CHAPTER VII

CONCLUSION AND SUGGESTIONS

Joseph Stiglitz, in his book, *Free Fall - America, Markets and the Sinking World Economy*[1], has pointed out the need for a stricter regulatory regime for derivatives. He argues for re-regulation and more government involvement in the economy. As Dr. Rakesh Mohan, Deputy Governor, RBI, in his paper prepared for the Financial Stability Review of Bank of France[2] observed, unproductive financial innovation will have to be discouraged in the new regulatory regime post crisis. Moreover, the debate on financial innovation and regulation has to be considered in terms of potential and systematic relevance of such innovations besides the capabilities for bringing them effectively under the regulatory umbrella. There are also suggestions to have a central counter party (CCP) for OTC derivatives especially for Credit Default Swaps (CDS) applicable to all jurisdictions, which will help to ensure greater transparency and better reporting. In addition, Dr Mohan suggests that public authorities should also encourage the financial industry to standardise contracts and to use a data repository for the remaining non-standardised contracts and promote fair and open access to central counterparty services. Dr Mohan also suggests that through the expanded Financial Stability Forum, now renamed as Financial Stability Board, there should be coordination amongst International

[1]Joseph Stiglitz, *Free Fall - America, Markets and the Sinking World Economy*, Penguin Books, London, (2010).
[2] Rakesh Mohan, "*Emerging Contours of Financial Regulation*", RBI Monthly Bulletin, June, 2009, available in http://rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/ECFRBU0609.pdf, accessed on 01.06.2016 at 21.04 hrs at p. 8.

Monetary Fund and the international standard setters, to create international standards, including those for macro-prudential regulation, and for having uniformity in the scope of regulation, capital adequacy and liquidity buffers. According to him the national financial authorities should apply these international standards of a common and coherent international framework in their countries consistent with national circumstances.

While understanding these suggestions, it must be kept in mind that India was less affected by financial crisis than USA and EU nations, and one of the important reasons for this was that the risk appetite of Indian Banks and other institutions were much less compared to US and EU banks due to cultural factors among other things. Moreover the Indian derivative markets being nascent, many of the high risk products including mortgage based derivatives were less prevalent in India than in other countries like USA and EU Countries. Another important aspect was that the real estate sector, though unregulated had not entered the derivatives market in a large way, so as to have the impact of falling realty prices felt on the financial sector. Combined with this, the tight regulatory control by RBI and SEBI over different derivative products and originators had helped to prevent systemic risk to a great extent.

However, it would be unwise to believe that our regulatory system is superior to other systems or that enough has been done to prevent the derivative products from posing a grave threat to the financial stability in India. On the contrary, the need for vigilant regulation suitable to the investment culture of the country and maturity of the markets, and ensuring transparency and appropriateness of the derivative products to ensure customer safety have been brought to the forefront by the experiences of countries that followed laissez faire policy in regulation of derivatives. It is also imperative that there should be some international standard setting process for both product design as well as approach towards risk of all forms so far as derivative products are concerned, since in the current globalised economy, strict regulatory regime in some countries and lax standards in others would lead only to regulatory arbitrage. In fact in a recent address to G20 nations, the Indian Finance Minister has called for global safety nets to address concerns over volatility in currency and stock markets[3]. In a globalised economy, regulatory arbitrage is much more dangerous since corporations have global presence and financial loss in some jurisdictions would have fatal effects in organisational efficacy in other jurisdictions, leading to a higher risk to investors from even tightly regulated countries. Hence there is a need for creation of a network amongst regulators in various countries, and also amongst the different regulators in the same jurisdiction, to ensure better regulatory cooperation, common regulatory standards and to ensure that regulatory arbitrage opportunities are denied to unscrupulous players in the market. An international regulatory framework arrangement, much like the BASEL guidelines for banks, should be brought in place for derivative instruments and trading in derivatives market. Such a framework should lay down standards of risk taking in derivative instruments, and guidelines to derivative product design and tighter control over the structure of

[3] See http://www.thehindu.com/business/Economy/g20-meeting-of-finance-ministers-and-central-bank-governors-at-ankara-devaluation-fed-hike-transient-real-economy-matters-says-jaitley/article7622010.ece, accessed on 06.09.2015 at 20.35 hrs.

underlying securities, which will then help to have a uniform standard across the world for such instruments. There should also be a proper control mechanism to identify sufficiently early, mitigate and to cover up the various types of risks involved in similar type of instruments. Such an approach would enable to retain the derivative products as good risk hedging tools for all investors, rather than an instrument to satisfy the greed of a few investment bankers.

In fact it should be kept in mind that financial products per se are not bad; it is the greed behind them that make them bad. It would be worthwhile to note that in 2014, the total Gross World Product[4] was US$ 77.269 Trillion while the total value of all derivative contracts in the world was US$ 629.142 Trillion[5]. As, in effect derivatives base their value on the products, some analysts[6] consider this as a ground to believe that derivatives are taking the global market to unreasonable levels. In order to keep away greed from derivative products, regulatory vigil should focus on the transparency of the products as well as the system, which will then make these products what they profess to be- money multipliers - not just for a few, but for all prudent investors.

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[4] The gross world product (GWP) is the combined gross national product of all the countries in the world. Because imports and exports balance exactly when considering the whole world, this also equals the total global gross domestic product (GDP). See https://en. wikipedia.org /wiki/Gross_world_product, accessed on 27-03-2016 at 23.47 hrs.

[5]http://stats.bis.org/statx/srs/table/d5.1, accessed on 27-03-2016 at 23.48 hrs.

[6] See Warren Buffet, in his interview to "Financial Review", by Tony Boyd in http://www.afr.com/markets/derivatives/warren-buffett-still-says-derivatives-are-weapons-of-mass -destruction-20150617-ghpw0a, accessed on 23-07-2016 at 17.20 hrs. The article states that "The total nominal amount of over-the-counter derivatives contracts outstanding in the world at December 2014 was $US630 trillion ($815 trillion), according to the latest statistics from the BIS in Switzerland. That is about eight times the size of estimated world gross domestic product of $US75 trillion."

The Report of the FSLRC outlines the approach towards future of regulation of financial instruments in the following words:

> In order to ensure that the law can keep pace with these changes, the draft Code empowers the Government to expand the list of financial products and services, as required. At the same time, the Draft Code also allows the regulators to exclude specific financial services carried out by specific categories of persons from the scope of financial services. Using this power the regulator will be able to specify exemptions, e.g. for hedge funds that do not access funds from more than a particular number of persons or investment firms that only advise their related persons. In doing so, the regulator would of course be bound by the objectives and guided by the principles set out under the draft Code.[7]

The report further reads as follows:

> There is a strong case for independence of regulators. Independent regulators would yield greater legal certainty. The quest for independence of the regulator requires two planks of work. On one hand, independence needs to be enshrined in the law, by setting out many processes in great detail in the law. On the other hand, alongside independence there is a requirement of accountability mechanisms.[8]

It needs to be kept in mind while understanding the suggestions, that these suggestions do not cover the areas already covered by FSLRC. The suggestions incorporated in this work are on the areas, which are left untouched by the FSLRC.

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[7] *"Report of the Financial Sector Legislative Reforms Commission"*, Volume I and II, Government of India, Ministry of Finance, March 2013, at p. xvi.
[8] *Id* at p. xv (Executive Summary).

RESEARCH FINDINGS:

Before one ventures to give suggestions to ensure a better regulatory framework for regulation of these instruments, it would be worthwhile to recapitulate the findings of this research:

1. The history of financial markets and financial derivatives instruments are almost simultaneous. In fact the history of derivative instruments starts at a time when people start giving value to objects, over and above their regular utility.
2. There is an inherent element of risk in every financial instrument.
3. The study of history has shown us that the loss occasioned by the derivative instruments will be more pervasive compared to direct products, because of the complexity and spread these instruments can achieve.
4. It is difficult even for the most trained professional to understand the risk factors fully and comprehensively, and in the case of many instruments, the risks take these instruments almost near to the spectrum of gambling or speculation.
5. Historically, there have been several efforts to regulate the impact of these instruments. However, the human ingenuity in terms of how to bypass the law, has almost always been smarter than regulatory efforts, and even when the regular markets try to regulate the products or any features, either a grey

market[9] opens up, or the financial experts hide the risk elements in clever usage of words and use interpretation of words as an aid to pass on these features under the guise of an unregulated or legally allowed product.

6. Financial markets and products need to be regulated as the financial sector has both internal and external risk elements - social, legal and political factors can affect the performance of financial products, and has always tend to attract fraudsters looking for easy money on account of the complexities of the product. Due to the vastness of the impact of financial failure on social and political structures, governments cannot afford to leave this sector unregulated. Moreover, there is scope for these products to be used as tools for money laundering, as the complexity of the instruments gives room for such activities.
7. It needs to be understood that most derivative products that had caused havoc in the financial markets had international ramifications. Even now no internationally accepted principles for regulation of financial markets as a whole or financial derivatives as a segment exists, though such principles exist regarding different sectors in the financial market, such as banking, insurance, trade, etc. For example, in Banking, there are Basel Regulations, which is based on the principle that the underlying principles of capital adequacy are same in the financial sector across jurisdictions. Similar understanding should be there at the product level as well.

[9]A grey market is a market where products which are not regulated are traded, it need not mean a market for banned or forbidden products, but in this context it would also include a market of forbidden securities.

8. There are four generally approved methods of regulation: - (1) Legislation (2) Direct Regulation by Statutory Regulatory Bodies (3) Indirect Regulation by Statutory Regulatory Bodies and (4) Self-Regulation. Among these, self-regulation is often preferred by the industry, because it offers flexibility and ease in product innovation. On the other hand, experience of major countries like the US, the UK and China shows that these prominent jurisdictions have an extensive legislative framework, supported by not less than three regulatory agencies, working in different financial sectors. Apart from RBI there are eight regulators in India. Similarly there are nine regulators in the US. Studies have shown that India is considered as one of the most compliant nations, in so far as regulatory compliance is concerned, in terms of putting across necessary regulations to ensure soundness of financial market infrastructure.
9. The absence of internationally accepted principles for regulation of financial instruments, including derivative instruments, has hampered the integrated regulatory regime.
10. In India, there is no clear indication in the Constitutional scheme regarding the regulation of financial derivatives though by virtue of the entries nos. 43, 47 and 48 of List I of Schedule 7 of the Constitution of India Parliament of India has the exclusive legislative power to legislate regarding the financial markets.
11. In India, the legislations such as SCRA, 1956 and FCRA, 1952 define the legislative backbone of the regulation of financial derivatives and the major

regulators like RBI and SEBI established under specific statutes act as shared regulators. In addition, there are sector specific regulators like IRDA, PFRDA and overseeing agencies like Ministry of Corporate Affairs and Ministry of Finance under which these regulators function. There is also a High Level Coordination Committee (HLCC) to avoid regulatory arbitrage and to iron out regulatory conflicts. Altogether there are about 60 statutes regulating various areas of financial sector, and in almost all areas, it is possible to create financial derivatives to hedge risks or maximise profits. In order to implement the convergence of regulatory schemes as recommended by FSLRC, FMC has been merged with SEBI in September, 2015.

12. In India, RBI mostly comes out with product specific regulations, whereas SEBI comes out with sector specific regulations. Both these regulators specify their regulatory directives through Master Circulars and Directives, which the bodies coming within their respective regulatory spheres are bound to comply. Failure to comply with regulatory requirements is met with administrative penalties. However, it is to be noted that OTC derivatives 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.

13. US, UK and China were taken as sample countries, and these countries have almost similar method for regulation of financial derivatives as India. The standard method adopted consistently in most of the common law jurisdictions is that there would be a statutory framework for macro

management of broader risk parameters and regulatory bodies will manage the changeable risk parameters. In all these countries, industry level self-regulatory bodies and international bodies like I.S.D.A. complement the regulatory efforts managing risk of the financial sector. The regulatory structure in these countries was studied in comparison with that in India.

14. Studies have shown that India is considered as one of the most compliant nations, in so far as regulatory compliance is concerned, in terms of putting across necessary regulations to ensure soundness of financial market infrastructure.
15. Judicial response to regulation of financial instruments is analysed from two perspectives: (1) decisions regarding Contract law relating individual instruments, and (2) judicial approach to regulation and regulatory behaviour. While analysing the approach of courts, it needs to be considered that though the instruments that are currently called financial derivatives since a long time, they came to be referred to as financial derivatives as a collective name only very recently. The response of Indian courts to contracts which are currently known as financial derivatives have passed through five phases. During the first phase of pre-1848 period, the Indian courts, keeping colonial objectives, were recognising and giving effect to futures and options contracts and were generally reluctant to categorise them as void contracts. However during the second phase from 1848 to 1917 the Indian courts were more inclined to find such contracts as another form of betting or gambling and were not willing to give effect to these contracts. In

the third phase, from 1917 to 1950's the courts were willing to give partial recognition to collateral contracts even when the main contracts were considered as wagers. During the period of fourth phase, which was marked by the Nehruvian socialist ideas permeating the society, statutory regulation was given effect to by courts and the trend was to avoid the contracts involving derivative transactions. In the fifth phase starting from 1990's, the judiciary started showing willingness to recognise the financial derivatives, and give effect to them, as valid contracts, by explicitly addressing them as valid contracts.

16. Regarding specifics of regulation, the general approach of the Indian Courts to the derivative contracts is to construe them as instruments that require domain expertise to interpret and leave the interpretation of contractual clauses to domain experts and confine itself to be an overseer of arbitration proceedings. Approach of US and UK courts are bolder: they would construe the parties on equal terms and give effect to contractual terms, by venturing to interpretation of contractual clauses. It can be seen that the courts in these major common law countries have been taking a liberal approach regarding financial derivative transactions and have been giving these contracts sanctity. At the same time, it can be seen that courts in US and UK have been showing more expertise in dealing with the contractual terms and have been straight in addressing the contractual issues, whereas courts in India have been preferring to leave interpretation of contractual

terms to the arbitrator, whom courts consider as expert in dealing with the subject, and limits its role as a supervisor regarding broad judicial principles.

17. In India derivatives' trading is regulated by a mixture of command control, franchising, contractual and self-regulatory mechanisms. There are regulatory gaps in the areas of supervisory autonomy, transparency and disclosure, regulation and inspection of market intermediaries, and oversight of the secondary markets.

18. FSLRC, which has been established to study and suggest comprehensive financial sector reforms in India has identified (1) Consumer Protection (2) Monitoring probability of failure (3) Specialised Resolution (4) Formulating and implementing capital controls (5) Measurement and management of systemic risk (6) Development of market infrastructure and processes, and redistribution of financial assets (7) Objectives, powers and accountability mechanisms for monetary policy (8) A specialised framework on public debt management (9) Establishing legal foundation to Securities Market and (10) Making certain adaptations to the foundations of existing commercial law surrounding contracts and property, as the goals of financial sector regulation. According to the FSLRC Report, laying down in black and white, the regulation making process, processes adhered to by regulator, systems of supervision, reporting mechanisms, and creating a mechanism of judicial review, are the pathways of accountability. FSLRC has therefore come forward with extensive suggestions for the improvement of financial sector regulatory architecture.

19. It needs to be kept in mind that new generation financial instruments including financial derivatives have impact beyond geographical boundaries. National efforts towards regulation need to be supplemented by international understanding. Ideally there should be a five layered regulatory structure:
    a. An international understanding on the broader principles of financial regulation and discipline,
    b. A strong statutory framework in accordance with these internationally agreed broader principles,
    c. A strong, objective oriented regulatory body or bodies, to manage both product based and sector based regulation, in implementation of the internationally agreed broader principles,
    d. An independent regulatory audit mechanism to identify regulatory gaps, and
    e. A strong dispute resolution mechanism to give credibility to the sector.

SUGGESTIONS FOR IMPROVEMENT OF REGULATORY FRAMEWORK:

On the basis of the above research findings, the following suggestions are made for reform:

1. **International Regulatory Regime:** Experience has shown that financial instruments, especially financial derivatives have strong international ramifications. Due to the very nature of these instruments, they always have a tendency to overcome any restrictive regulation by innovation. It only requires a change or addition of a word in the contract or even a subsequent

agreement between parties to change jurisdiction to bring a product out of national regulations. Hence there is a need for an International Regulatory Regime, through international cooperation in the model of BASEL regulations that will set regulatory guidelines and principles of regulation. It is ideal that BIS is entrusted with the task of settling these regulations, based on accepted principles for international cooperation, in the model of formation of BASEL regulations. These internationally accepted norms would become the bench mark for national regulatory bodies to frame their respective rules. As is practiced in similar regulations, enforcement would be on the basis of international acceptance and mutual cooperation of nations. These principles should be aimed primarily at management of risk. While IOSCO guidelines do act as such an international benchmark, it is restricted to securities market. This leads to a fragmented approach. Ideal regulatory approach is to put in place norms for the entire financial spectrum, so that, no activity falls outside the purview of regulation. Moreover, the chance of using these instruments for money laundering activities also makes international regulatory efforts mandatory.

2. **National Legislation vesting the regulatory role over all monetary instruments and all parties dealing with such instruments on a single national regulator:** There should be a proper national legislation, vesting on a single national regulator, the regulatory role over all monetary instruments and all parties dealing with such instruments that have impact on the economic ecosystem of the country. This would resolve two issues in

the current financial regulatory scenario. Firstly, at present all regulatory activity is focused on entities. Secondly, the fragmentation of regulators lead to multiplicity of regulatory approached. In an article entitled "*Escaping Entity-Centrism in Financial Services Regulation*"[10], Anita K. Krug of University of Washington has warned against entity centrism, and has taken a stand that,

> The entity itself has no function or meaning apart from its role as a facilitator, whether for lawmakers and regulators, who are accustomed to thinking of regulatory subjects in terms of entities, or for providers of financial services, who are able to realize efficiencies both by pooling (in entities) consumers of their financial services and by separating (in entities) the assets and liabilities associated with particular tasks or functions.

There is a growing opinion against focusing on entities as the point of regulation. While Anita Krug does not specify an instrument based regulation as a solution, the proposal here is that, while it would be unwise to remove entity based approach wholly, the regulators shall also ensure that no monetary instrument shall go outside its catchment area. For this, regulators should be able to make rules to incorporate widest definitions in the statutes for monetary instruments, and also ensure that all entities that deal with particular instruments shall be regulated by a single regulator. For e.g., it would be ideal if all OTC financial derivative transactions are regulated by the same regulator irrespective of the nature of entity which is

[10] Krug, Anita K., Escaping Entity-Centrism in Financial Services Regulation (December 11, 2013), Columbia Law Review, Vol. 113, No. 8, p. 2039, 2013; University of Washington School of Law Research Paper No. 2013-08. Available at SSRN: http://ssrn.com/abstract=2243052 or http://dx.doi.org/10.2139/ssrn.2243052, accessed on 07.09.2015 at 09.13 hrs.

dealing with it. Secondly, though the regulators are doing regulatory function with respect to entities and instruments, there are no clear cut legislative provisions that enable them to do so. Currently SEBI is regulating entities, based on executive notifications which are susceptible to challenge[11]. A complete institutional relook is required in respect of regulatory agencies. We have been seeing sectorial regulators for quite some time, and hence even the policy makers seems to have become unable to find out-of-the-box solutions for our regulatory issues.

A market specific regulator rather than player specific regulator can ensure that all innovations are properly captured in the regulatory field. For example, instead of RBI regulating banks and SEBI regulating listed banking companies, if all aspects of the business of banking are dealt with by a bank regulator, it would at the same time promote innovation and to ensure that the regulator would understand all aspects of banking business. This will boost confidence between the banker and the regulator and consequently would pave way for a two way communication that would bring a robust regulatory scenario. In India, there should be ideally a single regulator, for regulation of all monetary instruments, including financial

[11] There is no provision of Securities (Contract) Regulation Act, 1956 that would give SEBI an exhaustive power over all sorts of derivatives business. SEBI is doing this by a combination of provisions such as S. 13, 14 and 16, which empowers SEBI to ban or restrict certain type of transactions, over a certain period. As per language of the statute these powers are to be exercised in the case to case basis, but which are exercised in a blanket manner at present. In fact, a close look at the regulatory scheme would show that it is doubtful whether SEBI or central government is vested with such a power, since if regulation is made, considering the derivative products as wager, the central government lacks legislative competency to bring a statute or regulation in that regard, as it falls in State List (List II of the Constitution of India).

derivatives. This regulator shall be responsible for regulation of all entitles and all types of financial instruments, which affect the monetary stability of the country. It would be preferable if the RBI being the central bank takes over the role of apex regulator, since the very purpose of a central bank is to ensure a steady financial and monetary policy that serves the economic interest of the country. Thus it would be ideal that entire regulatory regime for financial instruments is managed by the RBI. However, if the government decides to have another apex regulator above RBI, all regulators should report to this body, and this body shall be responsible for formulation of regulatory policies and regulatory goals. All the other regulators shall become constituents of this apex regulatory body. Sub regulators such as IRDA, PFRDA and SEBI can have an implementation role, while the apex regulator would control the entire policy formulation with respect to financial and monetary sector. This apex body shall be responsible for resolution of regulatory disputes between different regulators. The apex regulator would also set the minimum regulatory policies within which the sub regulators and self-regulatory bodies work. Regulatory policies of the national regulator with regard to risk management should confirm to the international norms accepted by the international community.

3. **Self-Regulatory Bodies for sectoral regulation**: In order to ensure better co-operation amongst different market players, it is ideal that each of the different sectors in finance have its own self regulator. The national

regulator will lay down minimum regulatory standards. They can be either in addition to or in lieu of other sector specific regulatory bodies. These sector specific self-regulatory bodies will be bound to follow these minimum regulatory standards, but can lay down its own higher standards. But the regulatory directives proposed by SRO's cannot be lighter than the minimum regulatory standards prescribed by national regulator. The national regulator will only supervise the regulatory enforcement. However, where SRO's fail to arrest any signification financial turmoil within the sector, the national regulator will have power to override SRO and take remedial action including compulsory winding up of the delinquent market player.

4. **Periodical Audit of Regulatory Regime:** It has been the practice of the governments and policy makers to frame laws and regulations and then vanish from the scene leaving it to the regulators and market players to work out the practical aspects of these regulations. A review of the effectiveness and functioning of regulatory regime seldom happens and when it happens, it usually happens as a knee jerk reaction to a major regulatory failure. However, if a periodical review of the effectiveness of and functioning of regulatory regime is undertaken, the policy makers can evolve remedial measures and ensure that the legal framework remains effective and contemporary. One issue with such a periodical review is the political bias that may creep into such reviews about the legal framework put in place by a prior government. This is a real issue in a country like India, which see periodic change in governments and government policies. If a periodical

review of the effectiveness of legal framework is undertaken by an international body with reference to compliance of internationally accepted principles, this bias can be avoided to a great extent. At present, IOSCO and BIS, is undertaking such a periodic review on a voluntary basis based on Principles for Financial Market Infrastructure evolved by BIS. However, there is no compulsion on BIS to undertake such a study, and these Principals are purely voluntary. Hence it is suggested that there should be a mandatory periodical (not less than once in five years) audit of regulatory regime compliance with reference to regulatory guidelines and principles of regulation at both national and international level to understand the effectiveness of the regulatory policies, and to ensure that there is a constant follow up. It is suggested that BIS, once it gets recognised as the apex body to formulate the internationally accepted guidelines, also sets up audit wing, which would in turn conduct this periodical audit with reference to effectiveness of the national regulatory regimes. Such an international audit organisation would help to get a comprehensive audit opinion about the effectiveness of regulatory regime in a national and international level, which will create an atmosphere for greater cooperation among nations in evolving mutually accepted principles, where such need exists.

5. **Adequate Disclosure:** Regulator shall ensure that there is adequate disclosure of:

    a) All relevant details of parties engaging in transactions relating to financial derivatives.

b) Risk parameters of transaction, parties and underlying assets, choice of law and legal risk.

c) Full description of underlying assets and if there are further layers of assets, description of all such layers, including risk perceptions.

d) Income and Expenditure arising from these assets, including that of participants, and loss, if any, actual or perceived with respect to these assets.

6. **Product Approval Regime with Default Approval Clause**: Regulator shall also ensure that financial innovation is not stifled. At the same time it should not compromise on the quality and more particularly, reliability of the instruments. This could be more effectively ensured by a product approval regulatory regime[12], which would ensure that all new financial products should get pre-approval of the regulator. In order to ensure that innovation is not stifled, it should be mandated that the regulator should approve the product within a specific time, failing which the filing party would be free to float the product, subject to a review by the regulator at any subsequent stage. The regulator shall also be bound to give written reasons if a product gets declined.

7. **Mandatory Risk Management Fund and Risk Insurance Policy**: It should also be provided that every filing party shall create a mandatory risk management fund, equivalent to the total value of risk perceived by the

[12] See Saule T. Omarova, "From Reaction to Prevention: Product Approval as a Model of Derivatives Regulation", 3 Harv. Bus. L. Rev. Online 98 (2013), wherein the author discusses the advantages of a product approval regime.

filing party. If subsequently, the regulator finds the product or filing party is creating more risk than perceived initially, the regulator can demand either increasing the fund value or winding up the product and if lesser risk is perceived, the risk management fund value can be reduced. It can also be stipulated that a part of the funds shall be mandatorily used to pay premiums for an investor risk insurance policy, so that, in case the entity fails, the investors gets paid from the insurance receipts.

8. **Registry of Monetary Instruments:** Setting up a registry of all financial and monetary instruments, with value above a particular threshold limit or exposure to public over certain number of persons, will help identification and tracking of risk of such instruments. Ideally, such registry should be a web based registry, with a nominal fee. All documents relating to all types financial and monetary instruments above a threshold value shall be compulsorily registrable. A statutory provision making all the transactions whose documents are not filed in the registry unrecognizable in any forum, including arbitration and without any legal effect, within the territory of India, would help to ensure compliance. The threshold should be fixed by regulator on the basis of prevailing market conditions, and shall be revised periodically.

9. **Fixing Responsibility on Individual Players:** Regulation should also aim at fixing the responsibility of individual players, including officials of banks, and all persons who had dealt in relation to a particular transaction, and parties who make fraudulent moves that lead to market crash, shall be

identified. It shall also be ensured 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. It would be ideal that there is a properly laid down "Account Discovery Disclosure Matrix". This simply means that each individual official who is dealing with financial instruments should make proper disclosures about their income and the income of their relatives/ related institutions periodically, and there should be clear guidelines as to who all will be considered as relatives/related institutions and what all income shall be revealed, and this would differ as the position of the individual official increases in the organisation. Officers with higher responsibility should make more disclosures. Similarly there should be appropriate provisions in the law to keep account trails of individual and corporate accounts, of organisations as well as individuals involved in financial derivatives in an easily accessible manner and subject the same to periodical auditing.

Law should be modified so as to permit investigative agencies to collect account details of individuals and/or organisations involved in the transactions, and to freeze them, if there is evidence that these are siphoned off by these persons in order to cheat the unsuspecting investors. Moreover, there should be strengthening of criminal liability provisions for fraudulent market transactions, which would enable the state to effectively deal with entities/persons violating the market discipline. It is suggested that in the proposed Financial Code, separate procedural and substantive provisions should be laid down for dealing with financial frauds and acts violating market discipline.

10. **Specialised Judicial Bodies:** There is need for setting up specialised judicial bodies, with an appropriate appellate channel, with power of judicial review over the regulators. These judicial bodies shall have special rules of procedure. Ideally the judicial bodies with power of judicial review over the regulators shall also be vested with the power to impose criminal penalties with respect to the financial irregularities.

11. **Compulsory Resolution Fund:** Ever since the evolution of financial sector as a major force-to-be-reckoned, big players in the financial sector have been considering themselves as invincible. Many a time, corporations aspire to become big solely for the purpose of enjoying the immunity. There is a belief that if the organisation is big enough, the governments cannot afford them to fail. Hence they expect that the government will always be there to bail them out of their difficulties even if these difficulties arose due to mismanagement. This would give them the courage to take unwanted risk. To avoid such a practice, it is suggested that (as different from the resolution mechanism proposed by the FSLRC), there should be a compulsory fund for settling the investors to be invested. The entity that floats a financial product will keep invested an amount proportionate to the value of total stake of the organisation (including debts, investments, shareholding etc.) in such fund. An organisation with small stake holdings should contribute a smaller amount and one with larger stake holding should contribute a higher 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 is necessary to prevent the government by helping the big players and letting small players lose their investment. This would also give a more equitable ground in the financial market for players to take calculated risks similar to banks maintaining statutory liquidity ratio and cash reserve ratio permitting banking institutions to assume safe risks.

Money has only so much of value that it commands. The real value of money is the perception it has in the minds of persons who deal with it. This is true for all derivatives of money. Money is only a feeling of value attached to some physical thing. The value of money, financial and monetary instruments, at all times depended on the demand it had in the minds of people. As Jeff Madura[13] puts it, the performance of various financial institutions is linked to regulation. A common dilemma in regulating any type of financial institution is the difficulty in imposing enough regulation to ensure safety to investors without imposing something that reduces competition and efficiency. The same is true with regard to regulation of financial instruments also. The regulatory agencies should focus both on the financial instrument as well as the parties, since the key to prudential regulation is to understand these instruments and markets in their proper perspective. Instead of stifling innovation, the theme of the regulatory regime shall be to put up sufficient checks and balances to avoid market frauds and

[13]Jeff Madura, *Financial Markets and Institutions*, Florida Atlantic University, USA, (2001) at p. 7.

manipulators and at the same time facilitate market growth and economic growth. The regulatory regime should also ensure that the performance of financial markets is for the benefit of all players and the society, in its widest sense, in an equitable manner.