

CHAPTER I

INTRODUCTION

Invention of money was one of the factors that spear-headed the evolution of humanity into modernity. The word money is evolved from Latin word “*moneta*”, which meant a place for coining money or mint, which in turn was evolved from the title or surname of the Roman goddess Juno, in or near whose temples generally coin was minted in ancient Rome¹.

In fact, money in itself is an abstract concept. It is a medium of exchange. Its value is relative. It is for this reason that materials which are otherwise inconsequential have come to be used as money. It also needs to be understood that money itself is a derivative concept. The value of money depends upon the underlying trust factor. When the trust is lost, even beggars do not accept the money, as it happened in Zimbabwe².

Along with the evolution of money, finance also developed as a major force to be reckoned with. As per Online Etymological Dictionary, the term “finance” is derived originally from Latin word “fin”, which evolved into “finer”, and it means

¹ See the evolution of term “money” in Online Etymological Dictionary, available in http://www.etymonline.com/index.php?allowed_in_frame=0&search=money&searchmode=none, accessed on 26.10.2015 at 23.10 hrs.

² Due to hyper-inflation, value of Zimbabwe’s local currency depreciated. 1 US dollar reached a value of 35 quadrillion Zimbabwean dollars. As nobody wanted Zimbabwe dollars, Zimbabwe replaced it with US Dollars. However, to overcome non availability of US Dollars, the Zimbabwe’s Central Bank introduced Bond Coins, which have the same denominations and value as U.S. cents but can only be used in Zimbabwe. As per the report, even beggars are not accepting bond coins. <http://www.thehindu.com/opinion/op-ed/comment-zimbabwes-dollar-coins-face-consumer-resistance/article6768451.ece>, accessed on 26.10.2015 at 23.32 hrs.

“to end or settle a dispute or debt”. The word “finis”, which means a payment in settlement, fine or tax, was evolved from “finer”. In old French, “finis” also meant ransom, which was adopted into English. By late 15th century, the word came to denote taxation and by mid-16th century, it came to be used in the sense of management of money, or science of monetary business³. During 20th and 21st century, finance became the most powerful industry. Newer forms of financial instruments evolved, such as bonds, deposits, financial derivatives, bit coins,⁴ etc.

There was always a parallel school of thought, considering money as an evil. Very interestingly Online Etymological Dictionary suggests that there is a possibility that the word was originally derived from Latin word “monere” which meant advice or warn⁵. All religions considered money as a necessary evil and have been cautioning its disciples against hoarding of money⁶. Money has become the root of economy, and production and distribution of money was nationalised by most countries. In the course of time, several derivative forms of money evolved such as negotiable

³ See the etymological derivation of the word as available in http://www.etymonline.com/index.php?allowed_in_frame=0&search=finance&searchmode=none, accessed on 01.11.2015 at 22.09 hrs.

⁴ Bitcoin is a type of digital currency in which encryption techniques are used to regulate the generation of units of currency and verify the transfer of funds, operating independently of a central bank. Its promoters call it crypto currency. According to Bitcoin website, it is a consensus network that enables a new payment system and digital money. It is the first decentralized peer-to-peer payment network that is powered by its users with no central authority or middlemen. From a user perspective, Bitcoin is pretty much like cash for the Internet. Bitcoin can also be seen as the most prominent triple entry book keeping system in existence. See <https://bitcoin.org/en/faq#what-is-bitcoin>, accessed on 27.10.2015 at 00.42 hrs.

⁵ *Supra* n. 1

⁶ *Holy Bible* at 1 Timothy 6: 10, says “For the love of money is a root of all kinds of evil.” *Holy Quran* at Chapter 9 Verse 34 (At Twaba) says “O you who believe! Verily, there are many of the (Jewish) rabbis and the (Christian) monks who devour the wealth of mankind in falsehood, and hinder (them) from the Way of Allah (i.e. Allah's religion of Islamic Monotheism). And those who hoard up gold and silver [Al-Kanz: the money, the Zakat of which has not been paid] and spend them not in the Way of Allah, announce unto them a painful torment”. *Kaivalya Upanishad*, Verse 2 reads as follows: “Neither by works, nor by offspring, nor by wealth, but only by means of renunciation can the life eternal be achieved”

instruments, bonds etc. which also came to be used side by side with money for transactions. However many derivative products of money remained outside the regulatory regime for a variety of reasons. The foremost reason for such non regulation was that money, which is the underlying asset of all financial instruments, was a product of human mind, and its value depended on the human perception of how much it is valued. Hence every time someone tried to regulate it, newer products were invented to by-pass the regulation. Another reason was that since production of money was nationalised, the governments considered money as an already regulated field.

However, almost as frequent as innovations were introduced in financial instruments, there were scandals that had the effect of shaking the trust of general public about such instruments. As trust is a key word on which the value of money, and all its further derivatives rest upon, duty was bestowed upon the governments to maintain the trust in financial instruments. This necessitated tougher legislative attempts. The ability of financial instruments to mutate itself in the face of regulation was overcome with the help of regulatory efforts, which combine the power of legislation with the flexibility of specialised regulators. In a world which is capital centric, when these instruments brought in profit to the investors, all were happy, and none was concerned with the fine print and the real nature of the instruments. When it generated profits, governments worldwide were least bothered about the risks that these instruments brought to customers.

However in finance, there was always a circle of events. At times things became worse than expected. Many a time, the expectations given by rising profits could

not be sustained, and then the investors started having losses. The credibility and confidence of people on governments rested largely on money and monetary instruments. Hence, when financial transactions led to large scale losses to public, the governments were forced to intervene and take legislative and executive measures to restore public faith in the monetary system.

Of late, the financial crisis of 2008⁷ brought to forefront governmental lapses in putting in place appropriate administrative mechanisms to contain the risk posed by these instruments. After the crisis was over, there was serious rethinking about regulatory strategy on financial instruments. Almost all developed countries introduced knee jerk regulations to counter the allegations of legislative inaction.

The purpose of this study is to examine how far these regulations have become fruitful in the light of legislative improvements in India and worldwide. It may be kept in mind that there are innumerable varieties of financial instruments, with varied scope starting from currency notes and simple promissory notes to lotteries, digital currency etc. It is near impossible to study the regulatory policy or structure of all these instruments in a single work. Hence focus of this study is on financial derivatives, which are considered to be the prime reason behind the 2008 crisis and the focus of present regulatory efforts. The concept of legal framework in the context of this study contemplates the legislative initiatives within which executive bodies work and make executive orders for regulation of the new generation monetary instruments.

⁷ See for details *infra Chapter VI*, pp. 225 - 229

The purpose of this study is to examine, how far these regulatory measures have proved fruitful, and whether there is any further scope for improvement.

The hypothesis which is being tested is whether financial instruments, especially financial derivatives have a tendency to overcome regulations. The need for laying down international standards and norms through consensus to ensure a level playing field, to reduce chance of fraudulent transactions is also probed.

THE BASICS OF THE STUDY

During the past century, as an industry, the financial sector has emerged as a major global political force. Such a development of financial sector was not very rapid. In fact the financial sector has been controlling the political scenario of the world since the very early days in varying degrees. It is often accused that many incidents, which have directly or indirectly changed the world, have had links with financial sector.⁸ With the revolution in communication technology, growth of financial sector saw new heights. It can be safely said that financial sector is one of the most emerging fields in the 21st century.

Financial sector, like any other industry, works in the form of a market. There are three sets of players in any market: producers/sellers, buyers and intermediaries. The markets work based on the interplay between these three sets of players. In the financial markets, the financial products are bought and sold. The financial markets

⁸See "*History of Money*" at <http://www.xat.org/xat/usury.html> , accessed on 05.09.2015 at 23.58 hrs.

hugely influence the wealth creation process of the country, and sometimes the political setup of the world itself⁹.

Like any other market, during early days, the financial markets were localised, but with the advent of globalisation most financial markets across the world have started accommodating a combination of local and global players. Globalisation has also made the effect of small variations in the financial markets felt across the globe making the financial market a true epitome of globalisation. The end result is that no country can intentionally cause the financial downfall of any other country, since any small downturn in foreign financial markets would affect them as well. Financial markets are very sensitive to political, social, economic and regional policies and processes. On many occasions, financial markets even play a great role in influencing the political, social, economic and regional policies of many countries.

Money and monetary instruments had a great role in the evolution of humanity from primitive stages to the modern society. Even monetary historians differ regarding evolution of money. Some argue that it was from barter to money, or money and credit, whereas others argue that the money, credit, barter grew simultaneously. The assignment of monetary value to an otherwise insignificant object such as a coin or promissory note arises as people and their trading

⁹ *Ibid.*

associates evolve a psychological capacity to place trust in each other and in external authority within barter exchange¹⁰. As David Kinley¹¹ puts it:

...the thing which was fittest at the time to serve as medium of exchange at the time became the medium; but the fittest can mean only that which cause less inconvenience than other things, which are used for the same purpose. The reduction of the number of things used as money came from noticing the wider acceptance of some as compared to other.¹²

In short, every such thing was not money, but a derivative of money, or a monetary instrument. The underlying value was nothing but a combined perception of utility and availability of that object to create the perception of money. At every point of time, when any of these factors changed, the society found new ways to overcome the same. From cowry shells to bit coins, these innovations were, at some instances, a response to strict regulatory regimes that attempted to control supply of money.¹³ To understand the financial instruments better, a study of the evolution of financial markets and financial products is essential.

At the same time, one need to understand that since there are wide varieties of instruments which could be called financial instruments, a study of the regulation of entire gamut of financial instruments would be voluminous. Financial derivatives, which are a species of financial instruments, have come into focus after

¹⁰ See https://en.wikipedia.org/wiki/History_of_money, accessed on 29.08.2015 at 14.22 hrs.

¹¹ David Kinley, *Money: A Study of the Theory of the Medium of Exchange*, Macmillan and Co. London, (1904).

¹² *Id* at p. 21.

¹³ See Alastair Hudson, *Law on Financial Derivatives*, Sweet & Maxwell, London, (1998), at p. 8. Tracing the history of modern financial derivatives, Hudson argues that the currency swap, one of the earliest of the modern derivatives, first emerged as a method of eluding national exchange controls.

studies started to point out that these products are the prime cause of the financial turmoil of 2008. Financial derivative is a contract whose value is based on the value of another security, called the underlying security. The term financial derivatives came to be used only recently to refer to a set of products, whose value depends upon the value of underlying. The history of financial derivatives dates back to the period of development of financial instruments. Though these instruments were being extensively used in the 18th, 19th and 20th century, during the initial years, they were considered to be trade contracts, rather than instruments *per se*. The term “financial derivatives” came to be known as a collective name for all such instruments in the last decade of 20th century when the investment banking became one of the major pillars of financial industry. Since then the growth of these instruments were phenomenal. In the recent years, the traded value of OTC derivative products has far surpassed the global GDP value by almost 8 times¹⁴. Considering the fact that OTC derivatives are only one of the several types of financial derivatives, one can see that financial derivatives have achieved great importance in the short span of twenty or twenty five years since 1990’s. These figures also show the tremendous impact of this type of financial instruments on the global economy and the need for regulation of these instruments. After the financial crisis of 2008, there is increased attention on the regulation of these instruments. Many countries have tried to tighten the regulation of financial instruments in

¹⁴ As can be seen from the latest statistics, the notional value of futures exchange traded instruments across the world is US \$ 24918 Billion and that of options instruments globally is US \$ 38394 Billion as on December 2015, whereas the notional value of OTC Contracts worldwide as on the second quarter of 2015 is US \$ 492,911 Billion. See http://www.bis.org/statistics/d5_1.pdf, accessed on 06.06.2016 at 00.19 hrs. The Global GDP for 2015 was US \$ 73, 170.77 Billion (See <http://www.statista.com/statistics/268750/global-gross-domestic-product-gdp>, accessed on 06.06.2016 at 00.24 hrs.).

particular and financial derivatives specifically. It would not be wrong to say that most of these regulatory measures were a knee jerk reaction to the huge financial crisis, and mostly half-hearted attempts in regulation. Hence there is a need to study the present regulation of financial derivatives and the chances of further improvement.

NEED FOR THE STUDY

As Alastair Hudson¹⁵ puts it, the lawyer's approach to derivatives structures must remain flexible enough to move between different types of products, and re characterise the transaction, while retaining the same commercial effect and pricing strategy¹⁶. According to him there would be difference between how a lawyer and finance professional sees a financial derivative product, and this difference gives a lawyer a very strictly defined and specific role as a manager of risks in financial markets.

In fact, it is an acknowledged fact that indiscriminate use of financial derivatives triggered the financial crisis of 2008. It is pointed out that prior to this financial crisis the risks inherent in these new products were not fully understood by banks themselves or by the regulators and supervisors¹⁷. The report of the INTOSAI¹⁸ identifies some of the causes of the financial crisis. The report divides these causes

¹⁵ Alastair Hudson, *Law on Financial Derivatives*, Sweet & Maxwell, London, (1998).

¹⁶ *Id* at p. 9.

¹⁷ See *The Causes of the Global Financial Crisis and Their Implications for Supreme Audit Institutions*, Report of the Sub Committee of International Organization of Supreme Audit Institutions (INTOSAI), Stockholm, and (2010) which is an umbrella organisation for external government auditors available in <http://www.intosai.org/uploads/gaohq4709242v1finalsubgroup1paper.pdf>, accessed on 30.09.2015 at 00.45 hrs.

¹⁸ The International Organisation of Supreme Audit Institutions.

into macro-economic causes, financial market causes, policy implementation and regulatory failures.

Among the macro-economic causes, low inflation and falling interest rates resulted in increased borrowing. This in turn resulted in a tendency to take higher risks without adequate capital. The large gap between richer countries, with large current account surpluses and poorer countries with very huge current account deficits resulted in higher prices, lower government bond yields and lower returns on fixed income financial assets across all advanced economies. Many central banks, including the US Federal Reserve considered that they should not respond to the rapid rise in credit and asset prices, and resorted to dropping of interest rates as a counter measure to falling prices. In most of the countries which took this approach, the responsibility to address the financial cycles implicitly rested with the government, but it was not clear who was responsible for the financial cycle. As a result no action was taken to address rapid credit expansion and increased leverage.¹⁹

The major financial market causes listed in the report are increased complexity of financial markets, institutions and instruments owing to innovation. The under estimation of system wide risk, inadequate risk management by placing reliance on misleading data structures, failure of stress tests to understand the impact of system wide shocks such as liquidity shortages and failure of risk management agencies to evaluate risks, increased risk taking due to flawed compensation system in markets,

¹⁹ *Supra* n. 17 at p. 20.

circumvention of capital requirement regulations by banks and Pro-cyclical credit conditions also were considered as the causes of financial crisis²⁰.

The report also identifies fragmentation of supervisory structures, lack of coherence and efficiency of the regulatory agencies in the US and the EU, lack of International harmonisation and coordination, failure of supervisors to understand the risks and flouting of capital requirements by banks, winding up issues by banks, too big to fail syndrome that forced governments to guarantee credit risks which makes the banks and institutions take risks without responsibility as the major policy implementation and regulatory failures²¹.

From a financial perspective, financial derivatives therefore require serious regulatory introspection, as their notional market value is still very high compared to the global Gross Domestic Product²².

Niall Ferguson²³ argues that the prime cause of the financial crisis was the rise and fall of securitised lending which allowed banks to originate loans, and then to repackage and sell them on²⁴.

Even International Finance Commission²⁵, which belongs to the World Bank Group, is using derivative products to hedge the interest rate, currency, or

²⁰ *Id.* at p. 21.

²¹ *Id.* at p. 26.

²² For details see *Supra* n. 14.

²³ Niall Ferguson, *The Ascent of Money: A Financial History of the World*, Penguin Books, U.K., (2009).

²⁴ *Id.* at p. 65.

²⁵ Hereinafter referred to as IFC.

commodity price exposures²⁶. Thus, the derivative products are extensively used and promoted the world over, and at the same time, the risk posed by these instruments, is seldom properly understood, assessed and contained to the minimum. Hence, there is a need to study the regulatory structure of these instruments, to find out ways in which the risk posed by these instruments can be mitigated.

As can be seen in the subsequent chapters, financial derivatives are traded either through an exchange (Exchange Traded Derivatives) or between parties (Over-The-Counter (OTC) Derivatives). While it is easy to bring exchange traded derivatives within the regulatory regime, Over The Counter derivatives is traded based on mutual trust of parties, and it is difficult to bring them within the regulatory net. This is because standardisation is possible for exchange traded derivatives by making listing regulations. The very advantage of OTC derivatives is the flexibility in terms that it offers to the parties, which defy any efforts of standardisation. Though self-regulatory bodies like International Swaps and Derivatives Association (I.S.D.A.) have given contract templates to bring in uniformity in the contracts, the possibility of creation of contracts with unique terms in itself adds to the risk posed by these instruments. While these OTC derivatives are traded on mutual trust basis, the very concept of trust in the present day corporate world is uncertain and difficult to define. Hence it is all the more important to understand

²⁶See IFC website, which claims that by allowing private sector clients in the emerging markets to access the international derivatives markets in order to hedge currency, interest rate, or commodity price exposure, IFC enables companies to enhance their creditworthiness and improve their profitability. See http://www.ifc.org/wps/wcm/connect/topics_ext_content/ifcexternalcorporate_site/ifc+finance/our+finance+products/risk+management/riskmanagementproducts, accessed on 26.04.2016 at 00.37 hrs.

the risk posed by these instruments and find out ways in which the governments can control these instruments and ensure that these instruments are used for the common good, and not to perpetrate fraud and manipulation.

From the above discussion, what is sought to be brought to fore is that financial instruments has been almost coexistent with money. In fact money is also a form of financial instrument. There have been serious attempts to ban certain types of financial instruments in several jurisdictions. What is more important is that financial markets have shown remarkable resilience and where ever attempts have been made to regulate, the markets have come around and evolved new financial derivatives. Financial derivatives are those products that evolved during a phase of innovation, which was necessitated on account of several reasons. These products were once considered as the one-stop-solution for all financial worries, as they were considered as the best hedging or risk mitigation tool.²⁷ However, after the 2008 crisis, they were considered as “weapons of mass destruction” considering the ripple effect with which financial exposures of a few firms brought down the world economy.²⁸

The crux of this work is to explore how these failures of the individual players, regulators and auditors to comprehend the systemic risks involved in these complex financial transactions can be contained. To get to this aim, the process involved beyond the creation of derivatives and the players involved needs to be understood.

²⁷See *Supra*. n. 23 at p. 119. According to Ferguson, the view in Chicago in 2007 was that the world’s economic system had never been protected against the unexpected.

²⁸*Id* at p. 119.

This study examines the existing regulations that govern the financial derivatives, how far these regulatory measures have proved fruitful, and whether there is any further scope for improvement.