal once dominance has been established. This lack of a competitive effects screen is exacerbated due to the Act’s broad articulation of dominance. As we will see, the Commission may view any kind of lock-in, such as a contract between two parties, as evidence of a dominant position. So far, it appears that the Commission has

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290 In FICCI-Multiplex, the Commission interpreted clauses (a), (b) and (c) of section 19(3) to be “aggravating factors” and clauses (d), (e) and (f) to be “ameliorating factors.” FICCI Main Order, page 93, available at http://www.cci.gov.in/May2011/OrderOfCommission/FICCIOrder260511.pdf.

291 This deviates from Article 101(3) of the TEFU, which *requires* that an agreement share the benefits with consumers, not involve restrictions that are unnecessary to attaining the efficiency objective, *and* not substantially eliminate competition.

learned from its MRTP-era mistakes and has refrained from condemning dominance without proof of a corresponding abuse.293

IV. ENFORCEMENT OF THE ACT TO DATE

During its first three years of enforcement, the Commission has issued over one hundred orders under Section 3 and Section 4 of the Competition Act. While the Commission has done an excellent job responding to inquiries (and denying complaints that fail to allege competition abuses), the Commission has struggled when applying basic antitrust economic analysis. This is primarily due to a skill deficit—the members are not trained in antitrust economics, and while they have all held high positions in the Indian government, none have a background in antitrust enforcement. Not surprisingly, the Commission has developed a pattern of opting out of making a decision or imposing a penalty when the option is available. And the Act’s inclusion of flexible tests has further exacerbated the Commission’s capacity constraints.

A. MCX and Market Definition

Market definition is the first step in abuse of dominance analysis. An incorrect definition of the relevant market can lead to the condemnation of competitive behavior or the exoneration of abusive conduct. However, the Commission has not yet articulated a consistent approach to market definition and has failed to use rigorous economic analysis when defining markets.

293 The TEFU technically includes exploitative abuses, but the EC rarely chooses to penalize behavior that is solely exploitative.
In the controversial *MCX Stock Exchange Ltd. & Others v. National Stock Exchange of India Ltd. & Others* case, the Commission imposed a large penalty on the National Stock Exchange after a market definition disagreement. The facts of the case are as follows. In 2008, MCX (Multi Commodity Exchange of India Limited) launched a stock exchange with permission to operate in the currency derivatives segment. The National Stock Exchange, India’s largest equity and derivative trading platform, was MCX’s main competitor for currency derivatives (or CD) services. In 2009, MCX accused NSE of using its dominant position to harm competition in the market. Specifically, NSE used a transaction fee waiver for the CD transactions and also refrained from charging an admission fee for membership in its CD segment (which was allegedly subsidized by entry fees for other operations). These fee waivers (which were the exchange’s primary source of revenue) allegedly made it impossible for MCX to operate profitably.

The Commission concluded a two-year investigation by finding NSE guilty of abusing its dominant position in the currency derivatives segment of the stock exchange services market. The Director General initially defined the relevant market to be the entire stock exchange services market in India (including equity and derivatives). He analyzed competitive constraints as well as demand side substitutability to arrive at this conclusion. The Commission majority disagreed with this conclusion, and instead defined the market to be “stock exchange services in respect of currency derivatives.” The Commission focused on demand side substitutability, explaining: “detailed analysis of the relevant market [which was not included in the 172 page opinion] led to the conclusion that the CD segment a) is not conventionally interchangeable with the [other segments], and b) currency derivatives, equity and equity derivatives neither have the same characteristics nor the intended use.”

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Notably, the Commission refused to use a formal SSNIP test, the hypothetical monopolist test used to define markets in a number of jurisdictions, including the United States. In a SSNIP test, the competition authorities begin by defining the narrowest product-market and evaluate whether a hypothetical monopolist would be able to profitably increase prices. If too many customers would switch to substitute products in response to the price increase, the narrow market will not be considered the relevant market and the substitutable product is added to the market. In rejecting this test, the Commission explained, “The Commission finds it rather unnecessary to dive into technical tests such as SSNIP… an attempt to determine even hypothetical competitive prices would be nothing more than pure indulgence of intellect and unwarranted misuse of an econometric tool, which in itself is not error-proof.” Instead, the Commission relied on the “undisputed fact” that the underlying assets, equities, and currencies are entirely different because they are not “interchangeable or substitutable” for products in other segments. While the Commission refused to endorse a formal SSNIP test, its focus on substitutability resembled the SNNIP inquiry in some respects. However, the Commission’s refusal to apply a concrete test frustrated those who hoped that the decision would provide a market definition framework for future litigation.

Later, in the landmark *DLF* case (which will be discussed in detail later in the paper), the Commission retreated from its anti-SSNIP sentiment. In the *DLF* order, the Commission majority found that SSNIP “is often applied in abuse of dominance cases.” However, it concluded that SSNIP would have led to the same result, but the conclusion was not supported with economic analysis. And in a later case, the Commission defined the market without mentioning SSNIP at all. Thus, the members have avoided demonstrating the validity of their market definition choices with economic analysis, instead using conclusory statements about SSNIP to rubber-stamp their intuitions.

295 MCX Main Order, page 99-100.
B. Arriving at Abuse of Dominance in MCX

In *MCX*, the Commission found that the NSE was dominant in the relevant market based on its dominance in other segments, its early start in the business, its reserves, and its profit surpluses. The Commission declined to rely on predatory pricing regulations, and instead found NSE guilty of unfair pricing because it had waived its transaction fee, the exchange's principal source of revenue in the currency derivatives segment. The Commission believed that NSE used waived this fee with the objective of pricing MCX out of the market. It held that “zero” pricing is undoubtedly below cost and ignored NSE's justification that it ran the currency derivative segment without incurring any costs.

The Commission avoided complicated predatory pricing analysis by choosing to penalize NSE for unfair pricing. However, the Commission did not specify a measure of cost that it used to determine that the pricing was unfair. The order did not mention average variable cost, average fixed cost, or marginal cost. Instead, the Commission relied on its intuition that pricing at zero could not be above or at cost. While this may have been the correct outcome, an examination of NSE’s cost structure was an essential analytic step. The Commission should be careful not to come down strongly on pricing or discounting that appears “too low”—low prices benefit consumers and should not be discouraged.

The dissenting position, which concurred in the market definition but refused to find a dominant position, also erred in its application of the Competition Act. The dissenting opinion concluded that cross-subsidization cannot constitute an abuse. But they did not need to go this far—without dominance, there could be no abuse. Thus, it appears that the members of the Commission are still coming to terms with the contours of the Competition Act.
It is not clear that the \textit{MCX} case was rightly or wrongly decided. While the Commission found no evidence that the segments of the stock exchange were cross-subsidizing each other, there was ample evidence that the NSE’s fee waiver was foreclosing competitors from the market. Competitive foreclosure is central to the predatory pricing inquiry in the U.S. At any rate, the lack of rigorous analysis, which seems to be an exercise in avoidance, is disconcerting. Before \textit{MCX}, the Commission had issued only minor penalties and cease and desist orders. By imposing a substantial penalty on the NSE, the Commission demonstrated that it would take a hard line against abuses by dominant firms. Further, the Commission revealed that it is willing to scrutinize the conduct of any firm that enjoys a dominant market position. If a dominant firm excludes others from participating in adjacent markets, it may be heavily fined. However, without clear analysis, Indian businesses cannot be sure which factors will lead to a substantial penalty like the one that was imposed in \textit{MCX}.

\textbf{C. DLF and Abuse of Dominance – Ghosts from the MRTP era?}

In another landmark case, \textit{Belaire Owner’s Association v. DLF Limited and HUDA}, the Commission fined India’s largest real estate firm INR 630 crore, vindicating a group of homeowners in a high-end housing project who alleged that DLF had delayed the completion of building plans. The homeowners alleged that DLF had abused its dominant position and imposed arbitrary, unfair, and unreasonable conditions on the apartment owners. The complaint listed 21 unreasonable conditions (such as “abnormal delays”) that were forced on them.
The Commission defined the relevant market to be the high-end residential market in an area of Delhi called Gurgaon.\textsuperscript{297} As was previously discussed, the Commission purported to use a SSNIP test, intuited first that a customer who wanted to live in Gurgaon would not look elsewhere, and that a 5% increase in the price of neighboring flats would not cause buyers to shift to the Gurgaon development (or, that the two residential areas were not substitutes). The Commission relied on industry report market share data in order to conclude that DLF had a dominant market position (its share was 50% of the market).\textsuperscript{298} The Commission found DLF guilty of abuse of dominance, finding the terms of the agreement as well as DLF’s conduct to be unfair and exploitative.

Critics of this decision believe that the Commission erred in allowing the complaint to proceed. The complaint, which resembles a contractual dispute, would not survive under Section 2 of the Sherman Act. For one, there is no remedy for exploitative abuses under U.S. law--U.S. courts have emphasized that the competition laws exist to protect competition and not consumers.

At first glance, it appears that the \textit{DLF} signals that the Commission’s resources are being diverted from legitimate competition concerns. But supporters of the decision argue that the Commission was faithful to the Competition Act in taking on this case. As mentioned, the Competition Act allows the Commission to consider exploitative abuses as well as exclusionary abuses (absent a competitive effects test, the Commission is free to condemn a broad range of conduct by a dominant body as abusive). This is disconcerting and perhaps should be altered in later amendments to the Act.

\textsuperscript{298} The Commission did not conduct their own economic analysis to test the propositions set out in the market reports.
Defenders of the decision further point out that the Commission is mandated to protect the consumer, and under this theory, they argue that penalizing the real estate firm with a hefty fine will incentivize housing developments to treat their customers fairly. In addition, the choice to adjudicate matters of this kind may serve to fill regulatory gaps. There is no regulation of real estate and development in India, and contract cases often languish for many years in court. However, this does not mean that the Commission is the appropriate body to resolve these issues. If the Commission turns its attention to contractual disputes, which seem to be under the jurisdiction of the Consumer Protection Act, they will be forced to divert resources from other matters, which may result in a net consumer welfare loss. In many ways, it is surprising that the Commission chose to investigate this case at the exclusion of other compelling claims. A cynical view is that this case proves that the Commission will use its grant of discretion to protect India’s richest citizens, such as the wealthy homeowners who brought the complaint in DLF.

D. Lack of Enforcement in Cartel Cases

While the Commission has taken a hard line against abuses by dominant entities, it has declined to engage in substantial enforcement efforts against horizontal agreements. The Commission has investigated only a handful of cartel abuses and has found an actionable violation in three.\(^\text{299}\) In these cases the Commission imposed paltry fines on the guilty parties despite its power to levy higher fines against horizontal agreements.\(^\text{300}\) And it has dismissed


\(^{300}\) In the Multiplex Association of India case, the Commission held that the Copyright Act gave a movie producer cartel no protection, and held that the producers had engaged in “cartel-like” behavior that was reachable under Section 3. The Commission then analyzed the factors listed in Section 19(3) and found that the
several promising cases even after the Director General's investigation found evidence of a *prima facie* case.

In *Neeraj Malhotra v. Deutsche Post Bank Home Finance*, the Commission dismissed (in a 4 to 2 decision) an allegation that an Indian Banking Association violated Section 3 of the Competition Act. During his initial investigation, the Director General found sufficient evidence to support a Section 3 claim, including minutes from a 2003 meeting held by the Indian Banking Association (“IBA”) in which a group of banks decided to limit market competition by fixing a prepayment charge on loans and to generate fee based income through these fixed charges.\(^{301}\) The banks justified this agreement by claiming that the levied prepayment charges were important in order to “prevent migration of borrower accounts from one bank to another,” and “to dissuade the borrowers from shifting to other banks,” among other things.\(^{302}\) Despite this compelling evidence, the Commission dismissed the Section 3 claims as unsubstantiated. The Commission also dismissed abuse of dominance producer’s behavior had had an AAEC on competition. But when it came time to determine the penalties, the Commission focused on two mitigating factors (that it had previously discounted). First, the Commission noted that the dispute began before the Competition had become effective (although some of the exclusionary behavior continued afterwards). Second, the Commission emphasized that the MRTP Commission had passed an injunction against the multiplexes in 2007. Case 01/2009, Main Order of the Commission, at 122, available at http://www.cci.gov.in/May2011/OrderOfCommission/FICCIOrder260511.pdf. The Commission concluded that the ends of justice would be met by imposing a fine of 100,000 INR on each of the 27 defendants along with a cease and desist order. This was contrary to the penalty provided in Section 27 of the Competition Act, which would have been equal to three times the profits earned during the period of agreement, or ten percent of turnover, whichever is higher.

\(^{301}\) The DG highlighted a statement from the IBA Circular which said, “At the meeting the need for a common approach in fixing prepayment charge on loans was suggested by some of the members. After detailed discussion, the Committee, while fully appreciating the market dynamics, decided that a suitable communication be sent to member banks bringing out the viewpoints expressed by the members so that the member banks could take a decision on levy of commitment charges and prepayment charges.” *Neeraj Malhotra*, Dissenting Order by R. Prasad, page 5, available at http://www.cci.gov.in/menu/RPrasadDissenting.pdf. Various other circulars were sent out, including one that “specifically spelt out levying of 0.5%-1% prepayment charges as reasonable and the decision in this regard was left to banks to decide.” *Neeraj Malhotra*, Order of Commission, page 147, available at http://www.cci.gov.in/menu/OrderOfCommission.pdf.

claims (even with evidence that the prepayment penalties were being used in order to prevent locked-in customers from switching to other banks).

It is not clear why exactly the Commission shied away from condemning this straightforward cartel abuse. In the U.S., this evidence would be sufficient for a finding of a horizontal agreement between unrelated rivals, which is per se illegal. And while the Section 101 of the TEFU allows the EC to hear defenses before condemning an agreement, the bank justifications would have certainly failed to excuse this concerted behavior.

The Commission’s reticence may be due to a lack of capacity. The opinion did not rely on antitrust economics to support its finding. The Commission majority instead emphasized the fact that the banks had not adopted an entirely uniform prepayment charge (all the banks charged a rate between 0% and 2%, with almost all charging 1%). And the majority opinion emphasized that while the circular specified a “reasonable” rate, it stated that it “should be left to the banks to decide.” Thus, there was not unequivocal evidence of an agreement, according to the Commission.

If this evidence is not sufficient to establish an offense under Section 3, it is not likely that the Commission will ever be able to investigate and condemn horizontal agreements by competitors. Cartel cases are notoriously difficult to prove—very often the illegal concerted behavior will be hidden from the authorities. But in this case, the Commission had direct evidence of a meeting between competitors and an agreement to fix a fee rate. It is not clear why the Commission was willing to impose a hefty penalty on the DLF housing group but refrained from condemning the explicit horizontal agreement made between sixteen of India’s largest banks.

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In another case, the Commission found “cartel-like behavior” between film distributors and producers, but then imposed a paltry fine. The Commission collected just one lakh from each of the guilty film distributors and producers despite the fact that the Act specifically defines the penalty for cartel violations at three times the company’s profit or 10% of its turnover, whichever is higher. Critics reasoned that corruption at the Commission might have contributed to the lenient outcome.

Circumstantial evidence suggests that corruption may have affected the Commission’s investigation in Deutsche Bank. For one, the complainant (a lawyer) failed to respond to the commission after the director general filed his investigation report. Many speculate that he was paid off or threatened, an occurrence that is not uncommon in high stakes cases in India. While his absence should not have adversely affected the Commission’s investigation, his disappearance means that there has been no appeal of the Commission’s order. While the Act states that “any person aggrieved by any order of the Commission” may appeal the order, no borrower has stepped in to do so.

Finally, the lack of cartel enforcement has rendered the Competition Act’s leniency program completely ineffective. The leniency program provides reduced fines for whistleblowers to incentivize self-reporting. The program was heralded as an important tool for the Commission to use to unearth cartel activity. However, the program has failed to inspire any

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304 See, footnote 30.
305 A lakh is a unit equal to one hundred thousand.
306 Critics allege that the commission has selected its cases with an eye towards preferential treatment for complainants with deep pockets, and will take a lenient attitude when cases allege abuses by wealthy defendants. However, the Commission has imposed hefty fines on large business in other cases, such as MCX, which complicates this theory.
308 See, §46 of the Competition Act.
cartel participants to come forward. Until the Commission begins to enforce Section 3 and impose fines, the leniency program can provide no benefit to whistleblowers.

V. HOW TO BUILD A ROBUST COMPETITION INSTITUTION IN INDIA?

The Commission’s first three years of antitrust enforcement have been successful in many ways. They have made good on their promise to review mergers quickly. They have worked hard to clear a heavy docket, including many cases that had been left behind during the transition from the MRTP Act. They have properly dismissed consumer protection suits that do not allege a Competition Act violation. In many ways, they have made the most of their limited resources.

However, several issues remain. Serious capacity issues are crippling the Commission’s enforcement efforts. In order to correct these problems, the foundation of the Commission must be altered. The members must either be trained or replaced with individuals who have a background in antitrust economics. And they should begin to use economic analysis when arriving at conclusions in the orders. This will help them develop precedent that the business community can rely on. Further, the Commission must change its enforcement priorities and focus on cartel abuses. For one, taking a hard line on cartel abuses would result in significant consumer benefits and promote a competitive market, increasing overall welfare, which would improve the Commission’s institutional standing. Further, the economic analysis used in demonstrating a naked restraint would arguably be simpler than the nuanced inquiry for abuse of dominance violations such as predatory pricing (in which the Commission would not only need to define markets, but also determine the correct measure of cost, and so on). Thus, taking on relatively straightforward abuses would help the Commission develop institutional capacity with a relatively low margin for error.
A. Training

The biggest impediment to well-reasoned orders is that the members are not trained in competition law. The majority of the members who issue the decisions are ex-bureaucrats who have had impressive careers in government, but in fields outside of competition law. For example, Amitabh Kumar, the first Director General of the Competition Commission, was a former Income Tax Commissioner. He knew nothing about competition law when he arrived and taught himself competition law in order to prepare for the job.\(^{309}\) Without proper training, the Commission will continue to engage in rough and ready economic analysis, resulting in poorly reasoned decisions.

Further, the members of the Commission have not taken an aggressive approach to enforcement which indicates that they may be insecure about their own skills. When given the chance to refrain from deciding a case, they have done so. For example, as of August 2011, the Commission had taken up 82 cases but had pronounced a judgment in just three.\(^{310}\) And the members have chosen to investigate only a handful of cases *sua moto*. Further, the Commission has imposed penalties in a small number of cases (without explanation as to why these cases warranted such hefty penalties). These facts support the conclusion that the members of the Commission are insecure about their skills and ability. And without taking on an active role in enforcement efforts, the Commission is prohibited from doing much to promote a competitive market.

However, so long as capacity continues to be an issue, this insecurity may be a blessing. As mentioned, the Commission’s penalties have been modest thus far (except for recent abuse of

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\(^{309}\) Interview with Amitabh Kumar, January 15, 2012.

dominance cases) and the large majority of their decisions have been uncontroversial. But the Commission may burden the growth of the Indian economy if it imposes hefty penalties and blocks mergers without an understanding of basic antitrust concepts.

**B. Corruption**

It is unclear whether the Commission’s mistakes have been the sole product of capacity issues or whether they have also been undermined by corruption. On the one hand, the Commission does not seem to be favoring big business, at least in its merger analysis. However, there are inexplicable contradictions in their orders thus far. Why, for example, did the Commission target DLF, while refraining to investigate the alleged price fixing in *Deutsche Bank*? Why did the leading plaintiff disappear in the *Deutsche Bank* case? And is there any truth to the rumors that the *MSX* majority opinion was written by a team of lawyers?

The limited resources allocated to the agency only exacerbate corruption. The Commission should also be as independent as possible and free from all political interference. For this reason, it is a mistake to staff the Commission exclusively with ex-bureaucrats who may not be invested in their new duties. For one, critics allege that the members may be pre-occupied with notions of rank and seniority. For example, two members were outraged with the appointment of Ashok Chawla as agency chief because he had previously held a less senior

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311 Professor Singh points out that the Commission has pushed back against corporate lobbies by adopting a literal interpretation of the merger regulations. This has led to “absurd interpretational outcomes” and “portends high transaction costs for the businesses.” Rahul Singh, *India’s Tryst with ‘The Clayton Act Moment’ and Emerging Merger Control Jurisprudence: Intersection of Law, Economics and Politics*, (Publication Forthcoming).

The members even threatened to quit if the appointment succeeded. Other individuals have alleged intimidation within the branches of the Commission has contributed to an environment where members of the staff are afraid to disagree with their superiors. This environment is not conducive to the generation of neutral outcomes that would solely facilitate market competitiveness.

The Commission could also improve the transparency of its processes. The Commission has not made public the complete set of investigations that it has opened, nor has it make the entire set of Director General’s reports available for public scrutiny. Doing so would help alleviate corruption concerns.

C. Precedent

The Commission should to use rigorous economic analysis to create precedents that the business community can understand and rely on. Once the Commission is comfortable applying antitrust economics, it should articulate economic frameworks for each decision. So far, the Commission’s orders have offered very little guidance. The Commission has chosen to apply a SSNIP test when performing market definition in a handful of cases. In other

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314 John Samuel Raja D & Rohit Deb, Can understaffed Competition Commission of India deliver prudent judgments?, THE ECONOMIC TIMES (August 15, 2011), available at http://articles.economictimes.indiatimes.com/2011-08-15/news/29889067_1_cci-members-competition-policy-competition-regulator. (“There is an inherent conflict of interest in this directional flow of orders and division of responsibilities. Asks a senior official in the DG office: ‘Do you expect us to submit a report that is contrary to the commission’s finding that there is a violation of competition laws when my performance rating and budget approval is in their hands?’ Of the 60 investigations completed by the DG, only thrice has it reversed the initial opinion of the CCI members to say there is no violation.”)

Perhaps members of judiciary would be in a better position to focus on the merits of the case. In the Steel Authority of India case, the Supreme Court overturned an order by the CAT which disagreed with the Commission’s finding. This was a momentous moment because the chief of the CAT, a recently retired Supreme Court judge, was overruled by inferior justices.
cases, they have described the test as an “indulgence of intellect.” The Commission would be wise to take a consistent approach to market definition so that entities planning mergers or engaging in aggressive behavior may be on notice that their behavior may bring them under scrutiny of the antitrust laws. And adopting economic tests and articulating bright-line rules would help the Commission avoid the chilling of pro-competitive behavior.

**D. Carving out Enforcement Priorities**

After the Commission has addressed its capacity issues, it should carve out enforcement priorities and refrain from becoming backlogged by a flood of meritless complaints. The Commission has stated that it intends to pursue a greater number of cases *suo moto*. This approach, if thoughtfully pursued, is a necessary step.

**i. Enforcement Priority: Hard Core Cartels**

Judge Posner once wrote that the focus of the antitrust laws should be limited to (1) cartels and (2) horizontal mergers large enough to create monopoly power or to facilitate cartelization. If the Commission wishes to achieve its consumer protection mandate, it must take a hard line on cartels. The Commission would do well to focus their attention on horizontal abuses for several reasons. For one, the Commission would not need to engage in a complicated inquiry. Once evidence of a horizontal agreement has been found, the agreement will be presumed to have an AAEC. By focusing on straightforward abuses, the

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315 For one, the Commission has so far been focusing on clearing its docket and responding to claims (a number of which do not allege competition abuses). In many cases, the Commission will accompany a dismissal for failure to allege a competition abuse with lengthy analysis. For example the Commission dismissed Suomoto v. North Delhi Power Ltd. & BSES & Ors., Case 19/2008 available at [http://www.cci.gov.in/May2011/OrderOfCommission/SuomotoMain19-2008.pdf](http://www.cci.gov.in/May2011/OrderOfCommission/SuomotoMain19-2008.pdf), for the failure to implicate a competition issue. But this is embedded in a longer discussion about whether or not fast-running electricity meters were actually running fast. This additional analysis is a pure waste of resources.

Commission would be able penalize culpable parties with a smaller margin for error. This would also give the members time to develop their skills before they take on more complicated cases.

Further, by coming down strongly on cartel abuses, the Commission would help the Commission gain public approval. Horizontal price-fixing imposes tangible consumer harms. And a number of studies have alleged that cartels, both within India and internationally, have artificially inflated prices in a number of sectors. The public may be more likely to support an agency that penalizes collusive behavior in order to benefit the general public.

While the Commission would be wise to address the cartel abuses that have been filed by private parties, the Commission should also try launch *sua moto* investigations of sectors that are allegedly cartelized. So far, complaints have alleged abuses in the cement, steel, tire, and trucking industries. But the Commission may also find a range of abuses in the Indian healthcare industry. In India, pharmacists often negotiate terms with drug manufacturers. Further, tying has been alleged to exist between hospitals and pharmacies. These abuses have a substantial negative impact in India, where the high cost of healthcare is the number one factor causing an Indian family to fall below the poverty line.

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Other developing countries have focused on price-fixing for staples, such as milk, bread, transportation, and utilities, which harms the broadest base of consumers. Researchers at CUTS, an independent consumer organization, have found that seller cartels target basic necessities, such as diet staples. By targeting such abuses, the Commission would demonstrate its commitment to protect consumers at all income levels.

Further, the Commission should begin to initiate investigations against international cartels. The U.S., Canada, and Europe have imposed penalties on international cartels for decades in the potash, soda-ash, and bulk-vitamin industries. A study by Levenstein and Suslow calculated that developing countries were substantial importers of these cartelized products. For years, CUTS has asserted that the Indian economy has been adversely impacted by soda ash and bulk vitamin cartels. In the 1990s, CUTS began to investigate an alleged global conspiracy to fix the prices and sales volume of vitamins. The organization estimated that the cartel was extracting $25 million in illicit profits due to the cartelization of the Indian market throughout the 1990s. The organization documented the evidence that it collected, and passed on the information to the Director General of the MRTP Commission. However, after a preliminary investigation, the DG reported that no case could be made. However, Section 32 of the new Competition Act makes clear that extraterritorial abuses are within the Commission’s jurisdiction. The Commission would do well to re-open investigations in these and other sectors.

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321 Margaret Levenstein and Valerie Y. Suslow, Contemporary International Cartels and Developing Countries: Economic Effects and Implications for Competition Policy, 71 ANTITRUST LAW JOURNAL 802 (2004).
Finally, recent acquisitions of Indian pharmaceutical companies by multinational firms have raised substantial competition concerns.\textsuperscript{323} As mentioned, this has resulted in complaints that the merger thresholds are too high and should be calibrated by sector. Another solution would be to amend the Act to allow the Commission discretion to review mergers that do not meet prescribed thresholds if an AAEC was likely to occur. However, this approach would add to uncertainty and would likely meet resistance from the business community.

\textit{ii. State Owned Enterprises and Liberalization}

In India, State-owned monopolies are widespread and dominate the infrastructure industries. In the past few decades, an emphasis on privatization inspired the government to offload government shares in more than forty state owned enterprises. However, the government still maintains a control over India’s most profitable companies.\textsuperscript{324}

The Commission has expressed interest in privatizing state owned enterprises and breaking apart certain industrial sectors.\textsuperscript{325} R. Prasad, a member of the Commission (known for his many dissenting opinions) explained that this is a high priority for the Commission. He hopes to continue to re-open investigations against Coal India within the next six months.\textsuperscript{326}

The question of industry privatization is complex and has vocal supporters and detractors. It is not clear that privatization will guarantee greater efficiencies and consumer choice (especially in the case of natural monopolies with large economies of scale). And if a publicly owned entity is sold to a private monopolist, this will likely result in greater consumer

\begin{enumerate}
\item \textsuperscript{323} \textit{Pharma acquisitions to be routed through CCI}, \textit{THE HINDU} (October 11, 2011), available at \url{http://www.thehindu.com/news/national/article2526526.ece}.
\item \textsuperscript{324} Madhu Bala, \textit{Economic Policy and State Owned Enterprises: Evolution Towards Privatization in India} (November 14, 2006), available at \url{http://mpra.ub.uni-muenchen.de/17946/1/MPRA_paper_17946.pdf}.
\item \textsuperscript{325} Vinod Dhall, \textit{Competition Law & Policy in India}; Presentation prepared by the Competition Commission of India (June 2004), available at \url{http://cci.gov.in/images/media/presentations/1vinod_dhall_16june04.pdf}.
\item \textsuperscript{326} Interview with R. Prasad, January 14, 2012.
\end{enumerate}
harm. However, in general, freeing up the market has generated great economic benefits for developing countries. To the extent that privatization is a “competition policy” issue, the Commission will not have a substantial role to play. However, if the Commission continues to scrutinize state-owned monopolies, this would at least re-open the question of whether the Indian system results in consumer harm.

VI. Conclusion: An Antitrust Regime by India, for India

In re-drafting its competition laws, the Indian government chose to adopt a competition enforcement regime inspired by the laws that have matured within developed nations. The Competition Act borrows statutory language from competition law in the western world and thus benefits from the evolution of antitrust enforcement that has occurred over the last century. But while Commission’s starting point is an amalgamation Western competition law, its enforcement has been unique. India must continue to develop enforcement priorities and interpret its guiding statute in a way that is congruent with its unique economic situation. As Eleanor Fox has said, “the challenge is to understand when foreign [competition] law is appropriate and when it is not.”

India has one of the fastest-growing economies and a vibrant private sector. However, this growth has not changed the economic position of half of India’s population, which still lives under the poverty line. Going forward, the Commission should continue to foster market efficiency and support a competitive marketplace that will promote economic growth. It should not overly burden business with uncertain rules for compliance. But the Commission

327 This was the case in Mexico, where a private company was effectively protected by the government in order to benefit its president. See, Mary Anastasia O’Grady, A Telecom Monopoly Cripples Mexico, WALL STREET JOURNAL, (Feb. 10, 2006), at A19.
must also calibrate its competition priorities in order to protect a broader base of consumers. It may choose to enforce its laws with an eye towards upward mobility for the poor. In order to do this, it must begin taking a harder stance against cartel enforcement.

The Commission has chosen to depart from U.S. and EU antitrust jurisprudence in several respects. While I have criticized its abuse of dominance analysis, some may argue that the Commission’s heavy scrutiny of conduct by dominant entities is sensible. The Commission may wish to ensure that dominant firms are not using their power and leverage to exclude smaller firms. An enforcement policy that handicaps dominant firms in order to protect competitors (who are likely to be smaller start-up firms) departs from the U.S. model but may promote economic mobility. The Commission may decide that this tradeoff is worthwhile in order to promote development. However, the Commission will harm India’s market competitiveness if it punishes efficiency. This could cripple major industries and harm the global competitiveness of its strongest sectors. Thus, the Commission must not lose sight of economic efficiency in its quest to promote development and upward mobility. Only time will reveal whether the Commission will successfully balance these objectives.
PUBLIC GOODS AND CONTRACT STANDARD CLAUSES: A NEW APPROACH

Enrico Baffi

ABSTRACT

In this paper the author has tried to find different market failure in situations where many scholars think that the market doesn’t work well. He has considered two hypotheses but the idea has surely a wider application. In the author’s opinion some clauses are similar to those known in legal terms as “standard”. Such clauses are often vague, imprecise, give judges a great discretionary power and need a lot of precedents to be clarified. In some situations a firm could insert a clause of this kind, and this would be efficient, but the problem is that that firm bears all the cost of the clarification of the clause. The other firms can wait and exploit learning externalities. The problem of these clauses is that are socially efficient but they are public goods in economics sense. It’s impossible to avoid the situation wherein another firm uses the clause once it has been clarified. So the first firm which has the idea of inserting the clause will decide not to spend money for the clause and it will start to hope that some other firm will produce the clause. It also wants to behave as a free rider in the same way as other firms. But in this way the efficient clauses are not produced. With mandatory rules the clause is produced according to Kaldor–Hicks efficiency criterion and there is the chance that many firms pay something toward it. For instance in case of the standard of good faith, if only the first firm introduces this clause it had to pay a lot of money for litigation and it could suffer a loss in terms of reputation so the legal system introduces a mandatory rules. The same problem is with the clause of corporate charter. The author hence argues that the idea has many and wide applications.

330 Enrico Baffi, professor of Law and Economics at University Guglielmo Marconi. I’m in debt with the participants of the Eight Annual Italian Law and Economics Conference, that have given me many ideas.
I. INTRODUCTION

The aim of this work is to show how it is possible to identify market failures other than those traditionally identified by lawyers and law and economics scholars to justify the mandatory provisions of contracts between professionals and consumers and the equally mandatory provisions governing the abuse of economic dependency. This is a new approach that can be extended to other situations and appears to rest on fairly solid microeconomic foundations. There is no doubt, however, that much criticism can be leveled against it. Very briefly, the author shall argue that the production of clauses characterized as being rather vague, indeterminate and open to discretionary interpretation by judges is a public good in the economic sense, insofar as the clarification of their content, which is normally achieved through court decisions, can also benefit persons who have not paid for their production and who have no intention of paying, i.e. free riders.
The costs would consist in those involved in the drafting of the clause and the legal costs due to disputes, as well as the reputational costs if the court decisions are unfavourable to the drafter. The consequence is that a producer who inserts a clause that is vague, i.e. not fully specified, would have to bear all the costs for its clarification and the operation would no longer be to his advantage. The result is that a potentially efficient clause is not inserted into contracts.

The paper starts by examining the concept of “standard clause”, because this expression has different meanings, all of which are equally relevant for the analysis that will be carried out. Subsequently, reference will be made to these meanings in an attempt to re-examine the provisions specified above. The paper also considers a number of observations that emerge prima facie and closes with some concluding observations.

II. STANDARD CLAUSES

The term “standard clause” has essentially three meanings.

A. The first meaning

In the first case it refers to clauses in forms and general conditions of contract that are not negotiable. The phenomenon probably should not be seen as stemming from some presumed bargaining power\textsuperscript{331} of the drafter with respect to the other party but is essentially due to transaction costs. Normally neither the drafter nor the other party has an interest in negotiating standard clauses.

\textsuperscript{331} One author wondered how it was possible to talk about bargaining power in relation to door-to-door salesmen of encyclopedias. See F. Kessler, \textit{Contract of Adhesion - Some Thoughts about Freedom of Contract}, 43 \textit{Columbia Law Review} 629 (1943).
This is due to two important factors; the first is the increase in labor productivity over the last two centuries and the second the fact that the negotiation and management of standard clauses are labor-intensive activities, i.e. require a considerable input of labor compared with other activities that have benefited from the increase in productivity due to technological innovation and the increase in capital.\textsuperscript{332} The result has been that the relative prices of amendments to clauses have increased with respect to the prices of goods that have benefited from the increase in labor productivity and the accumulation of capital. As an illustration, one could consider a situation of negotiation over the amendment of a clause providing a benefit to a consumer of 100. Two centuries ago the time needed for a negotiation with a probably positive outcome would say have an economic value of 30, so that it was advantageous for the consumer to negotiate. Today the time needed would be an inflated value of 200 (owing to the increase in wages). Hence there is reduced incentive to negotiate. If one would rather not refer to labor costs, one could say that negotiations are time consuming for the consumer,\textsuperscript{333} i.e. take time that could be used in other ways. It may also be disadvantageous to negotiate from the standpoint of utility of consumer time, consumer's deriving the greater utility from free time.\textsuperscript{334}

\textsuperscript{332} The change in relative prices between labor- and capital-intensive activities was first examined by Baumol. As Baumol explains: “A half hour horn quintet calls for the expenditure of 2- man hours in its performance, and any attempt to increase productivity here is likely to be viewed with concern by critics and audience alike” - W. Baumol, \textit{Macroeconomics and Unbalanced Growth: The Anatomy of Urban Crisis}, 17 \textit{American Economic Review} 415, 416 (1967). Think also of theatrical performances in general: the scope for an increase in productivity is very small. It follows that the price of theatre tickets is bound to increase and, unless the state provides a subsidy, theatrical activity could even disappear. The same applies in large part to nursing services in hospitals.

\textsuperscript{333} The concept of “time consuming” was introduced by Becker - See G. Becker, \textit{A Theory of Allocation of Time}, 75 \textit{Economic Journal} 493 (1965).

\textsuperscript{334} It may be found that a standard clause entails inefficiencies, but it nonetheless remains a second-best solution. By way of example of how this might play out, consider a situation wherein in the middle ages a feudal lord had the monopoly of the crossing of a river on a bridge. In view of the limited value of time, the monopolist and travelers could negotiate in order to arrive at the best price. The monopolist could charge different prices, according to his assessment of travelers’ ability to pay, charging a low price to those with little money. In this way the typical deadweight loss due to monopolists’ fixed prices would be partly eliminated and the exploitation of the bridge pushed until the marginal cost was reached. It is likely that many authors perceive that the fixed prices of standard contracts cause inefficiencies of this kind, but the solution of negotiations would be even more costly for companies.
But negotiations also involve a great deal of work for the drafter, i.e. they are labor intensive. Modern technology has not yet made it possible to negotiate automatically, so that persons must be involved in negotiations. In view of the relative increase in wages, this activity costs more than other activities of a capital-intensive nature, with a consequent large increase in the costs borne by consumers, to the extent that they are passed on to them. The same problems apply to the management of a non-standard contract. It is a labor-intensive activity. Until new technologies allow non-standard contracts to be negotiated with a small labor input (early signs of this can be seen now) the activity of negotiating and managing low-value contracts will be highly inefficient.

B. The second meaning

The term “standard clause” has a second meaning, probably used less frequently than the first but equally important. It is used, in fact, to indicate that the contracts adopted in a given industry contain a similar, if not identical, clause. There are various possible explanations for this. The one that appears most convincing is based on network effects, as discussed by US authors in the 1990s. Imagine that a number of firms adopt a particular clause; firms that come after can decide to enjoy network effects by adopting the same clause. Network effects occur when an entity obtains a benefit by adopting the same products or the same “network”, in the strict sense of the term, as other entities. Thus, for example, a consumer

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335 If the supply curve is perfectly elastic, the cost is passed on to consumers in full.
336 The contracts offered by firms that operate on the Internet give consumers a range of options. The management of these contracts is completely automated. Although this cannot be considered real negotiation, consumer choice has been increased.
338 The concept of network externalities risks being confused with that of learning externalities, which have some points in common. As we shall see, however, the difference is very important. The benefits of learning externalities stem from the use of a term in the past. Positive network externalities arise from the contemporaneous use of a given term by a number of firms. In this case there are no benefits arising from the past use of the term but benefits arising from its contemporaneous use. In other words a firm cannot take
who joins the telephone network has the network effect, or positive externality, of being able to contact all the persons who have already joined. Alternatively, when a number of consumers adopt the same product, they will have the positive externality of paying a lower price for complementary goods thanks to economies of scale.

Network effects are generally of a bilateral nature. Thus a firm that adopts a clause similar to that of other firms will benefit the latter because the legal disputes it will engage in will help to clarify the meaning of the clause. But at the same time the legal disputes of the other firms will benefit the first firm because they will clarify the content of the clause, i.e. the interpretation that judges intend to adopt. It needs to be made immediately clear that recourse will often be made to the network effects produced by judges’ decisions when these serve to clarify the interpretation of a clause. In other words reference will be made to the network effects produced when a number of firms use the same clause.

Some authors make a clear distinction between learning externalities and network externalities. The former are the benefits a firm obtains from a clause (to remain in this field) that has already been used for some time by another firm or by a number of other firms, so that its content has been clarified in part. In this case the economic benefit of the clarification is already internalized in the value of the clause the new producer will adopt. This firm enjoys a benefit that is not accompanied by a network externality (usually of a reciprocal nature) benefiting the first firm(s) to use the clause. Network externalities, by contrast, are concerned only with the future; in other words the calculation of network externalities must be based on what will probably occur in the future and not on the benefits that it is already certain will be obtained from learning externalities.

previously realized benefits from other firms. See M. Kahan and M. Klausner, Standardization and Innovation in Corporate Contracting (Or ‘The Economics of Boilerplate’), 83 VIRGINIA LAW REVIEW 713, 725 (1997).
This is an assessment that requires the concept of expected value. The firm must imagine what it will gain if there are network externalities and decide, on the basis of this calculation, whether to adopt the clauses that other firms may or may not adopt. As we shall see, this distinction is very important because it helps us to understand the probable market failure that justifies intervention of a mandatory nature by the legislator in some situations. A firm that decides to use a clause that has already been applied must calculate what is the level of probability that other firms will use that clause and cannot merely copy a clause for which precedents have already been created. A calculation must be made based on expected value. As mentioned, it does not enjoy a sure benefit due to learning externalities.

At this point there arises of problem of some significance, even though it goes beyond what has been discussed here so far: when network externalities are reciprocal, i.e. when firm A benefits from the activity of firm B and vice versa, a firm that must decide whether to use a clause will not take account of the benefit the other firms will derive from its use of the clause.339 There is a positive externality that is not internalized. Clauses could therefore be excessively diversified.340

As per the above discussion in all circumstances it may be concluded that as a consequence of network externalities, if a group of firms adopts a certain clause, there will be similar copied behavior by the others to enjoy the benefits derived from widespread use of the clause in question.

339 Supra note 8, at 734. They state that there are two possible reasons for a firm making a sub-optimal choice of clause: the first is that it may decide not to adopt a clause not knowing whether it will become a standard allowing the firm to benefit from network externalities; the second is that a firm that adopts a clause that is able to produce network effects does not take into account the benefits accruing to other firms and could over-customize its clause.

340 Since the businessman does not take account of the benefits he produces for others, he might prefer a different clause that takes account only of his own benefits and therefore does not aim at standardization.
C. The third meaning

The third and last meaning of the term “standard clause” has been used mainly by economists and especially law and economics scholars, who have put forward the confrontation between rules and standards. A rule has a well-defined and unambiguous meaning, so that judges have little room to exercise discretion. They are only required to apply the precept that is clearly indicated in the rule; they must apply what it specifically provides for. A standard instead is a rule that is formulated in a vague, partly indeterminate, manner, that can be interpreted in different ways and that contains more than one meaning, so that judges have ample room to exercise discretion and their decisions can vary considerably even with regard to similar cases.

To give a traditional example: the speed limit of 50 km an hour for driving in built-up areas is a rule, while the requirement to drive at a reasonable speed in built-up areas is a standard. As can be seen, in the first case judges have very little room to exercise discretion, whereas in the second they have much more.

III. TWO PROBLEMS OF FRAMING MANDATORY PROVISIONS IN ECONOMIC TERMS

Having defined the concepts of “standard” and “rule”, we can now tackle a problem that has been examined by a number of authors, with different results. It should be noted that we will

341 See L. Kaplow, Rules versus Standards, 42 DUKE LAW JOURNAL 557 (1992). This article describes all the differences between “rules” and “standards”.
342 In traditional language the terms “rule” and “standard” indicate two types of provisions established by a legislator with different characteristics. In what follows here they will also be used to indicate conventional clauses having the same characteristics as the legislative provisions referred to above.
343 On the criteria for formulating legal rules with a view to their efficient interpretation, an important article is that by Goetz C. & R. Scott, The Limits of Expanded Choice: An Analysis of Interactions Between Express and Implied Contract Terms, 74 CALIFORNIA LAW REVIEW 361 (1985).
consider two rather different fields of research, linked, however, by a single market failure justifying the intervention of the state.

The first case concerns the clauses governing relations between consumers and professionals and especially unlawful clauses, which are deemed to be null and void. The Italian Article 33 of the Consumer Protection Code states that “In a contract concluded between a consumer and a professional clauses are considered to be oppressive that result, even if in good faith, in a significant imbalance for the consumer in the rights and obligations deriving from the contract.” Article 26 of the same Code states that “Clauses considered to be oppressive pursuant to Articles 33 and 34 shall be null and void while the rest of the contract shall continue to be valid.” If the legislator introduced a mandatory provision, it must be considered, from the standpoint of an economic analysis of the law, that there was a market failure, i.e. that the market was not able to arrive at the optimal solution on its own.

Some scholars err on the side of caution and have attributed this failure to information asymmetry or, more exactly, in the rational apathy of consumers, who do not read all the clauses of a contract (because it is too costly to do so). Producers, taking advantage of this excessive cost for consumers, especially with regard to the clauses that are unlikely to be applied, introduce clauses that are oppressive (inefficient, i.e. entirely to their advantage) precisely as regards the matters consumers do not read about. They insert inefficient clauses, entailing a loss of wealth for the company. It is especially ironical that all producers insert unlawful clauses with the result that there are inefficient contracts for a low consideration –

344 Article 33, Consumer Protection Code.
345 Article 26, Consumer Protection Code.
346 Consider the instance wherein insurance against a certain event costs the producer 5 and the consumer 10. The efficient solution would be for the producer to insure himself and make the consumer pay 7 or 8. If the parties read the contract, the consumer would think that optimally, he would pay the producer seven or eight but the producer would be the one who would take out the insurance policy, so both benefit. If the consumer does not read the clause, the producer will not incur the cost of the insurance and the consumer will continue not to be covered by the insurance policy, which would have been efficient.
because the savings on the inefficient clauses are generally used to attract a larger number of consumers with a lower consideration. By imposing efficient clauses, the legislator has eliminated the deadweight loss even if this may entail an increase in the consideration (although such an increase is generally smaller than consumers’ willingness to pay for an efficient clause). Thus, even with a higher price, consumer welfare increases due to the more advantageous clause.

The problem at this point is to clarify what exactly the market failure is. If the mandatory provision is efficient, what exactly is the market failure that has been corrected? But is there really a market failure? Consider an initial hypothesis: that a businessman inserts in his contract exactly what is established by Articles 33 and 36 of the Consumer Protection Code. Would he not have solved the problem of inefficient clauses? The producer would have repeated the concept inherent in the mandatory provision and would have attracted new customers putting their trust in the protection clause.

Several problems arise at this point: in the first place how to make the clause known to consumers. This problem could be solved, however, by specifying that the clause in question is to be the first in the contract and printed in large letters. Consumers’ attention should therefore be drawn to this clause.

IV. A Possible Solution to the Problem in Terms of Market Failure

But there is a much more serious problem that must be highlighted: the clause prepared by the producer is a “standard” according to the third definition given of this word. In fact it is not clear which clauses are the inefficient clauses, except for some abnormal cases, and

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347 For a more complete analysis of the phenomenon, with reference also to the United States, the reader is invited to consult E. Baffi, I limiti all’autonomia contrattuale nel pensiero economico e filosofico moderno, in RIVISTA CRITICA DEL DIRITTO PRIVATO Year XXII, 4, at 660 et seq.
judges would therefore have a great deal of discretion. They would be able to decide similar cases in different ways. This discretion would entail the possibility of decisions unfavourable to entrepreneurs, with consequences for their reputations and legal costs. Entrepreneurs would then bear all the costs of the disputes, which would serve to make the clause clearer and more precise (especially in the legal systems based on the principle of binding precedent, although there is also a tendency in the Italian system to adhere to the decisions of the Court of Cassation) the Italian court that decide on the legitimacy of rules interpretation.

Learning externalities enter the picture here.³⁴⁸ The other entrepreneurs could wait for judicial experimentation to clarify the clause and only then insert it into their contracts. Thus the first entrepreneur would bear all the costs of producing, leading such a clause to be called, in economic language, a “public good” (the clause passes from being a “standard” to become a “rule”) and the others would behave as free riders (i.e. would enjoy the benefits produced by the first entrepreneur without paying anything). Since the first producer cannot exclude the others from the benefits obtained through experimentation with the clause, they will appropriate the better results without having to pay anything.

It is therefore the failure of the “public good” market³⁴⁹ that prevents the production of an efficient clause. The first producer would have to bear all the costs, but at this point gives up.

³⁴⁸ The most obvious benefit of using an existing clause is that it is not necessary to spend resources to prepare a new one. Among the costs involved in preparing a clause, those that give the greatest savings when recourse is made to previously prepared formulas are the costs arising due to drafting errors. In contrast, a new term or a term that has not been widely used may often entail very high drafting costs. On this point, see M. Kahan and M. Klausner, supra note 8, at 720. But as regards learning externalities, we shall see that the main benefit lies in the fact that the clause imitated has already been tested by the courts and has a clearer and more precise meaning. In short learning externalities bring the following advantages: a) efficiency in drafting clauses; b) reduced uncertainty as to the meaning and validity of clauses as a result of judges’ earlier decisions; and c) the familiarity with the terms of lawyers, other professionals and investors. See M. Kahan and M. Klausner, supra note 8, at 720–21.

³⁴⁹ This aspect had already been noted by J. Gordon, The Mandatory Structure of Corporate Law, 89 COLORADO LAW REVIEW 1549, 1567 (1989). Gordon was also in favour of a mandatory provision that would impose the
The private cost would normally be higher than the private benefit, even though the production would be socially useful. Thus a clause that would probably be efficient does not emerge. This is why American scholars distinguish between learning externalities and network externalities. For the former nothing is paid and they discourage the achievement of an efficient clause. For the latter it is the future that counts not what has already been obtained free of charge; free riding cannot exist.

V. A Second Case

Another case in which doubts arise about the exact failure of the market that can justify an intervention of a mandatory nature by the legislator is that of abuse of economic dependence. Such abuse is forbidden and punished by Italian Law 192/1998, which governs sub-contracting in productive activities. The ban, drafted with reference to subcontracting, affects all the unjustifyably onerous conditions applying to a firm (whether customer or supplier) that is economically dependent on a contracting firm that imposes conditions excessively biased in its favor.

The concept of abuse of economic dependence follows, according to the best court decisions, from the fact that a firm makes specific investments to the benefit of another firm, specific investments that have a much lower value if used for another purpose. Knowing this, after the contract has been signed the dominant firm can ask, perhaps arguing that its costs have changed (in order to mask the violation of a contractual obligation), for a reduction in the price of the goods produced by the economically dependent firm.

adoption of the same clause by all firms. In this way the cost of creating the public good, definable as a “clarified and precise rule”, was borne by everybody.

Since the latter cannot put its plant to any other use, it may ultimately be prepared to accept a reduction in price down to the variable cost of the goods produced or at any rate down to the point where it could produce for another firm at a slightly higher price. In this way it will not recover its fixed costs (the “specific investments”) and will make a loss. The difference between the price agreed and the lower price requested, which the economically dependent firm would accept is called “quasi-rent”.351

More precisely, under Article 9 of the above-mentioned Italian law on sub-contracting, Law 192/1998, economic dependence refers to the situation in which a firm is able to bring about an excessive imbalance between rights and obligations in its business dealings with another firm. Dependence is assessed with account also taken of the real ability of the party that has suffered the abuse to find satisfactory alternatives on the market. Similar rules are present in other European countries, as France.

The reference to the real ability of the party that has suffered the abuse to find sufficient alternatives on the market should be noted. In this case there would not be specific investments, or at least they would be minimal. As can be seen from the formulation of the mandatory provision; this is also formulated in the manner of “standards”. Here, what should be noted is that an entrepreneur could introduce a clause absolutely identical to Article 9 of the Italian law on sub-contracting. This should tranquilize sub-contractors, who would not risk being expropriated. Similar rules can be derived from the doctrine of unconscionability and relating rules.352 Also in France a discipline is present that introduce mandatory rules for the situation of abuse of economic defence.353

351 See the fundamental text on this subject – B. Klein , R. Crawford and A. Alchian, Vertical Integration , Appropriable Rents, and the Competitive Contracting Process, 21 JOURNAL OF LAW AND ECONOMICS 297, 298 (1978).
353 INTRODUCTION TO FRENCH LAW, (George Bermann and Etienne Picard eds., 2008) .
The problem is that for this clause it is not possible to formulate a “rule”, only a “standard” (in terms of their opposite meanings as referred to at the beginning of this paper), in view of the difficulty of identifying all the cases in which it can be applied. It is up to judges with their precedents to establish the precise cases. The clause would be vague, there would not be precise indications, it could be open to various interpretations so a great deal of clarification in the courts would be needed to turn this standard into a “rule”. Judges would have considerable discretion. But the first firm to adopt the clause identical to Article 9 of the law on sub-contracting would incur all the legal and reputational costs, without being able to make the other firms pay anything because such benefits cannot be excluded from consumption. The other firms would enjoy the learning externalities and once the provision had been made clear and precise (turned into a rule), they could introduce it into their forms. The clarification of the norm is a public good in the economic sense and it is not in a single entrepreneur’s interest to incur all the costs necessary to produce such a good even if that were socially (but not privately) desirable. Thus, an efficient norm is not produced owing to the failure of the market for the “public good”.

VI. SOME OBSERVATIONS

The problem of public goods in the economic sense of new clauses that appear as “standards” seem to already be known to commercial operators. It is not by chance that producers’ associations propose the insertion of certain standard clauses. If a number of firms insert the same clause, the other firms will have an interest in doing the same in order to enjoy the resulting network externalities and not be late in adjusting their forms (if a firm waits for an

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354 It should be noted that the term “rule” is not to be taken here as a “norm established by the legislator” but as a contractual clause that has a very high degree of precision.

355 A public good in the economic sense is marked, in the first place, by its not being excludable from consumption. In other words it is not possible for other persons to be excluded from enjoying it even without their having paid. The typical example in economics is the lighthouse: ships that do not pay anything for its services can still use its light to steer by.
excessive production of learning externalities, it could be late in offering its contract to consumers). What needs to be stressed is that the assessment of network externalities applies to the future: firms must understand how much they will gain by coming into line with the other firms and enjoying the future benefits the network externalities are expected to bring. When a firm relies only on learning externalities, in reality their value is certain and not expected or probable like that of network externalities. Producers must try to calculate what they will gain by inserting clauses used contemporaneously by other firms. It follows that the more firms adopt a clause, the greater will be the benefits expected from doing the same. Unfortunately, firms do not take account of the tendency for network externalities to be of a reciprocal nature and do not consider the benefits they produce for others.

A second point that can be made with regard to the reasoning put forward so far is that the general conditions often contain clauses that are standard in the second meaning attributed to the term. This is so because they are rules and therefore do not need a judicial specification.

In the field of corporate law it is possible to find, with specific reference to bond issues, clauses that are very similar, if not identical. This can be explained by considering that underwriters prefer to use identical clauses in order to exploit economies of scale. In addition, the correction of a bond covenant applies to all of them, so it is less costly for underwriters to make the change. It appears less likely that a series of lawyers will adopt the same standard clause, except in the case of a law firm with a large share of the market.

**VII. Conclusion**

As the analysis presented here shows, in the case of clauses to which consumers are a party it is not information asymmetry that causes market failure, nor, as in the case of sub-contracting, is it the dominant position that causes the inefficiency (this justification appears
rather fallacious because an entrepreneur who finds himself in a position of economic dependency is completely free, before signing the contract, to do so or not and can choose other solutions and invest in other sources of income). Firms could insert clauses identical to those mandated by the laws in question, but there is the problem of the costs incurred by the first mover, since they are standard rules. In fact the first mover bears all the costs but does not reap all the benefits. He does not internalize the benefits of his activity and it is no longer advantageous. There are free riders who, by definition, can enjoy something produced by others without having to pay a price.

One possible solution would consist in copyrighting new standard clauses. In this way those who want to use them have to pay a royalty to the inventor. But our legislator has preferred to proceed in a different way. Italian law provides for all such clauses to be obligatory, in the sense that it is not possible to derogate from them. This has fostered efficiency according to the Kaldor-Hicks criterion: some entrepreneurs will suffer net losses but society’s overall wealth will be increased. It is not to be imagined that acting in this way there can be very serious distortions: it appears difficult to suppose that an entrepreneur will withdraw from the market for fear of the new rules. If this were to be the case, however, there would indeed be a distortion.

We can conclude with a general observation: two different phenomena, such as abusive clauses in consumer contracts and abuse of economic dependence, marked by mandatory regulation, appear to be linked to the same economic justification, i.e. that the market can produce standards but not rules. If entrepreneurs could write their clauses in the form of rules, the problem of market failure would be considerably attenuated. In fact there would be no learning externalities to be copied and the first entrepreneur to introduce a rule (in the third definition of the concept of standard) would appropriate all the advantages. But in the
two fields examined in this paper producing precise rules is very costly, if not impossible. An excessively precise rule would require the consumer or producer it is aimed at to make an enormous effort to read it, which would trigger rational apathy and thus give rise in the system to the vicious circle examined here.

It should be noted that in many fields the spontaneous formulation of rules is highly complicated, so that recourse has to be made to standards. Consequently, an intervention by the legislator, making it obligatory for all to use the standard (rule) and distributing the legal and reputational costs among them, may be a solution with an important future.

In the analysis made here no account has been taken of the strong-weak contracting party antithesis, because for this author it does not appear to have a strong explanatory force and the microeconomic fundamentals do not appear clear (it is worth recalling door-to-door salesmen of encyclopedias).\textsuperscript{356}