CHAPTER VI

POLICY FRAMEWORK FOR REGULATION OF FINANCIAL DERIVATIVES

Financial Derivatives have established themselves as a major driving force in the international monetary sphere in the recent past. While derivatives were originally used as an effective monetary instrument to multiply the wealth through ripple effect, of late, these instruments are also used by banks and financial institutions to mitigate risk arising from the volatility of the underlying asset. This apart, derivatives along with the new generation monetary instruments such as investment securities in bearer form have already become the back bone of International Economy. Regulation of Financial Derivatives has a chequered history. There were periods in history when the trading in these instruments was banned. However like any prohibition, the prohibition of openly trading in financial derivatives only led to evolution of a clandestine market for these instruments and innovative players in these markets created new types of instruments to bypass regulatory restraints.

Derivatives regulation in the United States as well as in India is essentially a hybrid[1] of "institutional" and "functional" regulation. Some organisations that trade in derivatives are regulated by institutions like FSA, Securities and Exchange Commission, RBI, SEBI, etc. and these institutions have come up with disclosure norms to ensure greater transparency in the trading of derivatives. On the other

[1] For a detailed discussion on the hybrid regulatory regime in US, see James R. Barth, R. Dan Brumbaugh, Glenn Yago, (Eds.), *Restructuring Regulation and Financial Institutions, Kluwer* Academic Publishers, USA, (2001), at p.277.

hand, the functional regulatory regime controls the instruments are "financial instruments" with a slew of measures to ensure transparency and accountability. On the whole, it can be seen that the derivative regulation is more focused on self-regulation with an underlying assumption that the trade houses that utilises derivatives does so prudently and with self-regulation.

REGULATORY APPROACHES

There are three distinct approaches to regulation[2] as follows:

1. **Public Interest approach or functionalist analysis:** According to this approach, the State is considered to act in public interest to tackle market imperfections.
2. **Interest group approach:** This approach sees regulation is the product of relationship between different groups and between such groups and the State.
3. **Regulatory Capture approach:** Under this approach regulation is driven by the pursuit of self-interest by policy participants. Focus rests on individual actor rather than group or state activity. "Regulation is seen as another commodity, 'bought' by the economically powerful and used in a manner calculated to gain further wealth to the powerful."

In India, though in practice the interest group approach and the regulatory capture approach drives regulatory activities to a great extent, the public interest approach is the only publically taken approach to regulation. Generally, regulatory

[2] See Robert Baldwin, Colin Scott, Christopher Hood (Ed.), *A Reader on Regulation*, Oxford University Press, London, (1998), at p. 9-10.

framework of securities market has been divided into prudential regulation and conduct of business regulation. This division is arguably flawed in two respects: It inadequately reflects philosophical justification for regulation and it focuses on type of rule imposed rather than the type of risk which is to be addressed[3].

REGULATORY STYLES

Operating style of regulators differs with jurisdiction and regulatory styles are deeply rooted in a country's political, social and cultural past. Though there may be variations in the functioning of individual regulators, there are certain common traits that can be identified as the regulatory style of a particular jurisdiction. Generally critics have identified three major regulatory styles:

Formalised Regulation: United States of America follows this style which is largely dominated by formalized and legalistic style, administered by powerful regulators having rule making, enforcement and sanctioning powers, with formal and relatively transparent processes involving fairly lengthy decision making cycle.

Informal Regulation: UK follows this style characterized by less formal and less transparent regulators who wield substantial powers with little procedural check. Regulation has been considered a private affair between the regulator and the regulated in which third parties are deemed to have little interest or even right to information or consultation.

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[3] Alastair Hudson, *Modern Financial Techniques, Derivatives and Law*, Southern Methodist University, Institute of International Banking and Finance, Kluver Law International Sterling House, London,(2000).

Advisory Regulation: This system, which was largely followed in countries like Japan, where while regulatory authorities exercise wide discretion in issuing guidance, compliance is largely voluntary[4]. The old boy network, with retired government officials commonly transferring to the management of businesses ensured low relational distance in regulation.[5]

India generally follows the UK model of regulation, which is characterized by informal, less transparent and almost private regulation.

While we can broadly categorise regulation as above, based on jurisdictional culture, it is to be understood that regulatory models within a single jurisdiction is also not homogenous. There will be a number of varied approaches followed within a country itself depending on the sector being regulated. Some of the sub models of regulation are:

1. **Command and Control theory:** Classical model of regulation with the regulator making and enforcing the rules. In India, control of RBI is broadly falling within the category. RBI issues regulations, which generally the regulated entities have no option but to follow[6].
2. **Partial Industry Intervention theory:** The regulated businesses will have some obligations in their licenses which the agencies would enforce. A

[4] Harald Baum, "Introduction: Emulating Japan?" In Harald Baum (Ed.), *Japan: Economic Success and Legal System*, Walter de Gruyter, Berlin (1997) at pp.12-13.
[5] Ulrikr Schaede, "The 'Old Boy' Network and Government Business Relationship in Japan" in Harald Baum (Ed.), *Japan: Economic Success and Legal System,* Walter de Gruyter, Berlin, (1997) at p. 343.
[6] See for a contra view in the context of environmental regulation, Winston Harrington and Richard D. Morgenstern, "Economic Incentives Versus Command and Control", Resources, Fall/Winter 2004 at p. 13.

key aspect of such regulation is that though all players are obliged to have licenses, only those with a dominant market are exposed to all the regulatory requirements. SEBI in India generally operates in this mode[7].

3. **Franchising:** Firms wanting to carry the regulated activity bid for the right to do so. The franchise would be issued to the most favoured bidder, who will have to carry out regulated activity for a fixed period of years. The franchisee agreement would contain certain clauses as to quality and mode of carrying out the activity, which the regulator would then seek to enforce. Though such a model is largely not applicable in financial sector in India, telecom regulation in India is the best example for such a model of regulation[8].

4. **Regulation by Contract:** In this model, the government enters into contract with the regulated entities and clauses of contract contain the terms of regulation. A good example of this type of regulation can be seen in Stock Exchanges entering into listing agreements with companies and regulating the companies through these listing agreements. While the primary objective of entering into listing agreement is obviously not regulation, regulation takes place incidentally to the main purposes which help in achieving

[7] See for a detailed discussion on this theory in the context of consumer protection legislation, Ian Ayres, "Partial Industry Regulation: A Monopsony Standard for Consumer Protection", 80 Cal. L. Rev. 13 (1992) at p. 13

[8] See for a detailed discussion, Robert Baldwin, Martin Cave, Martin Lodge, *Understanding Regulation: Theory, Strategy and Practice, Oxford University Press Inc., New York, (2012) at p. 172.*

regulatory standard across all firms contracting with the regulatory body, without ever issuing a mandatory rule[9].

5. **Self-Regulation:** There is no accepted definition for the term self-regulation. In this scheme of regulatory regime, the representative organisations, for example a trade organisation, develops a system of rules which it will then monitor and enforce against, in some cases, its members and in rarer cases larger community[10]. These representative bodies function independently of government encouragement and mostly the major objective behind self-regulation is to prevent government from coming up with mandatory regulation[11].

COMPARATIVE ADVANTAGES OF DIFFERENT MODELS OF REGULATION:

Broadly speaking, all regulation is a coming from a defined regulator. Of the regulatory styles mentioned above, command control method, advisory method, partial industry intervention method, regulation by franchising and regulation by contract involves regulation where the regulator is independent of the regulated entity, and is an external body. Self-regulation is purely an internal affair of the regulated. Thus in effect there are only two effective models of regulation: (1) Regulation by an external regulator and (2) Self-regulation.

9 *Supra* n. 1 at p. 26.

10 *Id* at p 27.

11 In India, Foreign Exchange Dealers Association of India (FEDAI) is a recognised self-regulatory body in respect of foreign exchange swaps and International Swaps and Derivatives Association (ISDA) is the international self-regulatory body in respect of derivatives and currency swaps in general. The ISDA draft agreements have helped to bring in uniformity in contracts relating to derivative transactions and currency swap agreements world over and have been helping the derivative industry to function independent of governmental interference of any particular country in a self-regulatory mode.

Each of these models of regulation has its own sets of advantages and disadvantages. As pointed out by Cary Coglianese (*et.al.*)[12],

> Even as it has become widely accepted that it is socially beneficial to allow private businesses to make their own economic decisions in light of competitive and customer pressures, it is also widely accepted that certain types of business behaviour can be detrimental to society[13].

However it has been pointed out[14] that "Social scientists have shown that policy making and implementation generally fails to follow a rational order that accords with how we might think policy should be made and implemented." Let us now go through the comparative advantages and disadvantages of each of these regulatory models:

Command Control Model: This model creates a perception in public that the regulator is acting decisively. It helps the government also to be in the helm of affairs. Decisions can be made and implemented quickly and the government or regulator is able to set out clearly defined limits of unacceptable behaviour. At the same time the disadvantages of this method include the possibility of regulatory capture[15], the inherent complexity, inflexibility and over intrusiveness of this method, and complexity of the model which makes the rules made by regulator

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12 Carry Coglianese, Robert A Kagan (Eds.), *Regulation and Regulatory Processes*, The International Library of Essays in Law and Society, Ashgate, USA, (2007).
13 *Id* at p. xi.
14 *Id* at p. xii.
15 In Command Control method, the regulator and regulated works very close, and the information is provided by the regulated to regulator to carry out its duties. Regulatory Capture is the phenomenon where the regulator gets to be controlled by the regulated, and work in the interest of the regulated rather than that of the public.

susceptible to legal challenge. Sometimes, it is also difficult to set appropriate standards making the regulator look very weak[16].

Advisory Model: This model though requires an external regulator gives the regulator the flexibility to choose from the best practices in the industry. It is less intrusive. The advisories given by the regulator will act as minimum standards of regulation, and if the regulated entity has a better control, they can choose the same[17]. The disadvantage of this model is that when commercial advantages are overwhelming, there is a chance of ignoring the advisory. It also leaves the regulator with less domain control than command control method.

Partial Industry Intervention Method: Partial Industry intervention method helps to retain an unregulated market presence that can mitigate corrupt or misguided government regulation[18]. This method helps to promote regulation by restraining anti-competitive behaviour of dominant firms. It creates dual governance of individual markets by utilising both public and private forces. The competition between these public and private systems of economic governance can serve as a check on both forms of market failure.[19] This method however has the disadvantage that some firms that closely cooperate with the regulator can use this method to turn regulation to their advantage to the disadvantage of other firms.

[16] See http://www.unido.org/fileadmin/import/83247_Module5.pdf, accessed on 02.06.2016 at 09.02 hrs.

[17] See https://www.casa.gov.au/standard-page/building-new-casa-check-scorecard, accessed on 02.06.2016 at 09.06 hrs.

[18] Ian Ayres and John Braithwaite, "Partial-Industry Regulation: A Monopsony Standard for Consumer Protection", 80 Cal L. Rev. 20 (1992), p. 20.

[19] *Id* at p. 21.

Regulation by Franchising and Regulation by Contract: Both these methods have the advantage of reducing the cost of regulation for the government, since the role of the government is restricted to giving a broad outline of regulation and the rest is done by the regulated bodies themselves or by a franchisee regulator. The disadvantage is that the oversight mechanism is weaker, and in case of violation of regulatory principles, which often has disastrous consequences, the government is only left with a contract in hand.

Self-Regulation: The biggest advantage of self-regulation is that it involves lesser cost to government, as the government need not maintain an office or other paraphernalia required for a regulatory body. Oversight also becomes cheaper and easy. It can create realistic standards of regulation, and does not require legislative intervention. If the self-regulation works effectively there would be no need for government intervention. Hence self-regulation would be well informed and is supposed to get a high level of commitment from the regulated entities. The biggest disadvantage of self- regulation is that since the industry itself is regulating, regulatory enforcement may not be done efficiently. There is also a chance for the influential industry players to take control of the regulator, to their advantage and disadvantage of the less influential brethren, and sometimes even public at large. The self-regulation can at times lead to failure in early identification of risks also.

Before we advocate any particular form of regulation as the one suited for regulation of financial instruments, specifically financial derivatives, it would be beneficial to understand the self- regulatory landscape across the world. John

Carson[20] attempts to define self-regulation as a pyramid consisting of four tiers of regulation. The foundation of the system (Tier I) is “internal self-regulation” or internal controls used by financial firms. Tier II is the industry associations while Tier III is the Formal Self-Regulatory Organisation[21], term referring to a private organisation that performs industry, regulatory, or public interest functions under the supervision of a securities regulatory authority. Tier V, or the top most layer is the primary regulator, such a securities commission or financial regulatory authority.[22] His work identifies four basic models of regulation and one less developed model of regulation involving SRO’s. (1) Government or Statutory Model, where a public authority is responsible for securities regulation. Exchanges are usually responsible for very limited supervision of their markets but are not considered to be SROs. He quotes France (AMF), UK (FSA), and most European Union countries as examples.(2) Limited Exchange SRO Model, where the public authority, which is the primary regulator relies on exchanges to perform certain regulatory functions tied to operation of the market such as market surveillance and listing, while other regulatory functions are undertaken by the primary regulator. Examples of countries undertaking such a model are Hong Kong, China (HKEx[23]), Singapore (SGX[24]) Sweden (Nasdaq OMX Stockholm[25]), US (NYSE[26]). (3) Strong

[20]John Carson, “Self-Regulation in Securities Market”, Policy Research Working Paper 544, The World Bank Financial and Private Sector Development, Global Capital Markets Department, Securities Market Group, (January, 2011).
[21] Hereinafter referred to as SRO.
[22]*Supra* n.20 at p. 5. See also the pyramid of self-regulation at figure 2.1 at p. 66.
[23] Hong Kong Exchanges and Clearing Ltd., Hong Kong SAR, China
[24] Singapore Exchange, Singapore.
[25] Optionsmäklarna (OM AB) was a futures exchange founded in 1980’s to introduce trading in standardised Option Contracts in Sweden. In September 2003, Helsinki Exchange merged with

Exchange SRO Mode, where the public authority, which acts as primary regulator, relies on exchanges to perform extensive regulatory functions that extent beyond their market operations, including regulating members' business conduct. Examples of this model are Japan (TSE[27], and OSE[28]); Malaysia (Bursa Malaysia[29]); US (CME[30]). (4) Independent Member SRO Model, where the public authority as primary regulator relies extensively on an independent SRO to perform extensive regulatory function[31]. Examples are Canada (IIROC[32] and MFDA[33]), Japan (JSDA), South Korea (KOFIA[34]), US (FINRA[35] and NFA[36]), Colombia (AMV[37]) (5) Industry Association SRO Model where industry association functions mainly as voices of the industry and are mainly member-driven, but they also set standards or rules for specific securities market activities. Examples of such SRO's include ICMA[38], and AMBIMA[39] of Brazil.

OM and the joint company became OM HEX. In August 2004, the brand name of the company was changed to OMX.

[26] New York Stock Exchange, New York.

[27] Tokyo Stock Exchange, Japan.

[28] Osaka Securities Exchange, Osaka, Japan.

[29] Originally known as Kuala Lumpur Stock Exchange (KLSE, Bursa Saham Kuala Lumpur in Malay).

[30] Chicago Mercantile Exchange and Chicago Board of Trade is an American futures company and one of the largest options and futures exchanges.

[31] *Supra* n.20 at p. 17.

[32] Investment Industry Regulatory Organisation of Canada. It is a non-profit organisation working through a consolidation of the Investment Dealers Association of Canada and the Market Regulation Services Inc.

[33] The Mutual Fund Dealers Association.

[34] The Korea Financial Investment Association.

[35] Financial Industry Regulatory Authority.

[36] The National Futures Association.

[37] Autoregulador del Mercado de Valores de Columbia. Or Self Regulating Securities Market of Colombia.

[38] International Capital Markets Association

[39] Associação Brasileira das Entidades dos Mercados Financeiro e de Capitais or Brazilian Financial and Capital Markets Association.

He has also conducted a detailed study of regulatory models in various jurisdictions. Of this, let us examine the regulatory models in USA, UK, India and China. It needs to be kept in mind that the scope of his study is Self-Regulation in Securities Regulation, and hence he has not dealt with other regulatory models.

He points out that though US is often considered as the leading example of strong self-regulation, the US model suffers following defects. Self-regulation is not voluntary. It is mandatory that all broker-dealers must be members of a recognised SRO. Further, SEC[40] and CFTC[41] acts as separate statutory authorities to regulate the securities and futures markets respectively. As a result there is difference in approaches to reliance on, and oversight of, SROs in the securities market and commodities futures market. There exists a fragmentation of regulatory scenario with multiple SROs, i.e. with many firms regulated by several SROs. Similarly, independent SROs and exchange SROs operate in the US and exchanges have transferred regulatory functions to independent SROs rather than to government authorities as in other countries.[42] United Kingdom on the other hand relied almost entirely on self-regulation until 1997. In 1997, The UK government created the FSA[43] as a universal financial regulator and transferred all significant powers of the former SROs to the FSA, marking a complete departure from the historical reliance on self-regulation in its financial markets.[44] According to Carson, in India[45] exchanges retain significant SRO responsibilities. India relies extensively on its

[40] Securities and Exchange Commission.
[41] Commodity Futures Trading Commission.
[42] *Supra* n. 20 at p. 24.
[43] Here in after referred to as Financial Services Authority.
[44] *Supra* n. 20 at p.28.
[45] As well as in Australia, Hong Kong SAR: China, Japan, Korea.

two dominant securities exchanges to regulate trading, brokers, and listed issuers. Both the National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE) have important market regulation, member regulation, and listing regulation responsibilities, including extensive rules applicable to listed companies that are found only in the exchanges' listing agreements. Both the NSE and BSE are demutualised, albeit in different forms. They cooperate with, and are supervised by, the Securities and Exchange Board of India in carrying out those responsibilities.[46]

Instead of China, he looks into the position in Hong Kong SAR, China, which was taken over by China in 2000. According to him, the Securities and Futures Commission of China assumed responsibility for supervision of broker-dealers from the exchanges. The HKEx's self-regulatory role was therefore restricted to supervision of compliance with its trading and listing rules, with a Listing Committee that is independent of the Exchange administering the listing rules. The Securities and Futures Commission of China remains primarily responsible for market conduct and trading abuses and conducts market surveillance for violations of the law.

After analysing the developments in Securities' regulation in several countries including the above, Carson points out as follows:

> …, a trend away from the strong exchange SRO model has been observed. From a global perspective, a general shift towards stronger and more powerful statutory regulators has occurred. In the past two decades or so the legal and regulatory framework has improved greatly in many developed

[46] *Supra* n.20.

> and emerging markets. This has clarified the roles and powers of regulators and SROs[47].

After examining the various models, Carson is of the view that the crisis has demonstrated that sophisticated compliance systems and risk controls failed to address the risk of holding complex instruments, such as credit derivatives, and of selling them to clients. According to him a number of problems that have arisen are partly the result of a failure to adequately supervise financial firms, failures by both firms and their regulators to fully understand and control the business and product risks that firms assumed, as well as firms' failure to properly manage those risks. Since many of the failures involved banks, investment banks, and insurance firms that were mainly regulated by banking supervisors and other government regulators, or involved financial products that were not regulated by securities regulators, the direct effect of the crisis on securities regulators in general - and on self-regulation in particular has been limited.

The analysis of Carson[48] shows that at present, the experts do not see self-regulation, especially in financial instruments, as an effective tool for regulation. As Carson succinctly puts it: "

> IOSCO's Objectives and Principles of Securities Regulation (the "Principles") state that self-regulation - in particular formal SROs - is an optional feature of a securities regulation system. The Principles recognise that self-regulation may be an appropriate tool of regulation, but they do not recommend that SROs be part of the regulatory structure in every

[47]*Id at* p. 18.
[48]*Ibid.*

> jurisdiction. Principle 6 (IOSCO 2003: 12) states: "The regulatory regime should make appropriate use of self-regulatory organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets[49].

Similarly he notes:

> Demands for stronger financial regulation and consolidation of financial regulators could reduce reliance on self-regulation if the conflicts of interest inherent in self-regulation and the decentralization of supervision that a self-regulation system produces cause authorities to concentrate more powers in government regulators[50].

However, he concludes on a positive note for Self-regulation as follows:

> Where SROs have the necessary jurisdiction, they can play an important role in ensuring sound supervision of regulated firms... The crisis reinforces the need for strong, knowledgeable frontline regulators that are very familiar with the firms and that have the resources to carry out thorough, regular examinations of the firms.

At this stage, it would be worthwhile to also quickly go through the advantages and disadvantages of self-regulation as compared to other forms of regulation. Ian Bartle and Peter Vas in their Research Report for CRI, University of Bath entitled, "Self-Regulation and the Regulatory State- A Survey of Policy and Practice"[51] points out that in self-regulatory models, knowledge and expertise of all parties can

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[49] *Id*. at p. 7.
[50] *Id* at p. 53-54.
[51] Ian Bartle, Peter Vass, "Self-Regulation and the Regulatory State- A Survey of Policy and Practice", Research Report No. 17, Centre for the Study of Regulated Industries, University of Bath, London http:// www. bath. ac.uk/ management/ cri/pubpdf/ Research_ Reports/17_ Bartle_Vass.pdf, accessed on 15.01.2016 at 19.20 hrs.

be used more effectively, the approach to regulation is more flexible and adaptable, there is lower regulatory burden on business, there is more commitment, pride and loyalty within the profession or industry, there is lower costs to the state and the market can work better. According to the authors, self-regulation as an activity remote or removed from the interests of the regulatory state is an anachronism.[52] They argue that in most cases self-regulation is mostly enclosed by regulatory state, and where self-regulation operates, it operates with sanction, or support or threat of the regulatory state. The authors point out that:

> The modern regulatory state has become all-pervading in the ambit of its attentions, and self-regulation has now to be seen in this new context - simply as one of the 'instruments' available to the regulatory state[53].

The authors further argue that:

> A new regulatory paradigm can therefore be envisaged involving a form of regulatory 'subsidiarity', whereby the detailed implementation and achievement of regulatory outcomes can be delegated ('downwards') to industry bodies and private sector agreements. This is, however, accompanied by increasing public regulatory oversight based on systems control, transparency and accountability. Thus representation of the regulatory state as 'the governor of the machine' has to be accompanied by a 'better regulation' agenda.[54]

In short, it can be seen that though in many respects, self-regulation has its advantages, when it comes to individual states; self-regulation practically gives

[52] *Id* at p. 3.
[53] *Id* at p. 4.
[54] *Id* at p.4.

way to state controlled regulation. Carson also iterates the following as the reasons for reduced reliance on self-regulation: (1) Privatisation of securities exchanges, reducing their ability to perform regulatory roles effectively, since they focus more on profits (2) Intensive competition, both domestically and across border increased exchanges' concerns about cost structures, the potential for regulatory arbitrage, and free riding by competing markets on the primary market's regulation, thereby reducing their focus as a regulatory body. Such intense competition may create incentives to cut regulatory costs, to divert resources to commercial priorities, and to avoid regulatory actions that could damage business interests (3) Increasing Scandals and regulatory failures have raised questions about the effectiveness of SRO's to ensure market integrity and protect investors (4) Globalisation of markets and major securities dealers reduce the ability of SRO's to effectively regulate their members. As Carson puts it, Major dealers do business globally and are far less tied to affiliations with local exchanges and regulators than they were decades ago[55].(5) The government regulators have strengthened considerably in the last few years, and this also led to lesser reliance on self-regulatory bodies. (6) There is a global trend towards consolidation of financial regulators. (7) Cooperative regulation where the government regulators cooperate with SRO's thereby increasing complexity and amount of overlap between these two types of regulators (8) The governmental pressure to reduce regulatory costs, and increase efficiency to make their markets more competitive with regional and global competitors, has also been a reason for lessening reliance on SRO's.

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[55] *Id* at p. 13.

From the analysis of Carson, it is clear that self-regulation has not been particularly successful in ensuring strong regulatory enforcement. At the same time, the apparent advantages of the self-regulation including the domain familiarity and acceptability also should not be brushed aside. Moreover, the disadvantages of command control method also cannot be overlooked. One of the recent prominent arguments against command-and control regulation is that it engenders an adversarial resentment in regulated firms that leads to greater resistance of regulatory standards and less cooperative compliance by firms[56]. Viewing from this angle, it would be appropriate to have a strong and single national regulator, who will formulate national policies. Such national level policy lay down minimum regulatory standards for industry self-regulator. Any self-regulatory body will be bound to follow these minimum regulatory standards, but can lay down higher standards, but the regulatory directives cannot be lighter than the minimum regulatory standards.

OBJECTIVES OF DERIVATIVE REGULATION

The financial regulation in any country, should aim at the following aspects:

a) Ensuring that the underlying instruments are transactionally, informationally and functionally efficient.
b) Regulation should not hinder or have negative impact on financial innovation.
c) Steps should be taken to avoid regulatory arbitrage.

[56] Darryl K. Brown, "Street Crime, Corporate Crime, and the Contingency of Criminal Liability", 149 U. Pa. L. Rev. 1303 2000-2001 at p. 1304.

Financial Standard Foundation (FSF), after analysing the reports of International Organization of Securities Commissions (IOSCO) and Committee on Financial Sector Assessment (CFSA) and various other international bodies has set certain guidelines for regulation of securities market which are internationally accepted[57] and has been continuously monitoring the performance of various countries in meeting these objectives. The regulatory guidelines set by FSF are firstly, that the principles of the regulator should be clear and objectively stated. Secondly, the regulator should be operationally independent and accountable in the exercise of its functions and powers. Thirdly, the regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers. Fourthly, the regulator should adopt clear and consistent regulatory processes. Fifthly, the staff of regulator should observe the highest professional standards, including appropriate standards of confidentiality. Sixthly, the regulatory regime should make appropriate use of Self-Regulatory Organisations (SRO's) that exercise some direct oversight responsibility for their respective areas of competence based on the size and complexity of markets. This would also mean that SRO's should be subject to the oversight of regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities. Seventhly, the regulator should have comprehensive inspection, investigation, surveillance and enforcement powers. This would in turn mean that

[57] Based on data available on http://www.estandardsforum.org/india/standards/objectives-and-principles-ofsecurities-regulation , (Last accessed on 29-1-2011).eStandardsForum of the Financial Standards Foundation was founded in 2001 by the late George Vojta. It promoted sound global economic growth fostered by a transparent, stable financial system of effective institutions and policies. Upon the untimely death of George Vojta in late 2010, eStandardsForum's operations had to be terminated. The website which is trove of country related data on financial standards, which had an average of 2,000 unique daily visitors, was taken offline in May 2011.

the regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance programme. Eighthly, the regulator should have authority to share both public and non-public information with domestic and foreign counterparts. This means that the regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts. Ninthly, the regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers. Tenth, the regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme. Eleventh, regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme. This would mean that (1) there should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions (2) the holders of securities in a company should be treated in a fair and equitable manner (3) accounting and auditing standards should be of a high and internationally acceptable quality. Twelfth, regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme. Thirteenth, the regulation should provide for minimum entry standards for market intermediaries. This would mean that (a) there should be initial and on-going capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake (b) Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters and (c) There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk. Fourteenth, the establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight. To ensure this, there should be on-going regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants. Regulation should promote transparency of trading, should be designed to detect and deter manipulation and other unfair trading practices and should aim to ensure the proper management of large exposures, default risk and market disruption. The systems for clearing and settlement of securities transactions should be subject to regulatory oversight and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk[58].

To summarise, the regulator and regulated should know the objectives of regulation and the regulation should minimise systemic, legal and regulatory risk, and the procedure adopted by the regulator as well as the method of working of the

[58] *Ibid.*

regulator should be fair, effective, efficient, transparent and confirming to the regulatory objective.

DERIVATIVES REGULATION IN INDIA

In India, derivatives' trading is regulated by a mixture of command control, franchising, contractual and self-regulatory mechanism. As already mentioned, the SCRA, the FCRA, Depositories Act, 1996 and certain provisions of Companies Act, 1956 provide the statutory backbone for derivatives regulation. However it is worth noting that the bodies created by cooperation among market players and the SEBI generally maintains tight regulatory oversight over these market places. These bodies like the National Stock Exchange (NSE), Bombay Stock Exchange (BSE), Multi Commodities Stock Exchange (MCX),etc. act as franchisees to SEBI to enforce regulation of players in derivatives market through a process of listing contracts, rules and guidelines. Commodities market is regulated by yet another regulator, FMC which, unlike SEBI and RBI is not a statutory body but a department of Ministry of Consumer Affairs. FMC exercises considerable powers under FCRA, 1952 regarding futures and options trading in commodities (which is a variant of derivatives) and exercises its control both through command and control mechanism as well as through franchising regulatory duties to commodities exchanges such as MCX etc. There are also a host of self-regulatory organisations, at national level organisations like FEDAI[59]and at international level, the I.S.D.A. which set industry standards for derivatives trading and ensure compliance through a peer pressure mechanism.

[59] Foreign Exchange Dealers Association of India.

REGULATORY OBJECTIVES IN INDIA

As early as in 1997, SEBI and Price Water Coopers[60] along with USAID[61] had tried to outline the broad features of regulatory framework for the derivatives market. As per the PWC report[62] the following were the considerations that should be kept in mind while evolving an appropriate framework for exchange traded derivatives:

> …the regulatory framework must provide the necessary protections but not restrict market development. Such a framework should be based on: [a] The demand for such a market [b] Potential market participants and how they believe they would use the market [c] The existing financial and legal infrastructure and its integration into the regulatory structure and [d] The existing market environment and culture.[63]

The PWC report suggested that the principal function of the oversight by the government is to assure self-regulation is in public interest. To accomplish this oversight, regulator reviews the exchange rules and procedures expressly for the purpose of determining whether they are:

a) consistent with minimum best practice derivatives market standards and

b) designed to ensure a market that is open and competitive (free from manipulation and other forms of trade practice abuse).

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[60] Hereinafter referred to as PWC.
[61] United States Agency for International Development.
[62] Available on http://pdf.usaid.gov/pdf_docs/PNACC022.pdf, (Last accessed on 27.04.2015 at 20.48 hrs) at p 5-6.
[63] *Ibid.*

The self-regulator has the front line responsibility to assure financial integrity, to protect the customer and to ensure open and competitive markets that treat outside capital and all participants fairly and equitably. In addition to performing at least a periodic auditing of all SRO programs and activities, the oversight regulator steps into investigate alleged market manipulation or other wrongdoing and takes appropriate enforcement action when the SRO does not adequately fulfil its responsibility.[64] The report further points out the following minimum regulatory goals that are internationally accepted:

a) Financial safety, including integrity of clearing houses and market participants
b) Fairness, including fiduciary and related customer(investor) protection practices
c) Market efficiency and integrity.

Subsequently SEBI appointed Dr. L C Gupta Committee to study the appropriate regulatory framework for financial derivatives, which came up with the following broad regulatory objectives:

i). **Investor Protection:** This includes rules relating to ensuring fairness and transparency in market dealings, guidelines for safeguarding client's money, ensuring competent and honest service and market integrity.

ii). **Quality of Markets:** aims at enhancing important market qualities such as cost efficiency, price-continuity and price-discovery.

[64] *Id* at p. 6.

iii). **Innovation:** Should not stifle innovation which is the source of all economic progress.

While these objectives form the broad basis of the regulatory scheme floated by SEBI, the SEBI Circular No FITTC / DC / CIR-1 / 98 dated June 16, 1998, have also laid down how the stock exchanges should be regulated as follows:

> The derivatives exchange/segment should have a separate governing council and representation of trading/clearing members shall be limited to maximum of 40% of the total members of the Governing Council. The exchange shall regulate the sales practices of its members and will obtain prior approval of SEBI before start of trading in any derivatives contract.[65]

However RBI which regulates the interest rate derivatives, foreign currency derivatives and credit derivatives which are basically traded by financial institutions like banks and Non-Banking Finance Companies have an entirely different set of regulatory goals. In its guidelines entitled "Guidelines on Derivatives Trading",[66] RBI has outlined the following as the regulatory goals:

a) Ensuring suitability and appropriateness of the derivative products being offered to customers.

b) Providing adequate information to the investors about the products.

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[65]SEBI Circular No. FITTC / DC / CIR-1 / 98 dated June 16, 1998. A copy of the circular is available in http://www.sebi.gov.in/cms/sebi_data/attachdocs/1364459484666.pdf , accessed on 27.04.2015 at 20.33 hrs.

[66] DBOD.No.BP.BC. 86/21.04.157/2006-07 dated April 20, 2007 and the annexed guidelines available in http://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=3432 accessed on 27.04.2015 at 20.04 hrs.

c) Ensuring proper documentation of the derivatives product.

d) Identification of risk.

e) Risk measurement and setting proper risk coverage limits.

f) Ensuring independent risk control mechanism.

g) Segregating operational management control of the organisations dealing with derivatives.

h) Audit requirements.

RBI is enforcing these requirements through a command and control mechanism and hence the regulatory spectrum of RBI is wider than that of SEBI.

Out of the regulatory objectives identified by Financial Standards Foundation (FSF), except the requirement of internal control of market intermediaries all other regulatory requirements are either in progress for compliance or fully complied with in India. The report of CFSA of March 2009[67]categorically concluded that India has fully implemented the 20 numbered IOSCO (International Organization of Securities Commissions) principles, broadly implemented 8 and partly implemented the remaining 2 principles. The gaps in compliance, as observed by

[67] For details see http://www.estandardsforum.org/india/standards/objectives-and-principles-of-securities-regulation (Last accessed on 29-1-2011). The Financial Sector Assessment Program (FSAP) is a joint program of the International Monetary Fund and the World Bank. The Committee on Financial Sector Assessment (CFSA), co-chaired by Deputy Governor, RBI and Finance Secretary, Government of India had done a self-assessment in 2009. In the 2000 FSAP assessment, only the banking and securities market sectors were assessed by the IMF and the World Bank. In September 2010, IMF made it mandatory for 25 jurisdictions (including India) with systemically important financial sectors to undergo financial stability assessments under the FSAP every five years. As a Member, of G20, India requested IMF/World Bank to conduct such a review by way of a full-fledged FSAP. Accordingly, India's FSAP was conducted during 2011. The Mission completed its work and finalized its report in February 2012. The Financial System Stability Assessment (FSSA) Update, - on India was published on January 15, 2013 and is available at http://www .imf.org/ external/ pubs/ft/scr/2013/cr1308.pdf.

the report, included those in the areas of supervisory autonomy, transparency and disclosure, regulation and inspection of market intermediaries, and oversight of the secondary markets. Subsequently, in the Financial System Stability Assessment done by IMF in 2013, it was pointed out that the Indian economy and its financial system weathered the global financial crisis well. As per the report this was on account of strong balance sheets and profitability entering the crisis, a robust regulatory framework, timely actions to counter pressures on liquidity, the supply of credit and aggregate demand. However the report points out that there were still road blocks including (a) the prominent role of state in the financial sector leading to a build-up of fiscal contingent liabilities and creating a risk of capital misallocation (b) growing inter-linkage across markets and institutions as well as across borders in making the financial system essentially complex (c) worsening bank asset quality and (d) renewed pressures on systemic liquidity.

As per the report, on the regulatory front, the policy makers should iron out the following issues to ensure that the Indian oversight regime with respect to banks, insurance and securities market is fully in compliance with the international standards:

(a) There is lack of de jure independence across financial sector.
(b) There is lack of framework for consolidated supervision of financial conglomerates.
(c) Large Exposures and related party lending regime in banks which needs to be contained.
(d) Valuation and solvency requirements in insurance are not up to the mark.

(e) There is need for better monitoring of compliance with reporting, auditing, and accounting requirements for securities issuers.

(f) There should be mechanisms for pursuing criminal enforcement of market manipulation and other unfair practices.

(g) In Securities Clearing and Settlement systems, there should be a legal framework for settlement of corporate securities, liquidity risk management for central counterparties [68] (CCPs), and regulatory coordination.

(h) Supervisory effectiveness needs to be enhanced through augmenting resources and skilled personnel, and revising staffing policies to enable expertise to be built and retained in the supervisory function.

(i) Clear mandates to regulators that focus on the safety and soundness of regulated institutions, risk management, disclosure, and proper market conduct; supervisory involvement in decisions related to credit and asset allocation should be avoided.

(j) Multiple role of RBI is to be avoided to create better regulatory capability.

(k) Public Ownership of banks should not impose obligations or restrictions that limit banks' ability to remain competitive and sound.

(l) There should be better focus on crisis management structures and preparedness.

(m) The timeliness of corporate insolvency framework should be improved.

[68] In short CCP.

As per the report[69] by 2013, India had successfully implemented almost all of the IOSCO principles.

There is a clear division of regulatory jurisdiction over Indian financial markets between the SEBI, (the equity market regulator) and the RBI, which also oversees the government securities market. On this basis, FSF has concluded that India has complied with only 58.33 % of the IOSCO guidelines, with a rank of 14 in Financial Standards Index, in which Netherlands ranks first with 73.33 % compliance[70]. UK ranks 5 and USA ranks 7 in this index, as on March 2009, with 68.33% and 65% compliance respectively.

As a result of continuous debate that touches upon the securities law, Ministry of Finance, Government of India had appointed the Financial Sector Legislative Reforms Committee (FSLRC) with Justice B.N. Srikrishna as its chairman on March 24, 2011. The objective of this committee was to review and rewrite the legal-institutional architecture of the Indian financial sector. The Commission has put up its report on its website. The following passage from the report brings to light the approach of the commission to the regulatory regime in India:

> This problem statement differs considerably from approach taken by existing laws in India, which are sector-specific. The existing laws deal with sectors such as banking, securities and payments. The Commission analysed this issue at length, and concluded that non-sectoral laws constitute a

[69]See http://www.imf.org/external/pubs/ft/scr/2013/cr1308.pdf, accessed on 16-03-16 at 18.50 hrs.
[70] See *Supra* n.57 for details.

> superior strategy[71] …..At present, laws and regulations in India often differentiate between different ownership and corporate structures of financial firms. The Commission has pursued a strategy of ownership-neutrality: the regulatory and supervisory treatment of a financial firm would be the same, regardless of whether it is private India, foreign, public sector and co-operative. This would yield a level playing field.[72]

FSLRC has identified the following as the goals of financial sector regulation: (a) Consumer Protection (b) Micro Prudential Regulation, or capability to monitor the probability of failure (c) Specialised Resolution Mechanism capable of swiftly and efficiently winding up stressed financial institutions without compromising interest of small customers (d) Formulating and implementing capital controls on a sound footing in terms of public administration and law (e) Measurement of systemic risk and undertaking interventions at the scale of the entire financial system (and not just one sector) that diminish systemic risk (f) Development of market infrastructure and processes, and redistribution of financial assets (g) Objectives, powers and accountability mechanisms for monetary policy(h) A specialised framework on public debt management(i) Establishing legal foundation to Securities Market and making certain adaptations to the foundations of existing commercial law, surrounding contracts and property.

According to the Report, the Commission has adopted five pathways to accountability.

1. Laying down clear cut processes that the regulator must adhere to.

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[71] "*Report of the Financial Sector Legislative Reforms Commission*" Vol I, available at http:// finmin.nic.in/fslrc/fslrc_index.asp, accessed on 10.05.2015 at 20.39 hrs, at p. xv (Executive Summary).
[72] *Id* at p. xvi (Executive Summary).

2. Laying down regulation-making process (where Parliament has delegated law making power to regulators) with elaborate checks and balances.
3. Providing well established Systems of supervision.
4. Strong reporting mechanisms to achieve accountability.
5. A mechanism for judicial review for all actions of regulators through a specialised Tribunal.

LESSONS FROM 2008 MARKET CRASH

It would be worthwhile to note that most of the countries which rank above India in the Financial Standards Index was badly affected by the market crash of 2008 and have seen failure of institutions involved in derivatives trading. In India, no institution of considerable repute failed on account of the financial crisis.

After considering the most influential[73] committee reports regarding financial regulation and integration[74] Rakesh Mohan, Deputy Governor, RBI has come to the conclusion that all these reports acknowledged that the regulation and supervision in advanced economies were clearly too lax in the recent times, and that there needs to be re-thinking leading to much strengthened and perhaps intrusive regulation and supervision in the financial sector. Dr Mohan further goes on to observe:

[73] Rakesh Mohan lists the following committee reports as most influential reports: "Report of the High Level Group on Financial Supervision in the European Union" (Chairman: Jacques de Larosiere); "The structure of Financial Supervision: Approaches and Challenges in a Global Market Place" (Group of Thirty; Chairman: Paul Volcker); "The Fundamental Principles of Financial Regulation" (The Geneva Report); "The Turner Review: A Regulatory Response to the Global Banking Crisis" (Financial Services Authority of the UK); and finally, "The Report of Working Group I of the G-20 on "Enhancing, Sound Regulation and Strengthening Transparency" (G-20). See *id* at p. 5.

[74] Speech entitled "Emerging Contours of Financial Regulation: Challenges and Dynamics", by Rakesh Mohan, Deputy Governor of RBI, available in http://rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/ECFRBU0609.pdf, accessed on 27.04.2015 at 19.40 hrs.

> With financial deregulation in key jurisdictions like the United States and the UK, along with most other countries, financial institutions also grew in complexity. Financial conglomerates began to include all financial functions under one roof: banking, insurance, asset management, proprietary trading, investment banking, broking and the like. The consequence has been inadequate appreciation and assessment of the emerging risks, both within institutions and system wide.[75]

This systemic risk in conjunction with the unprecedented explosive growth of securitised credit intermediation and associated derivatives was based on an erroneous assumption that such products constituted a mechanism which took off the risk off the balance sheets of banks, placing it with a diversified set of investors resulted in the collapse of the global economy in 2008. The opaqueness of these derivative products, which was the result of their valuation becoming increasingly dependent on model valuation and credit ratings, rather than observable and transparent market valuation, made shadow banking system[76] and other rot in the system unobservable. As a result of all these factors, rather than reducing systemic risk, the system of complex securitisation and associated derivatives only served to increase systemic risk. Moreover, it became increasingly difficult to trace where the risk ultimately lay.[77]

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[75] *Id* at p. 6.

[76] A shadow banking system refers to the financial intermediaries involved in facilitating the creation of credit across the global financial system, but whose members are not subject to regulatory oversight. The shadow banking system also refers to unregulated activities by regulated institutions. See http://www.investopedia.com/terms/s/shadow-banking-system.asp, accessed on 09.06.2016 at 00.28 hrs.

[77] *Id* at p. 7.

Similar to Dr Mohan, many experts have found unregulated trading in derivatives as one of the crucial factors that led to the financial crisis of 2008. The main pitfalls, so long as derivatives regulation are concerned are as follows:

1. Deregulation of derivatives trading leading to lack of oversight over the practices of originator firms.
2. Watering down of the concept of risk during 1990's leading to further laxity in regulatory approach. According to Lynn Turner, former chief accountant of Securities Exchange Commission (SEC), what resulted in the effective collapse of major financial institutions such as AIG and Enron was the introduction of credit derivatives that the congress and administrations ensured would never be subject to regulation[78]. He points out that the regulatory system in place for years leading up to the crisis was not out dated but was systematically dismantled by the administration.
3. Increased complexity of the derivatives product made them beyond the understanding of regulator and common investors giving leeway to the originator to stash high risk financial products and market them as no risk products to unknowing investors.
4. Uncontrolled operation of Statistical Rating Organisations which continued to rate bad derivative products as good deepened the impact.

[78] See Lynn E Turner, "The Systematic dismantling of the System", CPA Journal May 2009 as quoted in Peter D Goldman, *Fraud in the Markets- Why It Happened and How to Fight It*, John Wiley & Sons, New Jersey, (2010).

5. Repeal of Glass-Steagall Act, 1933 which was designed to segregate banking and securities business with Gramm-Leach-Bliley Act, 1999 which effectively removed the segregation between investment and commercial banking led to creation of a vicious circle of bankers who were more interested in satisfying their greed than in ensuring consumer protection.

One of the important lessons that India learned from the financial crisis is that financial sector development per se cannot be an objective in itself. It needs to be pursued in the broader context of financial stability and has to necessarily correspond to the level of maturity of the financial system and the needs of the real economy. Reforming financial markets involves improving access to simple, transparent and easy-to-understand products. Increasing complexity does not facilitate the market mechanism[79].

The purpose of financial instruments is to transfer risk to those that understand these risks, not to hide or camouflage them. Regulatory comfort and assessment should therefore be a critical determinant in pursuing financial reforms. With regards to derivatives, India has both OTC and exchange traded instruments for currency and interest rates. OTC markets in India are well regulated, unlike many other jurisdictions, to address issues of leverage and customer appropriateness and suitability. Only OTC contracts where one party to the transaction is a RBI

[79]Inaugural address at the FIMMDA-PDAI Annual Conference, January 4, 2010, Mumbai by Dr Syamala Gopinath, former Deputy Governor of RBI, entitled “Financial Crisis- Some Regulatory Issues and Recent Developments”. The copy of the said address is available in http://rbidocs .rbi.org.in/rdocs/Speeches/PDFs/SMRM040109.pdf, accessed on 27.04. 2015 at 19.51 hrs.

regulated entity is considered legally valid. Suitable reporting and post trade clearing and settlement mechanisms are being further strengthened. In fact the realisation that OTC derivatives require more regulation is deepening even in USA where the Obama Administration's Reform Plan announced in June 2009 called for all OTC derivatives to be traded to recognised clearing houses to eliminate lack of transparency and threat of widespread defaults. According to the plan, clearinghouses and exchanges would provide a needed guarantee to derivatives transactions by requiring dealers and corporations to post collateral on the deals and meet daily margin requirements[80].

Lynn A. Stout, in an article entitled "Derivatives and the Legal Origin of the 2008 Crisis"[81] argues as follows:

> There is, however, another and deeper lesson to be learned from the 2008 crisis. That lesson is that law matters. All significant markets, including financial markets, must be built on some underlying legal infrastructure. (A completely "free" market without laws is a Hobbesian world where the strong and fast seize what they want from the weak and slow.) Without a deep understanding of the nature and importance of the legal rules that organize financial markets it is impossible either to understand the markets, or to predict their behaviour.[82]

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[80] See Roya Wolverson, "The Road to Financial Regulatory Reform", July 22, 2010, Council on Foreign Relations. The full text of the paper is available on http://www.cfr.org /publication/ 21266/road_to_financial_regulatory_reform.html, accessed on 27.04.2015 at 19.54 hrs.
[81] 1 Harv.Bus.L.Rev.1 (2011).
[82] *Id* at p. 37.

ISSUES OF DERIVATIVES REGULATION IN INDIA

A report of the High Level Committee on Financial Sector Reforms[83] identified the following issues in financial regulatory and supervisory structure in India:

1. Low Pace of Innovation: The pace of innovation is very slow. Products that are proposed to be introduced in India (though well-established elsewhere in the world) take several years to get regulatory approval.

2. Regulators often have unclear, sometimes mutually inconsistent and infeasible objectives as in the case of the RBI's mandate regarding exchange rates, inflation and growth. Objectives have not kept pace with changes in the economy.

3. Excessive regulatory micro-management leads to a counter-productive interaction between the regulator and the regulated. The regulated respond to the needs and opportunities in the marketplace while attempting to comply only with the letter of the law. The regulator then attempts to stamp out violations of the spirit through new rules and the regulated find new ways to get around them.

4. Some areas of the financial sector have multiple regulators, while others that could pose systemic risks have none. Both situations, of unclear responsibility and of no responsibility, are dangerous. Regulators also suffer from conflicts of interest, some explicit and some implicit. The report

[83] Raghuram G.Rajan (et.al), *A Hundred Small Steps: Report of the Committee on Financial Sector Reforms*, Planning Commission, Government of India, Sage Publications, New Delhi (2009), pp. 14-15.

identifies that there are areas of serious overlap between regulatory agencies. For example, there is regulatory overlap between:

- SEBI and MCA in regulation of issuer companies.
- SEBI and RBI in regulation of Foreign Institutional Investors and Exchange Traded Currency and Interest Rate products.
- RBI and State governments in regulation of cooperative banks.

5. Regulators tend to focus on their narrow area to the exclusion of other sectors, leading to balkanisation even between areas of the financial sector that naturally belong together. Financial institutions are not able to realise economies of scale in these areas, leading to inefficiency and slower growth. Moreover, by ignoring the links between areas, regulators miss sources of systemic risk. Macro-prudential risk assessments will become increasingly important as the economy modernises and becomes integrated with the world economy.

6. Regulatory incentive structures lead to excessive caution, which can be augmented by the paucity of skills among the regulators' operational staff relative to those of the regulated. Such caution could actually exacerbate risks. Regulated entities sense pervasive risk aversion on the part of the regulators, reflected in 'zero tolerance by the regulator for deviation from letter of law', and potential regulatory prohibition even if the activity is currently permitted by the letter of the law. This could be partly due to the

limited capacity, experience and skills of regulatory staff. But it is also partly due to the atmosphere of distrust associated with vigilance processes in the government and the open ended nature of parliamentary investigation into alleged or real regulatory lapses. Regulators confront immense heterogeneity in the entities they regulate as well as in the investors and customers whom they protect. This heterogeneity is in terms of experience, capital, capabilities as well as honesty. Regulators respond to this heterogeneity by targeting their regulations at the lowest common denominator.

7. OTC derivatives Contracts often fall outside the purview of regulatory directives. Many a times, they are disguised in the form of mutual obligations contract, and are netted off, to bring them out of the balance sheet. This creates a serious regulatory risk[84].

8. Absence of frank communication between regulators and the regulated for fear of more explicit micro management.[85]

The report also identified the following basic concerns that are applicable to regulatory frameworks across jurisdictions, which need to be taken into account while finding an appropriate regulatory solution for India:

1. It is not sufficient for regulators to only look at the part of the system under their immediate purview. Because markets are integrated, any unregulated

[84] *Supra* n. 41.
[85] *Supra* n. 71 at p. 125.

participant can infect markets and thus contaminate regulated sectors also. For instance, there is some evidence that unregulated mortgage brokers originated worse loans than regulated ones, contaminating the securitisation process. While the immediate conclusion is not to regulate everyone to the same degree, it does suggest regulators have to be alert to entities that could have systemic consequences, including consequences on the markets.

2. Capital regulation is no substitute for ensuring that the incentives of financial institution management are adequate-that the spirit of the regulation is being obeyed rather than just the rule.

3. In a market-based system, banks are not the only source of illiquidity risk. Any entity that has mismatched assets and liabilities (mismatched in terms of duration or liquidity) is subject to the risk of becoming illiquid. To the extent that entity is of systemic importance-either too big, too interlinked, or too many investors to fail-it will have a call on public funds. Systems will have to be evolved to assess and maintain the overall liquidity position of the financial system, over and above its capital adequacy.

4. Deep markets with varied participants can absorb overall risk better.

5. Consumer protection is important. While the line between excessive paternalism and appropriate individual responsibility is always hard to draw, in a developing country like ours, it may well veer to a little more paternalism in interactions between financial firms and less sophisticated households. It is important to improve consumer literacy, the transparency

of products that are sold, and in some cases, limit sales of certain products in certain jurisdictions, especially if they have prudential consequences.

6. There is no perfect regulatory system. What is essential is effective cooperation between all the concerned authorities, which transcends the specifics of organizational architecture[86].

In addition to the above, the report also seeks to identify the following regulatory gaps that exist in the Indian regime:

1. Absence of any mechanism for regulatory review of corporate accounting statements for compliance with disclosure requirements.
2. The growing number of credit cooperative societies and MFIs involved in deposit taking or gathering, with little oversight.
3. Absence of supervision of cross-market activities.
4. Inadequate regulation of financial planners and advisors[87].

The Committee's proposals therefore seek to create:

1. A better risk management process for regulators and the regulated, addressing both the environment in which they operate, as well as the way they tackle risks, while allowing the innovation needed to spur growth.

2. A more streamlined regulatory architecture that reduces regulatory costs overlaps silos and gaps.

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[86]*Id* at p. 13.
[87]*Supra* n. 71 at p. 125.

3. Better coordination between regulators so that systemic risks are recognised early and tackled in a coordinated way.

4. A coordinated process to protect consumer interests as well as raise literacy levels.

5. Better frameworks for reducing the level of financial risk - for example, through prompt corrective action.

In order to ensure that the vices of current regulatory regime does not impact the competitiveness of the financial markets, the committee recommended moving from "rule based" regulation to "principle based" regulation, where the focus would be more on adherence to spirit rather than letter of the rule as is currently followed. According to the report, the starting point of such a movement is by rewriting the legislation governing the regulators, by clearly defining regulatory objectives and principles. The committee also cautions that since Indian Courts are generally not in favour of excessive delegation of powers to the regulator, the rewriting should be cautiously done. It also recommends the government to lay down, with maximum possible clarity, the principles based on which the regulator could be held accountable. It also recommends that all financial regulators should be periodically made amenable to external evaluation, such as the standing committee of the Parliament. The committee, after making a comparative analysis of international regulatory architecture have come to the conclusion that it is premature to move towards a completely unified regulatory structure in India. A snap shot of International Regulatory architecture would show that 14 Countries have unified regulators separate from Central Bank, whereas 28 countries have a partly unified regulatory structure and 37 countries including India has institutional regulator.

It would be ideal to reproduce the table showing a snapshot of international regulatory architectures given in the FSLRC report to get a clear understanding of the classification of regulatory structure by the Commission.

A Snapshot of International Regulatory Architecture

Unified Regulators		Partly Unified Regulators		Institutional Regulators		
Unified Model Separate from Central Bank	Unified Model within Central Bank	Banking and Securities	Banking and Insurance	All Non-banks	At least one for banks, securities firms and insurers	
1. Austria 2. Denmark 3. Estonia 4. Germany 5. Gibraltar 6. Hungary 7. Iceland 8. Japan 9. Latvia 10. Nicaragua 11. Norway 12. S.Korea 13. Sweden 14. UK	15.Bahrain* 16. Bermuda* 17.Cayman Islands* 18.Ireland* 19.Kazakistan* 20.Malawi* 21.Maldives* 22. Malta* 23. Singapore* 24. UAE* 25. Uruguay*	26.Finland 27.Luxembourg 28. Mexico 29.Switzerland	30.Australia 31.Belgium 32. Canada 33. Colombia 34.Ecuador 35.El Salvador 36.Guatemala 37.Malaysia* 38.Peru 39. Venezuela 40.Netherlands 41.Trinidad & Tobago	42.Bolivia 43.Bulgaria* 44.Chile 45.Jamaica* 46.Mauritius* 47.Slovakia* 48.South Africa* 49. Ukraine* 50.Namibia	51.Albania* 52. Argentina* 53.Bahamas* 54.Barbados* 55. Botswana* 56.Brazil* 57. China 58.Croatia* 59. Cyprus* 60.Dominican Republic* 61. Egypt* 62.France 63.Greece*	64.Hongkong* 65. India* 66.Indonesia* 67. Israel* 68.Italy* 69. Jordan* 70.Lithuania* 71.New Zealand* 72. Panama 73.Philippines* 74.Poland* 75. Portugal* 76.Russia* 77.Slovania* 78. Srilanka* 79.Spain* 80.Thailand* 81. Tunisia* 82.Turkey 83.Uganda* 84. USA.*
As percentage of all countries in sample						
30%		5%	12%	10%		43%
Source: How Countries Supervise their banks, insurers and securities markets, 2004, London, Freshfields						
Note: * Indicates that banking supervision is done by Central Bank						

The commission identifies three types of countries broadly: (a) Countries having a unified regulator (b) Partly unified regulator and (c) institutional regulators. The commission also identified two types of unified regulators, those within the central bank and those outside it. It also identified two types of partly unified regulators, 12% have unified banking and securities regulators, while some have unified banking and insurance regulators and others have unified nonbanking regulators. 43% of the countries have institutional regulators. The commission also pointed towards the need for streamlining the regulatory structure in India to avoid regulatory inconsistencies, gaps, overlap and arbitrage. An important recommendation of the committee in this direction is to reduce the number of regulators, and, most importantly, to define the regulatory jurisdiction in terms of functions rather than the form of players. Accordingly, the committee recommends that all players performing a particular function shall be made to report to a single regulator regardless of their form[88].

In order for credit to flow freely, lenders should have sufficient knowledge about borrowers, be able to take the borrower's assets as collateral, be able to enforce penalties in case the borrower defaults (such as shutting the borrower's access to credit, at least for a while, or seizing the borrower's pledged assets), and be able to renegotiate their claims in an orderly fashion in case the borrower is simply not able to pay. A strong credit infrastructure allows widespread credit information sharing, low-cost pledging and enforcement of collateral interests, and an efficient

[88] *Supra* n. 71 at p. 133- 135.

bankruptcy system, which renegotiates un-payable financial claims while preserving the assets in their best use.

KEY RECOMMENDATIONS OF FSLRC

1. *Better Legislative Structure*: Law and regulations in India should treat the financial firms independent of ownership i.e. the regulatory and supervisory treatment of a financial firm would be the same, regardless of whether it is private India, foreign, public sector and co-operative. The State governments should accept the authority of Central Government to regulate on financial service providers coming within the purview of State list[89].
2. *Better Regulatory Structure*: A single framework for regulatory governance across all agencies. This is rooted in the fact that the requirements of independence and accountability are the same across the financial system. There should be a stronger mechanism to ensure independence and accountability of regulators. Standards of functioning for the government and regulator should be well defined[90].
3. *Better Judicial Review Mechanism of Regulations:* At present, regulations are not subject to judicial review. The Commission envisaged an important process of judicial review of regulations. It would be possible to challenge regulations either on process issues (i.e. the full regulation-making process was not followed) or substantive content (i.e. the regulation does not pursue the objectives, or exceeds the powers, or violates the principles that

[89] See for details *Supra* n. 71 at p. 21 to 27.
[90] See for details *Supra* n. 71 at pp. 29-40.

are in the Act). A unified Financial Sector Appellate Tribunal (FSAT) that would hear all appeals in finance is also envisaged. Single unified Financial Redress Agency (FRA) which would serve any aggrieved consumer, across all sectors is envisaged to ensure consumer protection[91].

4. *Better Consumer Protection:* Establishes certain basic rights for all financial consumers including the right to have Financial service providers acting with professional diligence, right to be protected against unfair contract terms, right to be protected against unfair conduct by financial service providers, right to be protected of misuse of personal information, requirement of fair disclosure, right to have their complaints redressed of complaints by financial service providers, the right to receive suitable advice, protection from conflicts of interest of advisors and access to the redressal agency for redressing of grievances. Regulator has been given an enumerated set of powers through which it must implement these protections. Alongside these objectives and powers, the regulator has been given a set of principles that guide the use of the powers[92].

5. *Better Financial Data Management:* The Commission envisages a single 'Financial Data Management Centre'. All financial firms will submit regular information filings electronically to this single facility[93].

6. *Better Micro Prudential Regulation:* Regulators have five powers through which they can pursue the micro-prudential goal: regulation of

[91] See for details *Supra* n. 71 at p. 32.
[92] See for details *Supra* n. 71 at pp.43 to 53.
[93] *Id* at p. 91.

entry, regulation of risk-taking, regulation of loss absorption, regulation of governance and management, and monitoring/supervision[94].

7. *Winding up Management:* A 'Resolution Corporation' would watch all financial firms which have made intense promises to households and intervene when the net worth of the firm is near zero (but not yet negative). It would force the closure or sale of the financial firm, and protect small consumers either by transferring them to a solvent firm or by paying them[95].

8. *Capital Control Management:* Making of rules' that control inbound capital flows (and their repatriation) and 'regulations' about outbound capital flows (and their repatriation).It is also envisaged that the implementation of all capital controls would vest with the RBI.

9. *Systemic Risk Management:* Management of Systemic risk by construction and analysis of a system-wide database, identification of Systemically Important Financial Institutions(SIFI's), construction and application of system-wide tools for systemic risk regulation, inter-regulatory co-ordination and crisis management. The Commission envisages the Ministry of Finance as playing the leadership role in crisis management[96].

10. *Financial Inclusion and Market Development:* The Financial Economic Policy would consist of (i) The development of market infrastructure and processes and (ii) Redistribution and financial inclusion

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[94] *Id* at p. 102.
[95] *Id* at pp. 69 to 71.
[96] *Id* at pp. 89 to 97.

initiatives, where certain sectors, income or occupational categories are the beneficiaries[97].

11. *Monetary Policy Management:* Taking away the role of RBI in deciding the monetary policy, the Commission recommends Ministry of Finance to define the objective of monetary policy. While it places an array of powers with the RBI in the pursuit of this objective, it also makes decisions on the use of these powers the turf of an executive Monetary Policy Committee (MPC).The task of cash management and an overall picture of the contingent liabilities of the Government are put on a single agency.

12. *Investor Disclosure Management*: Issuance of securities requires three kinds of restrictions. At the time of the issue, adequate information must be available for an investor to make an informed decision about valuation. Once the trading commences, a continuous flow of information must be available through which the investor can make informed decisions. Finally, a set of rules must be in place through which all holders of a given class of securities obtain the identical payoffs. These three objectives would be achieved through regulations.

13. *Financial Regulatory Architectural Changes*: Commission proposed a financial regulatory architecture featuring seven agencies.

    a. The existing RBI will continue to exist, though with modified functions. Under the new scheme the RBI will control the monetary

[97] *Id* at p. 13.

policy, regulation and supervision of banking in enforcing the proposed consumer protection law and the proposed micro-prudential law, and regulation and supervision of payment systems in enforcing these two laws.

b. The existing SEBI, FMC, IRDA and PFRDA will be merged into a new unified agency that would implement the consumer protection law and micro-prudential law for all financial firms other than banking and payments.

c. The existing Securities Appellate Tribunal (SAT) will be subsumed into the Financial Sector Appellate Tribunal (FSAT). FSAT will hear appeals against RBI for its regulatory functions, the unified financial agency, decisions of the FRA and some elements of the work of the resolution corporation.

d. The existing Deposit Insurance and Credit Guarantee Corporation of India (DICGC) will be subsumed into the Resolution Corporation, which will work across the financial system instead of the present banking system alone.

e. A new Financial Redressal Agency (FRA) will be created, which will become a nationwide machinery to become a one stop shop where consumers can carry complaints against all financial firms.

f. Public Debt Management Office (PDMO), a new Debt Management Authority, which will be independent from the government.

g. The existing FSDC will continue to exist. However it will have modified functions in the fields of systemic risk and development of a statutory framework. It will become a statutory agency.

The suggestions put across by the FSLRC are very comprehensive and covers most of the issue areas. However, due to the very nature of the instruments, an effort by a single government will not help much in reigning in these instruments. Moreover, unscrupulous traders will always invent products that would bypass all national regulations and will always get gullible investors, by misleading advertisements. As pointed out by Raghuram Rajan, Governor of the RBI on May 19, 2015 to the Economic Club of New York[98]:

> the current non-system in international monetary policy is…, a source of substantial risk, both to sustainable growth as well as to the financial sector. It is not an industrial country problem, nor an emerging market problem; it is a problem of collective action. We are being pushed towards competitive monetary easing and musical crises.

Thus we need a better coordination in management of these instruments, between countries, in addition to better national control.

SUMMATION

It is always ideal that regulation should be based on properly laid down principles. While Interest group approach and regulatory capture approach has its utility, ultimately public interest should supersede all other regulatory concerns. A mix and

[98]See "Going Bust for Growth", Raghuram Rajan, Governor of the Reserve Bank of India on May 19, 2015 to the Economic Club of New York Rajan":https://rbi.org.in/ Scripts/BS_Speeches View. aspx?Id=957, accessed on 20.05.2015 at 23.16 hrs.

match of regulatory styles would ensure regulatory depth, since giving some leeway to self-regulation is always an effective strategy to ensure competitiveness. In these areas the current regulatory regime in India is adequate and needs no re-looking. It can be seen that the objectives of all regulation boils down to three concerns(1) Consumer Protection (2) Ensuring Integrity and Prevention of frauds and (3) Managing Innovation. Viewed from this angle, while the present regulatory regime in India is good at managing innovation, the consumer protection and ensuring integrity of market players needs to be given serious attention. There are intermittent examples of fraudsters making use of the regulatory lapses to defraud customers, and innocent retail investors. As suggested by FSLRC, there is a need for creation of a compulsory fund for settling the investors who have invested. Contribution to the fund shall be by the players in the financial sector based on the value of total stake of the organisation (including debts, investments, shareholding etc.). A market player with small stake holdings should contribute a smaller amount and one with larger stake holding should contribute an amount proportionate to their stake holdings. The funds can qualify to be an investment, and this could be used to pay off the stake holder in case of failure of the organisation. This fund will be in addition to the insurance protection, and would be used to cover those types of investors, and stake holders, which insurance or other indemnity measures do not cover. A part of the fund can also be utilised for investor education about reasonable risks in the financial sector.

Regulation should also aim at fixing the responsibility of individual players, including officials of banks, and all persons who had dealt with relation to a particular transactions shall be identified and parties who make fraudulent moves that lead to market crash, and shall ensure that they cannot play in the financial markets, till a specified period, even if they change organisations so that the phenomenon of -seller escaping the aftershocks- syndrome can be nipped in the bud. While examining the FSLRC recommendations, Mandar Kagade[99] has pointed out that though Financial Stability and Development Council (FSDC) proposed by FSLRC is modelled on Financial Stability and Oversight Council (FSOC) under the Dodd-Frank Act, the Indian Financial Code fails to provide any explicit mandate to FSDC for eliminating moral hazard, and does very little to promote market discipline amongst shareholders, creditors and counter parties of SIFIs. It is also pointed out that issues relating to control of executive compensation have been overlooked by the Commission. It is argued that a methodology exposing senior management's personal wealth to risk of default should be envisaged to incentivise prudent behaviour from senior management.[100] This would ensure the senior management to have a more proactive role in ensuring prudent market behaviour, since it would also concern their personal wealth.

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[99] Mandar Kagade, "*Indian Financial Code's Revised Draft: Critique of Two Proposals*", Economic and Political Weekly, October 24, 2015, Vol L No. 43, p. 17.

[100] Mandar Kagade argues that Changes in the design of executive compensation can take one of the several forms: (i) Reducing the proportion of equity based compensation from the package of senior management by ordering the covered service provider(CSP) to buy back the stock and liquidate investment of senior management (ii) Order the CSP concerned to compensate its senior management in contingent convertible bonds, that convert into equity when the tier I capital falls below a stipulated threshold… Since these bonds convert into equity when the tier I capital falls below a stipulated threshold, they expose the senior management's personal wealth to risk of default and thereby generate high incentives for the senior management to be prudent in their investment choices as keep the CSP well capitalised See *Id* at p. 19.

Though FSLRC recommendations in some way address the concerns, it does not address it completely. Many areas, including the centralised regulator, strong judicial review mechanism etc. are missing in the FSLRC guidelines. Suggestions are made in the concluding chapter.