

CHAPTER III

REGULATION OF FINANCIAL INSTRUMENTS: A
COMPARATIVE ANALYSIS

In order to understand what is the ideal method of regulation of financial instruments one should know the different models of regulation that are followed and the comparative advantages of each such model. In fact the concept of regulation itself has only a contextual meaning. One can see that the meaning of regulation differs greatly in different contexts.

Generally, it can be said that there are at least three different models of regulation. Of this, regulation by regulatory agencies can be further categorised as direct and indirect regulation. Thus there are four regulatory models. These are:

1. **Legislation including subordinate legislation that involves statutory regulation:** Most jurisdictions have laws that control some aspects of the regulated business. In the context of financial regulation in India the best example is Securities Contracts (Regulation) Act, 1956.
2. **Direct Regulation by Regulatory Agencies:** Regulatory agencies which are mostly a creation of statute create rules for ensuring fair competition and achieving the other regulatory goals. Some examples in the context of financial regulation are the regulation by Reserve bank of India¹, Securities Exchange Board of India, and Forward Markets Commission etc.
3. **Indirect Regulation by Regulatory Agencies:** Agencies that control some part of financial markets envisage mechanisms to ensure transparency in financial disclosures by players. In the context of financial regulation in India, listing rules of Stock Exchanges, which

¹Hereinafter referred to as RBI.

indirectly ensures that customer protection at the appropriate level is maintained and regulation through taxation are examples.

4. **Self-regulation:** This means regulation by market players themselves. In most cases, market players form organisations, such as International Swaps and Derivatives Association (I.S.D.A.) and in their pursuit for maintaining a healthy competition among its members, they frame rules which are subscribed by the members².

In order to understand the broad contours of regulatory mechanism, it is necessary to examine and compare regulation across major economic powers in the world, such as USA, UK, and China. There is some similarity in the regulation of each of these countries. It needs to be understood that apart from these regulations, there are certain international standards of regulation, which have been formulated either by international agencies through international cooperative efforts such as through International Organisation of Securities Commissions³, Bank for International Settlements,⁴Basel Committee on Banking Supervision⁵ or by specialized agencies

²In 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, available in http://www.bath.ac.uk/management/crj/pubpdf/Research_Reports/17_Bartle_Vass.pdf, accessed on 15.01.2016 at 19.02 hrs., the authors argue that there are five different styles of self-regulation such as (i) *Co-operative*, where there is cooperation between regulator and regulated on the operation of statutory regulation, (ii) *Delegated*, where a public authority delegates implementation of statutory duties to self-regulatory bodies, (iii) *Devolved*, where the statutory powers are delegated to self-regulatory bodies, (iv) *Facilitated*, where despite absence of statutory backing, the state explicitly supports self-regulation and (v) *Tacit*, where there is neither statutory backing or explicit state support but the implicit role is influential.

³Hereinafter referred to as IOSCO. IOSCO is the international body that brings together the Security Regulators across the world. It was established in 1983 and has its office at Madrid, Spain. Its membership regulates more than 93% of the World's Securities Market in more than 115 jurisdictions. It works together with the G20 and the Financial Stability Board (FSB) on the global regulatory reform agenda.

⁴Hereinafter referred to as BIS. BIS is an international financial institution owned by Central Banks of the World. BIS was established in 1930, with office in Basel, Switzerland. It was established by an intergovernmental agreement between Germany, Belgium, France, the United Kingdom, Italy, Japan, the United States and Switzerland. At present it has as its members 60 Central Banks. As an organization of central banks, the BIS's objective is to make monetary

such as International Centre for Financial Regulation⁶, Governance LABEX ReFi⁷, Group of 30⁸, which many of these countries have adopted. Organisations like International Swaps and Derivatives Association,⁹ Financial Industry Regulatory Authority,¹⁰ International Capital Market Association,¹¹ Association for Financial Markets in Europe¹², British Bankers' Association¹³, Associazione Italian a

policy more predictable and transparent among its 60-member central banks. See https://en.wikipedia.org/wiki/Bank_for_International_Settlements, accessed on 01.06.2016 at 01.40 hrs.

⁵ Hereinafter referred to as BCBS. This Committee was established by Central Bank Governors of G10 nations in 1974 as Committee on Banking Regulations and Supervisory Practices. It aims to achieve its goal by setting minimum standards for the regulation and supervision of banks; by sharing supervisory issues, approaches and techniques to promote common understanding and to improve cross-border co-operation; and by exchanging information on developments in the banking sector and financial markets to help identify current or emerging risks for the global financial system. See <http://www.bis.org/bcbs/history.htm>, accessed on 01.06.2016 at 01.48 hrs.

⁶ ICFR is a non-partisan organisation focussed entirely on financial regulation and is a product of Collaboration between International Financial Services Institutions and the U.K. Government. See http://en.wikipedia.org/wiki/International_Centre_for_Financial_Regulation, accessed on 27.04.2015 at 11.55 hrs.

⁷ "Laboratory of Excellence on Financial Regulation" is a French initiative aiming at evaluation of regulatory policies. See http://en.wikipedia.org/wiki/LabEx_ReFi-European_Laboratory_on_Financial_Regulation, accessed on 27.04.2015 at 11.58 hrs.

⁸ Consultative Group on International Economic and Monetary Affairs, Inc., is an international body of leading financiers and academics which aims to deepen understanding of economic and financial issues and to examine consequences of decisions made in the public and private sectors and studies foreign exchange market, international capital markets, international financial institutions, central banks and their supervision of financial services and markets and macroeconomic issues such as product and labour markets. See http://en.wikipedia.org/wiki/Group_of_Thirty, accessed on 27.04.2015 at 12.01 hrs.

⁹ Hereinafter referred to as I.S.D.A. It is a self-regulatory body, which has more than 820 members in 57 countries; its membership consists of derivatives dealers, service providers and end users. It is a trade organization of participants in the market for over-the-counter derivatives. It is headquartered in New York. See http://en.wikipedia.org/wiki/International_Swaps_and_Derivatives_Association, accessed on 27.04.2015 at 12.13 hrs.

¹⁰ Financial Industry Regulatory Authority, Inc. (FINRA) is a private corporation that acts as a self-regulatory organisation and the largest independent regulator for all securities firms doing business in the United States. It offers regulatory oversight over all securities firms that do business with the public, plus those offering professional training, testing and licensing of registered persons, arbitration and mediation, market regulation by contract for the New York Stock Exchange, the NASDAQ Stock Market, the American Stock Exchange, and the International Securities Exchange; and industry utilities, such as trade reporting facilities and other over-the-counter operations. See http://en.wikipedia.org/wiki/Financial_Industry_Regulatory_Authority, accessed on 27.04.2015 at 12.17 hrs.

¹¹ In short ICMA. This was previously London Investment Banking Association (LIBA).

¹² In short AFME. This organisation was previously known as European Securitisation Forum (ESF).

Intermediari Mobiliari,¹⁴ Futures and Options Association,¹⁵ Securities Industry and Financial Markets Association,¹⁶ Asia Securities Industry and Financial Markets Association,¹⁷ Institute of International Finance, Inc.¹⁸ and US Structured Products Association¹⁹ etc. are examples of Financial Market Industries Self-Regulatory Organisations. While many of these organisations were initially established as trade groupings to facilitate mutual co-operation in trading and investment in the financial markets, over time, these organisations have evolved certain regulatory mechanism, which is made applicable in a “Best Practices” model²⁰.

The multitude of the regulatory agencies²¹ that work in the different countries to regulate the financial markets would show that on an average at least three to four regulatory agencies are working in each of these countries, irrespective of the political structure prevalent in the country.

Moreover, it is to be kept in mind that these products have international ramifications. Further in the eye of law, these are contracts enforceable by law,

¹³ In short BBA.

¹⁴ In short ASSOSIM.

¹⁵ In short FOA

¹⁶ In short SIFMA.

¹⁷ In short ASIFMA.

¹⁸ In short IIF.

¹⁹ In short SPA.

²⁰ Best Practices Model refers to the model of regulatory principles adopted by these bodies as Best Practices in the industry, and accepted by members by voluntary consent. There is no compulsion on any participant to adopt these regulatory practices, and individual members can very well adapt a different set of rules. However, due to wide acceptance of these best practices, the individual members are nearly bound to accept these best practices for fear of being branded as not following the best practices model. Thus this acts as a self-regulatory mechanism.

²¹ See http://en.wikipedia.org/wiki/List_of_financial_regulatory_authorities_by_country, accessed on 26.04.2015 at 15.23 hrs.

entered into between legally competent entities. In many cases, these contracting bodies are from different jurisdictions. Hence, private international law issues will be also be involved, so that international regulations by agencies such as UNIDROIT²², UNCITRAL²³, Hague Conference on Private International Law, would become applicable. The regulations by exchanges where these products are traded over the counter and the disclosure requirements under company law also top the regulatory efforts and are in addition to the national and international regulatory efforts focused on these products.

THE UNITED STATES OF AMERICA

Statutory Framework:

Since USA has a federal structure of governance, there are both federal and state laws that regulate financial markets. The major federal statutes that regulate financial markets are:

1. **Securities Act** (1933): The Act aims at regulating distribution of new securities. This Act was amended by Securities Litigation Uniform Standards Act (1998). This amendment was intended to pre-empt certain class actions that alleged fraud under state law "in connection with the purchase or sale" of securities preventing such suits being filed in Federal or State Courts.
2. **Securities Exchange Act** (1934): The Act aims at regulating trading securities, brokers and exchanges. This Act was amended by (a) Credit

²² International Institute for the Unification of Private Law.

²³ The United Nations Commission on International Trade Law.

Rating Agency Reform Act, (2006) that attempted to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency and competition in the credit rating agency industry (b) Foreign Corrupt Practices Act, (1977) that addressed accounting transparency requirements and bribery of foreign nationals (c) Williams Act (1968) regarding tender offers, (d) Tower Amendment (1975) that prohibits the Securities and Exchanges Commission and Municipal Securities Rule-making Board from directly or indirectly requiring issuers to file municipal securities documents with them before the securities are sold.

3. **Johnson Act** (1934): This Act prohibited foreign nations in default from marketing their bond issues.
4. **Trust Indenture Act** (1939) the aim of which is to regulate debt securities.
5. **Investment Company Act** (1940), which aims at regulating mutual funds, amended by National Securities Markets Improvement Act (1996) to promote more efficient management of mutual funds, protect investors and provides more effective and less burdensome regulation between states and the Federal Government.
6. **Investment Advisers Act** (1940) for regulating investment advisers.
7. **Securities Investor Protection Act** (1970) that established the Securities Investor Protection Corporation (SIPC).
8. **Private Securities Litigation Reform Act** (1995) aimed at limiting frivolous securities lawsuits.

9. **Sarbanes–Oxley Act** (2002), that set standards for all U.S. public company boards, management and public accounting firms to manage financial frauds.
10. **Energy Policy Act** (2005) which interalia provided for tax treatment of decommissioning funds and repealed Public Utility Holding Company Act (1935) also known as Wheeler-Rayburn Act.
11. **Dodd–Frank Wall Street Reform and Consumer Protection Act** (2010): This Act known as Dodd-Frank Act changed in the American financial regulatory environment that affect all federal financial regulatory agencies and almost every part of the nation's financial services industry. It amended Commodity Exchange Act, 1936, Consumer Credit Protection Act, 1968, Federal Deposit Insurance Act, 1950, Federal Deposit Insurance Corporation Improvement Act, 1991, Federal Reserve Act, 1913, Financial Institutions Reform, Recovery, and Enforcement Act, 1989, International Banking Act, 1978, Protecting Tenants at Foreclosure Act, 2009, Revised Statutes of the United States, 1926, Securities Exchange Act, 1934 and Truth in Lending Act, 1968.²⁴
12. **Jumpstart Our Business Start-ups Act** (2012) to encourage funding of United States small businesses by easing various securities regulations.

²⁴ Introduced in the House of Representatives as “The Wall Street Reform and Consumer Protection Act of 2009”, the Act became law on July 12, 2010. It was introduced by Barney Frank, who was the then Financial Services Committee Chairman and Chris Dodd, who was the Chairman of Senate Banking Committee, and hence the name Dodd-Frank Act.

Dodd Frank Act is a mammoth statute with 1601 sections divided into 16 Titles and covers almost the entire financial sector in USA. The stated aim of regulators was to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices and for other purposes.²⁵ It created regulatory agencies like Financial Stability Oversight Council, the Office of Financial Research, and the Bureau of Consumer Financial Protection and defined the regulatory role of agencies like Federal Deposit Insurance Corporation,²⁶ U.S. Securities and Exchange Commission,²⁷ Office of the Comptroller of the Currency (OCC), Federal Reserve (the "Fed"), the Securities Investor Protection Corporation (SIPC). The Act required all investment advisors to register with the SEC. The Financial Stability Oversight Council is charged with identifying threats to the financial stability of the United States, promoting market discipline and responding to emerging risks to the stability of the United States financial system. Its duties include identifying the risks to the financial stability of the United States from both financial and non-financial organisations, promoting market discipline by eliminating expectations that the Government will shield them from losses in the event of failure, and responding to emerging threats to the stability of the US financial system²⁸. The Council is vested with very broad powers to monitor,

²⁵ See the Preamble of the Act at <http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/html/PLAW-111publ203.htm>, accessed on 02.10.2015 at 19.24 hrs.

²⁶ Hereinafter referred to as FDIC.

²⁷ Hereinafter referred to as SEC.

²⁸ The Dodd Frank Act, s.112.

investigate and assess any risks to the US financial system. On a regular basis, the Council is required to make a report to Congress describing the state of the U.S. financial system. It has 10 voting and 6 non-voting members²⁹. Each voting member of the Council is required to either affirm that the federal government is taking all reasonable steps to assure financial stability and mitigate systemic risk or describe additional steps that need to be taken. This would ensure the parliamentary authority over the Council. One of the important features of the Dodd Frank Act is the emergency provisions. Under specific circumstances, the Chairman of the Council (who is also the Secretary of the Treasury), with the concurrence of $\frac{2}{3}$ voting members, may place non-bank financial companies or domestic subsidiaries of international banks under the supervision of the Federal Reserve if it appears that these companies could pose a threat to the financial stability of the US.³⁰ Once a company is brought under the supervision of the Council, the Council can set prudential norms for these entities.³¹ It also has the duty to resolve supervisory jurisdictional issues among other regulatory agencies³².

The Office of Financial Research is envisaged under the Act as basically a financial research office.

The Act also envisages under Title II, creation of an Orderly Liquidation Authority, to ensure that bankruptcies do not hamper the prospects of the stakeholders. One interesting feature that is relevant to the legal regulation is the provision for judicial

²⁹ *Id* s.111.

³⁰ *Id* s. 113.

³¹ *Id* ss. 114 and 115.

³² *Id* s. 118.

review.³³ According to critics, the entity which is put to liquidation under the Act has only 24 hours to convince a federal court to overturn that order. Unless the court somehow manages to decide the entire case in the company's favour before the clock expires, the government wins by default and can begin to liquidate the company even as appeals are pending. The Act further limits the authority of the courts by prohibiting them from reviewing whether the Treasury Secretary's decision was constitutional or whether the liquidation is actually necessary to protect financial stability. The Act prohibits the company from disclosing the liquidation threat before the district court decides the case. Once the liquidation goes forward, the creditors' only recourse will be to plead their case before the FDIC, with minimal judicial review - meaning those creditors' recoveries are "likely to be close to zero," as bankruptcy scholars Douglas Baird and Edward Morrison have put it³⁴.

Title V of the Act deals with Insurance Reform. It established The Federal Insurance Office³⁵ and provides that, among others, it has duty to identify the gaps in regulation of insurers that could contribute to financial crisis and making recommendations to the Financial Stability Oversight Council about insurers which may pose a risk and to help any state regulators with national issues³⁶.

So far as banking regulation is concerned, with the aim of reducing the amount of speculative investments on large firms' balance sheets, it limits banking entities to

³³*Id* s. 202.

³⁴ See <https://cei.org/blog/long-national-nightmare-dodd-frank-almost-over>, accessed on 02.10.2015 at 21.13 hrs.

³⁵See S.313 of the Dodd Frank Act.

³⁶See *id* Title V.

owning no more in a hedge fund or private equity fund than 3% of the total ownership interest. There is also a disclosure requirement mandating that no bank that has a direct or indirect relationship with a hedge fund or private equity fund, may enter into a transaction with the fund, or with any other hedge fund or private equity fund that is controlled by such fund without disclosing the full extent of the relationship to the regulating entity, and assuring that there is no conflict of interest.³⁷ Regulators are required to impose upon institutions capital requirements that are "counter cyclical so that the amount of capital required to be maintained by a company increases in times of economic expansion and decreases in times of economic contraction", to ensure the safety and soundness of the organization.³⁸ An insured state bank may engage in a derivative transaction only if the law with respect to lending limits of the state in which the insured state bank is chartered takes into consideration credit exposure to derivative transactions.³⁹

Title VII, also called the Wall Street Transparency and Accountability Act of 2010, is of great importance to this study, as it concerns with regulation of OTC Swaps markets. It mandates that the swaps shall be traded in the exchange only. Moreover, it mandates for a self-certification regarding compliance with the Act, when a registered entity lists for trading or accepts for clearing any contract.⁴⁰ Moreover,

³⁷ *Id* s. 619.

³⁸ *Id* s. 616.

³⁹ *Id* s. 611.

⁴⁰ *Id* s. 745. "It reads: A registered entity may elect to list for trading or accept for clearing any new contract, or other instrument, or may elect to approve and implement any new rule or rule amendment, by providing to the Commission (and the Secretary of the Treasury, in the case of a contract of sale of a government security for future delivery (or option on such a contract) or a rule or rule amendment specifically related to such a contract) a written certification that the new

the Commodity Futures Trading Commission is vested with the power to regulate OTC Swaps derivatives.⁴¹ The regulators are required to consult with each other before implementing any rule-making or issuing orders regarding several different types of security swaps.⁴² An "Inter-agency Group" is constituted to handle the oversight of existing and prospective carbon markets to ensure an efficient, secure and transparent carbon market, including oversight of spot markets and derivative markets.⁴³

Title IX⁴⁴, "Investor Protections and Improvements to the Regulation of Securities", revises the powers and structure of the Securities and Exchange Commission. To prevent regulatory capture within the SEC and increase the influence of investors, the Act creates an Office of the Investor Advocate⁴⁵, an Investor Advisory Committee composed of 12–22 members who serve 4-year terms⁴⁶, and an ombudsman appointed by the Office of the Investor Advocate.⁴⁷ It empowers Securities Exchange Commission to issue "point-of-sale disclosure" rules when retail investors purchase investment products or services. These disclosures includes concise information on costs, risks and conflicts of interest to establish such a standard and requires that the SEC study the standards of care which broker-dealers and investment advisers apply to their customers and report to Congress, to

contract or instrument or clearing of the new contract or instrument, new rule, or rule amendment complies with this Act.”

⁴¹However SEC also have regulatory role over “security based swaps” while the regulatory role of CFTC is over other OTC swaps instruments.

⁴²See S. 712 of Dodd Frank Act.

⁴³*Id* s. 750.

⁴⁴*Id* s.901 to 991.

⁴⁵*Id* s. 915, which amends S. 4 of Securities Exchange Act, 1934.

⁴⁶*Id* s. 911, which adds S. 39(a) to Securities Exchange Act, 1934

⁴⁷*Id* s. 914, which adds S. 4(g) (8) to Securities Exchange Act, 1934.

do "investor testing" and rely on experts to study financial literacy among retail investors.⁴⁸ Further, by creating a whistle-blower protection programme,⁴⁹ the SEC is given more teeth. US Freedom of Information Act is made inapplicable to SEC's surveillance, risk assessments, or other regulatory and oversight activities, subject to exceptions as regarding judicial or congressional inquiry. It also mandates creation by the SEC of an Office of Credit Ratings (OCR) to provide oversight over Nationally Recognised Statistical Rating Organizations (NRSRO) and enhanced regulation of such entities.⁵⁰ It also has provisions providing for increased regulatory oversight over NRSRO's by requiring them to establish, maintain, enforce and document an effective internal control structure governing the implementation of and adherence to policies, procedures and methodologies for determining credit ratings, providing that they should furnish to Office of Credit Ratings an annual internal control report, adhere to rules established by the Commission to prevent sales and marketing considerations from influencing the ratings issued by an NRSRO, and require Office of Credit Ratings to conduct an examination of each NRSRO at least annually and shall produce a public inspection report.⁵¹

The Act prohibits Securitiser's from hedging or transferring the credit risk. It is required to retain not less than 5% of the credit risk for an asset that is not a qualified residential mortgage. For commercial mortgages or other types of assets,

⁴⁸ *Id* s. 912, which adds S. 19 to Securities Act, 1934

⁴⁹ *Id* s. 922. Whistle-blower rewards range from 10 to 30% of the recovery. The law also provides job protection for SEC whistle-blowers and promises confidentiality for them.

⁵⁰ *Id* s. 932.

⁵¹ *Id* s. 939.

regulations may provide for retention of less than 5% of the credit risk, provided that there is also disclosure.⁵²

The SEC is allowed to classify issuers and prescribe requirements appropriate for each class of issuers of asset-backed securities. It mandates adoption of regulations requiring each issuer of an asset-backed security to disclose, for each tranche or class of security, information that will help identify each asset backing that security. SEC also has to issue regulations prescribing representations and warranties in the marketing of asset-backed securities. It would require each NRSRO to include in any report accompanying a credit rating a description of the representations, warranties and enforcement mechanisms available to investors, how they differ from the representations, warranties and enforcement mechanisms in issuances of similar securities. SEC also can require any securitiser to disclose fulfilled and unfulfilled re-purchase requests across all trusts aggregated by the securitiser, so that investors may identify asset originators with clear underwriting deficiencies. SEC will also prescribe a due diligence analysis/ review of the assets underlying the security, and a disclosure of that analysis.

One important feature of the Dodd Frank Act is that it covers something about almost all known financial instruments.⁵³ It also is legislated as a complete code

⁵² *Id s.* 942.

⁵³ Title XI deals with improving the powers and duties of Federal Reserve, Title XII for improving access to main stream Financial Institutions, Title XIII by reducing the funds available with Trouble Asset Relief Program, by amending Housing and Economic Recovery Act of 2008 and other sections of the federal code to specify that any proceeds from the sale of securities purchased to help stabilize the financial system shall be dedicated for the sole purpose of deficit reduction, and are prohibited from use as an offset for other spending increases or revenue reductions. The same conditions apply for any funds not used by the state under the American Recovery and

dealing with all the areas where financial regulation were identified as required to operate and amending a host of statutes working in the area to streamline regulatory regime.

Kimberly Summe, in her article⁵⁴ has crisply pointed out the purpose of Dodd Frank Act with respect to derivatives regulation as follows:

The Dodd-Frank Act has two primary objectives that relate to derivatives: first, to limit the systemic risk of modern finance, in part by changing the *locus* of trading in derivatives and the conduct of derivatives market participants; second, to limit the damage caused by the failure of a systemically important financial institution. With respect to the first objective, the Dodd-Frank Act's principal strategy required that certain derivatives be "cleared." With respect to the second objective, the Dodd-Frank Act singled out the entities most likely to cause systemic problems if they failed and subjected them to a new bankruptcy process.

In short, according to her, the Dodd-Frank Act's first objective was to limit risk before an institution collapses. Its second objective was to limit destruction after a systemically important financial institution has failed or is in danger of failing. She points out that it remains entirely possible that a clearing house itself is capable of

Reinvestment Act of 2009 by December 31, 2012, provided that the President may waive these requirements if it is determined to be in the best interest of the nation. Title XIV deals with Mortgage Reform and Anti-Predatory Lending Act, which imposes obligations on mortgage originators to only lend to borrowers who are likely to repay their loans, and requires standardisation of data collection for underwriting. Mortgage Originators, are prohibited from receiving compensation that varies based on the term of the loan and are imposed with duty to verify the consumer's ability to pay. Title XVI deals with S. 1256 of US Code Contract which are regulated futures contract, foreign currency contract or non-equity option. Certain securities futures contract or options on such a contract unless such contract or option is a dealer securities futures contract or a swap form of a derivative, such as interest rate swaps, currency swaps, etc. are excluded from the ambit of S. 1256 Contracts.

⁵⁴ Kimberly Summe, "An Evaluation of the U.S. Regulatory Response to Systemic Risk and Failure Posed by Derivatives", 4 Harv. Bus. L. Rev. Online 76 (2014).

failure, as several have failed in the past, and the concentration of derivatives trading in the largest global financial institutions has exacerbated this possibility. Further, the potential or eventual failure of a systemically important financial institution could have been addressed in a more judicially sound manner than the ad hoc approach policy makers chose to burden the FDIC with.

According to Saule T. Omarova,⁵⁵ fundamentally, the Dodd-Frank Act falls short of radically reshaping the structure or operation of derivatives markets. It does not impose direct, targeted regulatory restraints on the levels of risk, complexity or leverage in the OTC derivatives market.

Regulatory Agencies:

The following are the regulatory agencies that work in the USA to regulate financial markets:

1. **Securities & Exchange Commission:** SEC has the responsibility to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation. SEC ensures that public companies submit periodic reports regarding their activities including quarterly and annual reports and a narrative account, called the Management Discussion and Analysis⁵⁶ outlining the activities undertaken by the companies in previous year of operations and explains how the company fared in that time period. MD&A will also outline future goals and approaches to new projects during the

⁵⁵ Saule T. Omarova, "From Reaction to Prevention: Product Approval as a Model of Derivatives Regulation", 3 Harv. Bus. L. Rev. Online 98 (2013).

⁵⁶ In short MD&A.

coming financial year. SEC also maintains an online database called EDGAR (the Electronic Data Gathering, Analysis, and Retrieval system) from which investors can access this and other information filed with the agency. The SEC has five Commissioners who are appointed by the President of the United States with the advice and consent of the Senate. Their terms last five years and are staggered so that one Commissioner's term ends on June 5 of each year. To ensure that the Commission remains non-partisan, no more than three Commissioners may belong to the same political party. The President also designates one of the Commissioners as Chairman, the SEC's top executive.⁵⁷

2. **Commodity Futures Trading Commission:**⁵⁸ CFTC aims to foster open, transparent, competitive and financially sound markets, to avoid systemic risk and to protect the market users and their funds, consumers, and the public from fraud, manipulation and abusive practices related to derivatives and other products that are subject to the Commodity Exchange Act. CFTC oversees designated contract markets, swap execution facilities, derivatives clearing organizations, swap data repositories, swap dealers, futures commission merchants, commodity pool operators and other intermediaries. CFTC also have the same constitution as SEC and have 5 commissioners, of whom one is designated as Chairman by the President of The United States and not more than three of the commissioners can be appointed from the same political party.

⁵⁷See <http://www.sec.gov/about/commissioner.shtml>, accessed on 10.11.2015 at 16.18 hrs.

⁵⁸In short CFTC.

3. Federal Reserve System: The Federal Reserve System⁵⁹ (also known as the Federal Reserve and informally as the Fed) is the central banking system of the United States. It was created on December 23, 1913, with the enactment of the Federal Reserve Act, largely in response to a series of financial panics, particularly a severe panic in 1907. Federal Reserve has a Board of Governors comprising of 7 members appointed by the President. This board is also called Federal Reserve Board. There are 12 regional Federal Reserve Banks, a partially presidentially appointed Federal Open Market Committee, numerous privately owned U.S. member banks and various advisory councils. The Federal Reserve System was primarily created to address banking panics. The other objectives of Federal Reserve System also includes furnishing an elastic currency, creating a means of rediscounting commercial paper and establishing a more effective supervision of banking in the United States.

4. Federal Deposit Insurance Corporation: ⁶⁰ FDIC operates as an independent agency created by the Banking Act of 1933. It provides deposit insurance, guaranteeing the safety of a depositor's accounts in member banks up to \$250,000/- for each deposit ownership category in each insured bank.

⁵⁹Also known as Federal Reserve or informally as Fed, Federal Reserve is the Central Banker of The USA. See https://en.wikipedia.org/wiki/Federal_Reserve_System, accessed on 10.11.2015 at 16.23 hrs.

⁶⁰ In short FDIC.

5. **Financial Industry Regulatory Authority:**⁶¹ FINRA is an independent, not-for-profit organisation authorised by U.S. Congress to protect America's investors by making sure that the securities industry operates fairly and honestly. FINRA does this by framing and enforcing rules governing the activities of more than 4,015 securities firms with approximately 642,980 brokers, examining firms for compliance with those rules, fostering market transparency and educating investors.

6. **Office of the Comptroller of the Currency:**⁶² The OCC is an independent bureau within the United States Department of the Treasury. It was established by the National Currency Act of 1863. It serves to charter, regulate and supervise all national banks and thrift institutions and the federal branches and agencies of foreign banks in the United States. The main objectives of OCC include, ensuring the safety and soundness of the national banking system. It fosters competition by allowing banks to offer new products and services, and improving the efficiency and effectiveness of OCC supervision especially to reduce the regulatory burden. It ensures fair and equal access to financial services to all Americans. It enforces anti-money laundering and anti-terrorism finance laws that apply to national banks and federally licensed branches and agencies of international banks. It also works as the agency responsible for investigating and prosecuting acts of misconduct committed by institution-affiliated parties of national banks,

⁶¹ In short FINRA.

⁶² In short OCC.

including officers, directors, employees, agents, appraisers, attorney, accountants and independent contractors.

7. **National Credit Union Administration:**⁶³ NCUA is the independent federal agency created by the United States Congress to charter, regulate and supervise federal credit unions. It is governed by a three-member board appointed by the President of the United States and confirmed by the Senate. The Chairman of the Board is appointed by the President. Board members serve six-year terms, although members often remain until their successors are confirmed and sworn in. The NCUA is administered through five regional offices, each responsible for specific states and territories.⁶⁴
8. **Consumer Financial Protection Bureau:**⁶⁵ This agency was established by the Dodd Frank Act in 2012, to protect consumers by carrying out federal consumer financial laws. The CFPB frames rules, supervise companies and enforce federal consumer financial protection laws. It restricts unfair, deceptive or abusive acts or practices. It also addresses consumer complaints, promote financial education, research consumer behaviour, monitor financial markets for new risks to consumers and enforce laws that outlaw discrimination and other unfair treatment in consumer finance.

In addition, to these bodies, each state has its own banking authority.

⁶³ In short NCUA.

⁶⁴ See https://en.wikipedia.org/wiki/National_Credit_Union_Administration, accessed on 10.11.2015 at 16.44 hrs.

⁶⁵ In short CFPB.

THE UNITED KINGDOM**Statutory Framework:**

Till 2013, the financial sector of UK was regulated by Financial Services Authority,⁶⁶ Bank of England and the Treasury. The *Economic Times* describes the financial services regime in UK till 2009 as “light touch”, meaning regulators did not engage in proactive or aggressive regulation, for the fear that global banks might move out of UK leading to huge job losses.⁶⁷ Under the Banking Act, 2009, the FSA, Bank of England and Treasury were given collective powers to deal with financial crisis including the ability to put a failing bank under temporary public ownership. In March 2009, Lord Adair Turner, the then Chairman of FSA outlined⁶⁸ the failures of the then existing financial regulatory system in UK and suggested a four pronged regulatory response: (a) more coordinated international banking regulation (b) better capital adequacy norms, including requirement of higher levels of bank capital, and in particular of capital that moves more appropriately within the economic cycle, capital required against trading books and taking of market risk⁶⁹ (c) recognising regulation of liquidity as being at least as important as capital adequacy, including the need for a defined international standard for management and regulation of liquidity and (d) regulation of financial

⁶⁶ In short FSA.

⁶⁷ See http://www.economicsonline.co.uk/Business_economics/Banking+regulation.html, accessed on 05.11.2015 at 15.03 hrs.

⁶⁸ See, Speech of Adair Turner, the then Chairman of FSA during March 2009, available in http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0121_at.shtml, accessed on 05.11.2015 at 15.19 hrs.

⁶⁹ *Ibid.* According to Lord Turner, the system should require banks to build up sufficient capital buffers during good times, so that they can run them down during bad times. He calls it a system that introduced significant “Counter Cyclical”. He also called for a fundamental review as to how trading books are defined and how risks in trading books are estimated.

activities according to their economic substance and not legal form.⁷⁰ Following this, and also a consultative paper put forward by the Treasury in 2011,⁷¹ UK introduced Financial Services Act, 2012,⁷² amending provisions of Financial Services and Management Act, 2000 (FSMA), Bank of England Act, 1998 and Banking Act, 2009.⁷³

Under the new financial regulatory regime post the enactment of Financial Services Act, 2012, Financial Services Authority ceased to exist and two new entities namely, Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) were put in place.

While analysing the working of these regulatory agencies, industry experts are especially highly critical of their impact. In a report, from Wipro⁷⁴, the following key observations occur:

Regulators have themselves been going through significant change programs, including validation of skills, recruitment in key areas, model building and extending the data they are able to collect. Political will to reform banks remain high; the enhanced confidence in their own skills,

⁷⁰*Ibid.* According to Lord Hudson, it was necessary to ensure that if an economic activity is bank-like and poses a significant risk to consumer or financial stability, regulators can extend banking-style regulation and that accounting treatment reflects the economic reality of risks being taken.

⁷¹See “A New Approach to Financial Regulation: Building a Stronger System”, February, 2011, available in https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81411/consult_newfinancial_regulation170211.pdf, accessed on 05.11.2015 at 15.43 hrs.

⁷²See full text of the Act in <http://www.legislation.gov.uk/ukpga/2012/21/contents/enacted>, accessed on 05.11.2015 at 15.34 hrs.

⁷³In addition to these statutes, Regulation of Financial Services (Land Transactions) Act 2005, Banking and Financial Dealings Act 1971, Social Security Contributions (Share Options) Act 2001, Social Security Fraud Act (Northern Ireland) 2001 and Social Security (Mortgage Interest Payments) Act 1992 also deal with financial sector regulation.

⁷⁴See <https://www.wipro.com/documents/the-new-UK-regulatory-framework.pdf>, accessed on 05.11.2015 at 15.57 hrs.

increased resources and undoubted backing means regulators remain ambitious. Further, they have a clear lack of tools in their regulatory portfolio to comprehensively monitor the global financial system and identify emerging risks at an early stage.

Ashurst⁷⁵, a legal firm dealing in corporate law, in their report entitled “The UK’s new financial services regulatory structure one year on – The Industry Speaks”, has been highly critical of the impact of the new financial services regime in UK. According to them, on an analysis, where benefits are felt, they are felt only mildly, but where problems occur they are more severe. According to them,

...if a dual-regulated firm finds itself going through a period of regulatory change and/or scrutiny (for example, a change in control, a variation or permissions, supervisory or enforcement action), it will struggle to cope with the competing objectives of the two regulators. Often the regulators will not work together in such scenarios so the firm is faced with doubling up on the time spent communicating with the regulators, including two sets of correspondence, two sets of meetings, etc. In extreme scenarios, an approach can be agreed with one regulator only for the firm to then repeat the process with the other.⁷⁶

Regulatory Agencies:

The following are the regulatory agencies regulating the market place in the United Kingdom.

1. **Financial Conduct Authority:**⁷⁷ FCA replaced the earlier Financial Services Authority. FCA was established by Financial Services Act, 2012.

⁷⁵See https://www.ashurst.com/doc.aspx?id_Content=10297, accessed on 05.11.2015 at 16.04 hrs.

⁷⁶*Id* at p. 1.

⁷⁷In short FCA.

The objective of this body is to protect consumers, protect and enhance the integrity of financial system by protecting financial markets and to promote competition. According to FCA, it follows a proportionate approach in regulation by prioritising its work on the areas and firms that pose a higher risk to its objectives. FCA monitors which firms and individuals are able to enter the financial markets, making sure that they meet its standards before they are authorised by FCA. It supervises how they work and stop those that are not meeting their standards from carrying out the activities, impose penalties, and stop them from trading or to secure redress. It also ensures that consumers receive the information they need in the right way. It ensures that financial firms have a resilient infrastructure, with strong risk management, individual accountability and a responsible culture. From April 1, 2015, FCA has concurrent competition powers, under the Competition Act 1998 to enforce against and fine for breaches of domestic and EU competition law prohibitions on anti-competitive agreements (for example, cartels) and abuses of a dominant position. It has also powers under the Enterprise Act 2002 to make a Market Investigation Reference to the Competition and Markets Authority (CMA). FCA is funded entirely by the firms they regulate. FCA is not a Government Organisation, but is accountable to the Treasury and, through them, to Parliament. FCA evaluates its work through its yearly Business Plan and it describes the

progress it has made against this business plan, how data is used and how it is pursuing its statutory objectives in its Annual Report⁷⁸.

2. **Prudential Regulation Authority:**⁷⁹ PRA was created as a part of the Bank of England by the Financial Services Act, 2012 and is responsible for the prudential regulation and supervision of around 1,700 banks, building societies, credit unions, insurers and major investment firms. PRA's statutory objectives are (a) to promote the safety and soundness of the firms it regulates, (b) to contribute to the securing of an appropriate degree of protection for those who are or may become insurance policy holders; and (c) to facilitate effective competition. PRA advances its objective through (a) regulation and (b) supervision. Through judgment based, forward looking and focused regulations, PRA sets standards or policies that it expects firms to meet. Similarly it assesses the risks that firms pose to the PRA's objectives and, where necessary, takes action to reduce them. It is noteworthy that PRA is not working on a premise that it can avoid failures of financial firms' altogether. On the contrary, it seeks to ensure that a financial firm which fails does so in a way that it avoids significant disruption to the supply of critical financial services.⁸⁰

⁷⁸ See the website of FCA available in <http://www.fca.org.uk/about>, accessed on 25.06.2016 at 19.31 hrs.

⁷⁹ In short PRA.

⁸⁰ <http://www.bankofengland.co.uk/pr/Pages/about/default.aspx>, accessed on 10.11.2015 at 18.24 hrs.

In addition, the UK Competition Network⁸¹ has been created to help deliver stronger competition across the whole economy. The UKCN is an alliance of UK financial sector regulators which have a duty to promote competition in the interests of consumers. Its members include the FCA and the Competition and Markets Authority.⁸² The UK Regulators' Network⁸³ which is an initiative of the nine UK economic regulators, including the FCA, also promotes dialogue between the regulators in UK. The three main objectives of UKRN are (i) to improve the consistency of economic regulation across transport, energy, water, communications, financial services and other regulated sectors, (ii) to deliver efficiency of economic regulation and (iii) to improve understanding of how independent economic regulation works in the interests of consumers, markets, investment and economic performance. Apart from these, Bank of England, Treasury and Financial Policy Committee, function as regulatory bodies, having oversight over the other regulatory bodies in UK.

In addition to the above, as United Kingdom is part of European Union⁸⁴ the following regulatory authorities also control the financial markets in EU:

⁸¹ In short UKCN.

⁸² In short CMA. See for details <http://www.fca.org.uk/about/what/promoting-competition/working-with-other-regulators>, accessed on 10.11.2015 at 17.18 hrs.

⁸³ In short UKRN.

⁸⁴ In short EU. In a referendum conducted in United Kingdom the result of which was published on 24.06.2016, UK has voted to leave European Union. If UK government decides to act in accordance with the referendum, the Government will have to formally notify its intention to withdraw from EU under Article 50 of EU Treaty, and there after the terms of exit will be negotiated with each of the other EU Countries, and each will have a veto over the conditions. After that it is possible that the treaties of EU will no longer be applicable to UK. See "What happens now the UK has voted Brexit - and what is Article 50?", <http://www.telegraph.co.uk/news/2016/06/24/britain-votes-to-leave-the-eu-what-happens-now-that-brexit-is-a/>, accessed on 25.06.2016 accessed at 19.51 hrs.

1. **European Central Bank:**⁸⁵ ECB is responsible for conducting monetary policy for the euro area comprising of 11 member states of Euro Zone.⁸⁶ Its functions include the definition and implementation of monetary policy for the euro area. It supervises the conduct of foreign exchange operations. It also supervises the holding and management of the official foreign reserves of the euro area countries (portfolio management). It promotes the smooth operation of payment systems. It also holds exclusive right to authorise the issuance of banknotes within the euro area, collection of statistical data from national authorities or directly from economic agents. It ensures financial stability and financial supervision in Eurozone and maintains working relations with similar relevant institutions, bodies and fora, both within the EU and at the global level, in respect of the tasks entrusted to ECB⁸⁷.
2. **European Banking Authority:**⁸⁸ EBA is an independent EU Authority which works to ensure effective and consistent prudential regulation and supervision across the European banking sector. Its overall objectives are to maintain financial stability in the EU and to safeguard the integrity, efficiency and orderly functioning of the banking sector.⁸⁹ The main task of the EBA is to contribute to the creation of the European Single Rulebook in banking. The objective of such a Single Rulebook is to provide a single set

⁸⁵ In short ECB.

⁸⁶ The 11 member states are Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain. UK has acceded to some parts of Treaty on the functioning of the European Union, while retaining its powers in the field of monetary policy according to national law.

⁸⁷ See <https://www.ecb.europa.eu>, accessed on 10.11.2015 at 19.19 hrs.

⁸⁸ In short EBA.

⁸⁹ See <http://www.eba.europa.eu/about-us;jsessionid=E53360441E2E26477852304209B4C3C9>, accessed on 10.11.2015 at 19.17 hrs.

of harmonised prudential rules for financial institutions throughout the EU.

The Authority also plays an important role in promoting convergence of supervisory practices and is mandated to assess risks and vulnerabilities in the EU banking sector.

- 3. European Securities and Markets Authority:**⁹⁰ ESMA is an independent body which contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection. ESMA fosters convergence of supervisory objectives both amongst securities regulators and across financial sectors by working closely with the other European supervisory authorities competent in the field of banking (EBA) and insurance and occupational pensions (European Insurance and Occupational Pensions Authority).⁹¹ ESMA's work on securities legislation contributes to the development of a single rule book in Europe. It does so by ensuring the consistent treatment of investors across the EU, and also by enabling an adequate level of protection of investors through effective regulation and supervision. It also promotes equal conditions of competition for financial service providers. It ensures the effectiveness and cost efficiency of supervision for the regulated entities. As part of its role in standards setting and reducing the scope of regulatory arbitrage, ESMA strengthens international supervisory co-operation. ESMA undertakes the supervision of certain entities with pan-European reach upon

⁹⁰ In short ESMA.

⁹¹ In short EIPOA.

request. ESMA also contributes to the work of the European Systemic Risk Board, which identifies potential risks to the financial system and provides advice to diminish possible threats to the financial stability of the Union. ESMA is also responsible for coordinating actions of securities supervisors or adopting emergency measures when a crisis situation arises. ESMA has full accountability towards the European Parliament,⁹² Council of the European Union and European Commission.

4. **European Insurance and Occupational Pensions Authority:** EIOPA⁹³ is an independent advisory body to the European Parliament, the Council of the European Union and the European Commission. It aims at (a) consumer protection, (b) rebuilding trust in the financial system, (c) ensuring a high, effective and (d) consistent level of regulation and supervision taking into account the varying interests of all member states and the different nature of financial institutions. It works for greater harmonisation and coherent application of rules for financial institutions and markets across the European Union. It further aims to strengthen oversight of cross-border groups and promoting coordinated European Union supervisory response. EIOPA works to support (i) the stability of the financial system, (ii) transparency of markets and financial products, (iii) the protection of policy holders, pension scheme members and beneficiaries. It monitors to identify trends, potential risks and vulnerabilities that arise at the all stages at a

⁹²ESMA has to appear before the European Parliament through the relevant Committee known as ECON, at their request for formal hearings. See <https://www.esma.europa.eu/page/esma-short>, accessed on 10.11.2015 at 21.05 hrs.

⁹³See <https://eiopa.europa.eu/about-eiopa/>, accessed on 10.11.2015 at 21.17 hrs.

micro-prudential level, across borders and across sectors. EIOPA has a main decision-making body namely, Board of Supervisors,⁹⁴ a Management Board,⁹⁵ Board of Appeal⁹⁶ and Stakeholder Groups⁹⁷.

CHINA

Statutory Framework:

The legal system of China is different from other countries with which this comparative study is made. According to ADB report⁹⁸ the China's financial sector is now governed by the PBC Law, Commercial Banking Law, Negotiable Instruments Law, Insurance Law, Securities Law, Trust Law, and significant subordinate legislation such as regulations, decrees, provisions and opinions issued by different agencies.

The statutory base for Chinese Financial Regulatory System⁹⁹ is contained mainly in the Securities Law of the People's Republic of China (1998) as amended in 2004, revised in 2005, 2013 and 2014. It lays down that issuance and transaction of

⁹⁴ Board of Supervisors is composed of representatives of the relevant supervisory authority in each European Member State, EIOPA's Chairperson, and representatives of the European Commission, the European Systemic Risk Board, the European Banking Authority, the European Securities Markets Authority and Observers.

⁹⁵ Management Board is composed of the Chairperson of EIOPA, six representatives of national supervisory authorities and a representative of the European Commission. It is elected for two-and-a-half years and can be extended once. It ensures that EIOPA carries out its mission and performs the tasks assigned to it.

⁹⁶ The Board of Appeal gives parties right to appeal from decisions of ESAs. It is a joint body of ESAs, independent from their administrative and regulatory structures, and is composed of six members and six alternates.

⁹⁷ Stakeholder groups include representatives of the industry, consumers and beneficiaries as well as academics. The stakeholder groups are established to facilitate EIOPA's consultation with stakeholders in Europe.

⁹⁸ See <http://www.adb.org/sites/default/files/project-document/71112/tar-prc-34487.pdf>, accessed on 26.04.2015 at 19.06 hrs.

⁹⁹ Compiled from <http://en.pkulaw.cn/>, accessed on 26.04.2015 at 20.09 hrs.

securities shall adhere to the principles of openness, fairness and impartiality.¹⁰⁰ It prohibits fraud and insider trading,¹⁰¹ and provides that parties shall deal with each other in equal legal status and shall work in the principles of free will, compensation, integrity and credit worthiness.¹⁰² It also provides that the banking, securities, trust and insurance companies shall operate after establishing separate business divisions¹⁰³ to avoid consolidation of financial power in a single entity and to mitigate risk. It also stipulates that Securities Regulatory Authority shall adopt a centralised and unified supervision and administration of national securities market.¹⁰⁴ It provides for establishment of a securities industrial association for self-regulation of financial industry,¹⁰⁵ and that the audit organ of the state shall carry out auditing supervision of stock exchanges, securities companies, securities registration and clearing institutions, and securities regulatory bodies. It also provides for the reporting of public issuance of securities to Securities Regulatory Authority and also contains detailed safeguards regarding securities transactions.

Law on the People's Bank of China (1995), as amended in 2003, deals with the power and responsibilities of Peoples Bank of China (PBC). Under the said statute, PBC is entrusted with the responsibility to (i) formulate and implement monetary policy; (ii) exercise supervision and administration of the financial industry; and (iii) examine and approve the establishment of Chinese financial institutions,

¹⁰⁰ The Securities Law of Peoples Republic of China, 1998, Art. 3.

¹⁰¹ *Id.* Art. 5.

¹⁰² *Id.* Art. 4.

¹⁰³ *Id.* Art. 6.

¹⁰⁴ *Id.* Art. 7.

¹⁰⁵ *Id.* Art. 8.

including those with foreign investment and branch offices of foreign banks. The PBC Law also prohibits PBC from lending to government authorities.

The other statutes that deal with financial regulation in China are Law on Securities Investment Fund¹⁰⁶ (2003) as amended in 2004, revised in 2012, Law on Commercial Banks,¹⁰⁷ 1995 as amended in 2003, The Securities Law¹⁰⁸ (1999), the Trust Law (2001),¹⁰⁹ Banking Supervision Law (2003) as amended in 2006, Accounting Law of the People's Republic of China (1985) as amended in 1993, 1999, Law of the People's Republic of China on Certified Public Accountants (1993) as amended in 2014, Price Law of the People's Republic of China (1997), Audit Law of the People's Republic of China (2006 Amendment), Enterprise Bankruptcy Law of the People's Republic of China (1986) as amended in 2006.

While analysing the Chinese financial scenario, we need to keep in mind that as different from common law countries, though the statutes form an important pillar of regulation, the statutes only helps clarity, and the subordinate legislation and executive decrees and opinions plays a crucial role in regulating these entities. The role of legislation is only to define and present the executive resolve, and hence, most of the statutes will be phrased in most general terms and would enunciate principles rather than concrete steps.

¹⁰⁶ This statute provides for safeguarding the investors rights by ensuring that the lawful rights of investors and relevant parties are protected.

¹⁰⁷ This statute standardised the commercial behaviour of banks.

¹⁰⁸ This statute provides for regulatory and supervisory authority to the China Securities Regulatory Commission over the issuing and trading of securities, takeover of listed companies and over securities firms, securities exchanges, central depositories, clearing institutions, investment banks and credit-rating agencies.

¹⁰⁹ This Statute lays down the foundation for developing legal trusts in China and defines fiduciary duties and imposes rules governing boards of trustees.

Regulatory Agencies:

The Chinese regulatory bodies in financial sector include:

1. **China Securities Regulatory Commission:**¹¹⁰ CSRC is a ministerial-level public institution directly under the State Council. It performs a unified regulatory function, according to the relevant laws and regulations, and with the authority by the State Council, over the securities and futures market of China. It also maintains an orderly securities and futures market order and ensures legal operation of the capital market. It formulates legal policy for securities and futures market.¹¹¹ It acts as a supervisory body¹¹² over

¹¹⁰ In short CSRC.

¹¹¹ This includes that task to study and formulate policies and development plans for the securities and futures markets; draft the relevant laws and regulations on the securities and futures markets as well as put forward suggestions for formulation or modification of the said laws and regulations; and work out the relevant rules, regulations and measures for the securities and futures markets. See http://www.csrc.gov.cn/pub/csrc_en/about/, accessed on 16.03.2016 at 17.14 hrs.

¹¹² In pursuance of this function, it exercises a vertical administration over the domestic securities and futures regulatory institutions and conduct a unified supervision over the securities and futures markets; and perform a regulatory supervision over the managements and the managerial officials of the relevant securities companies, supervise the issuance, listing, trading, custody and settlement of stocks, convertible bonds, bonds of securities companies, and bonds and other securities under the charge of CSRC as assigned by the State Council; supervise the securities investment bonds; approve the listing of corporate bonds; and supervise the trading of the listed treasury bonds and corporate bonds, supervise the securities market behaviours of the listed companies and their shareholders who shall fulfil the relevant obligations according to the relevant laws and regulations, supervise the listing, trading and settlement of domestic contract-based futures; and monitor the overseas futures businesses of the domestic institutions in accordance with the relevant regulations, supervise the securities and futures exchanges as well as their senior managerial personnel in accordance with the relevant regulations; and supervise the securities and futures associations in the capacity of a competent authority, supervise the securities and futures business institutions, securities investment fund management companies, securities depository and clearing corporations, futures clearing institutions, securities and futures investment consulting institutions, and securities credit rating institutions; examine and approve the qualifications of fund custodian institutions, and supervise their fund custody businesses; formulate and implement measures on the qualifications of senior management for the relevant institutions; and guide the Securities Association of China and the Futures Associations of China in the administration of the qualifications of the personnel engaged in securities and futures businesses, Supervise the direct or indirect issuance and listing of shares overseas by domestic enterprises as well as the listing of convertible bonds by the companies listed overseas; supervise the establishment of securities and futures institutions overseas by domestic securities and futures business institutions; and supervise the establishment of securities and futures institutions in China by overseas institutions for

securities and futures market, issuance of securities, securities market behaviour of listed companies and their shareholders, listing trading and settlement of domestic and overseas futures contracts, securities and futures exchanges, their managerial personnel and securities and futures associations, entities dealing with securities, direct and indirect issuance and listing of shares by domestic enterprises overseas. It monitors information about securities passed on to consumers and members of general public, work with the relevant authorities in the examination and approval of the qualifications of the accounting firms, the asset evaluation institutions and their personnel for securities and futures intermediary businesses; and supervise the law firms, the lawyers and the eligible accounting firms, the asset appraisal institutions and their personnel in their securities and futures business activities. CSRC investigates and penalises the activities in violation of the relevant securities and futures laws and regulations, administer the foreign exchanges and international cooperation affairs of the securities and futures sector in the capacity of a competent authority; and perform other duties as assigned to it by the State Council¹¹³.

2. **China Banking Regulatory Commission:**¹¹⁴ CBRC is an agency of the People's Republic of China (PRC) authorised by the State Council to regulate the banking sector. Main functions of CBRC include formulation of

securities and futures businesses, Supervise the communication of the securities and futures information; and take charge of the management of the statistics and information resources for the securities and futures markets. See [http://www.csrf.gov.cn/pub/csrf_en/about/](http://www.csrc.gov.cn/pub/csrf_en/about/), accessed on 16.03.2016 at 17.14 hrs.

¹¹³See http://www.csrf.gov.cn/pub/csrf_en/about/, accessed on 10.11.2015 at 21.42 hrs.

¹¹⁴ In short CBRC.

supervisory rules and regulations governing the banking institutions. It authorises the establishment, changes, termination and business scope of the banking institutions, conducts on-site examination and off-site surveillance of the banking institutions, and take enforcement actions against rule-breaking behaviours. It conducts fit-and-proper tests on the senior managerial personnel of the banking institutions. It compiles and publishes statistics and reports of the overall banking industry in accordance with relevant regulations and provides proposals on the resolution of problems of deposit-taking institutions in consultation with relevant regulatory authorities. It is also responsible for the administration of the supervisory boards of the major State-owned banking institutions and other functions delegated by the State Council.

3. **China Insurance Regulatory Commission:**¹¹⁵ CIRC¹¹⁶ is an agency of China authorized by the State Council to regulate the Chinese insurance products and services market and maintain legal and stable operations of insurance industry. CIRC promotes insurance regulation by the following methods. (1) It formulates policies for developing the insurance industry. (2) It creates laws, rules and regulations to supervise the industry. (3) It scrutinises and gives approval to insurance companies, subsidiaries, insurance holding companies. (4) It approves and examines incorporation,

¹¹⁵ In short CIRC.

¹¹⁶ It was founded on November 18, 1998, upgraded from a semi-ministerial to a ministerial institution in 2003 and currently has 31 local offices in every province. See https://en.wikipedia.org/wiki/China_Insurance_Regulatory_Commission, accessed on 10.11.2015 at 23.49 hrs.

merger, splitting, change or dissolution of insurance entities. (5) It examines and approves the qualifications of managers of various insurance companies, by accreditation, regulation of the hiring of senior managers in various insurance companies. (6) It promotes pricing regulation and insurance schemes by regulating premiums, new insurance products and categories. (7) It supervises the financial health of insurance companies by ensuring payment ability of insurance, deposit insurance guarantee fund. (8) It also supervises policy-oriented insurance and compulsory insurance. (9) It regulates self-insurance, mutual insurance and insurance trade associations. (10) It supervises fair competition in industry by investigating and punishing unfair competition and illegal conduct, non-compliance of registration, supervising insurance companies with overseas operations. (11) It regulates overseas operations of domestic insurance firms. (12) It creates framework for insurance industry for information, risk, forecast, supervision, by creating standards for risk, forecast and profitability. (13) It reports to the People's Bank of China and undertakes other jobs delegated by the State Council.¹¹⁷

It can be seen that in most of these jurisdictions, there are at least 3 different regulatory agencies to regulate the financial markets.

¹¹⁷*Ibid.*

COMPARATIVE ANALYSIS

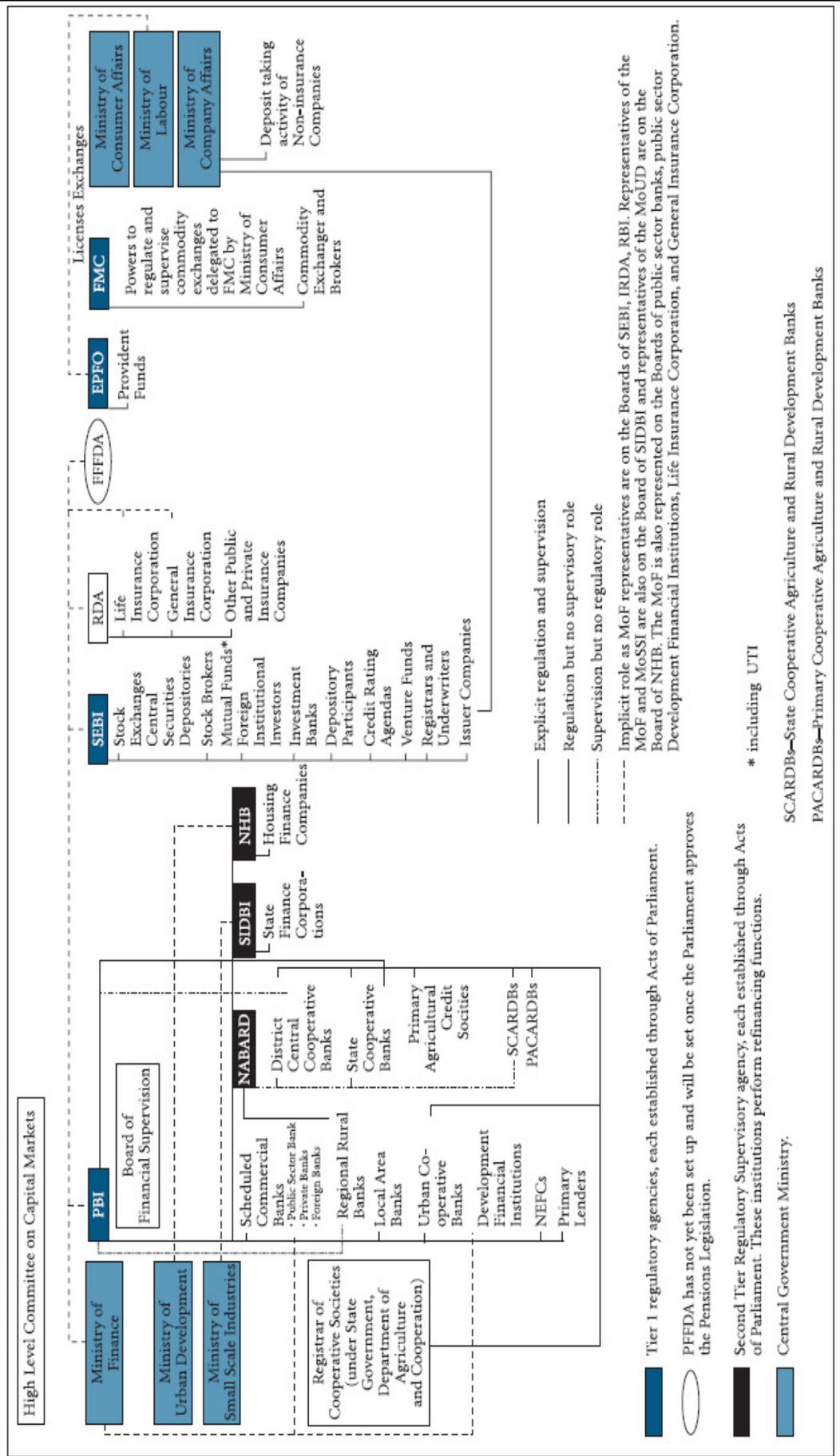
The effectiveness of regulation by these regulatory agencies has always been a question. As on June 2014, on the basis of a study based on Principles for Financial Market Infrastructures, finalised by the IOSCO and the BIS, India, along with Australia, Brazil, Japan, Hong Kong and Singapore are the most compliant amongst nations in putting across necessary regulations to ensure soundness of financial market infrastructure.¹¹⁸ The study was based on regulations for central counter-parties, trade repositories, payment systems, central securities depositories and securities settlement systems in place in 27 jurisdictions in the world which have completed the process of adopting the legislation, regulations and other policies that would enable them to implement the principles and responsibilities related to financial market infrastructures.

Raghuram Rajan Committee¹¹⁹ in its report entitled *A Hundred Small Steps: Report of the Committee on Financial Sector Reforms* have pictorially represented the regulatory structure in different jurisdictions as follows:

¹¹⁸See: “India Scores Above US, China for Financial Market Regulation”, *The Economic Times*, June 1, 2014, available in http://articles.economictimes.indiatimes.com/2014-06-01/news/50245846_1_iosco-pfmis-financial-market-infrastructure, accessed on 26.04.2015 at 15.54 hrs.

¹¹⁹ 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).

Figure 1: Current Regulatory Architecture



It is also to be noted that in most of these jurisdictions, historically the regulation focused on controlling the parties to the instrument or the market, leaving the regulation of the instruments to the general contract and taxation law of each country. So far as individual instruments or transactions were concerned, statutory regulation was limited to banning or controlling certain type of transactions, such as speculative transactions. While we can generally state that during the period upto 1980's no serious efforts were made to consider the monetary instruments anything than mere contracts and in some cases wagering agreements. Though there were limited numbers of cases relating to these instruments from very old times, especially as to the question whether these instruments are wagering agreements or not, or whether they are permissible contracts, serious focus on various legal issues involving these instruments began only after 1980's when they started taking central stage in boosting world economy. In fact the legal issues pertaining to these instruments are much varied in scope, than other contracts. It can be said that it was with the establishment of I.S.D.A., that attention was focused on the legal issues pertaining to these contracts at a micro level.

Alastair Hudson¹²⁰ has identified the following legal issues that pertain to the financial derivatives, which are almost equally applicable to most other new generation monetary instruments:

¹²⁰Alastair Hudson, *The Law on Financial Derivatives*, Sweet & Maxwell, London, (1998).

1. A derivative product can be defined in a number of ways. All derivative products are at their root an option, a forward or a swap. As rightly pointed out by Hudson¹²¹, a forward can be defined as two options exercised on a forward date selected, while a swap could be defined as a series of twin options which are exercised of on a series of dates prescribed in the documentation. This flexibility offers the parties the advantage to mask the product. That is, in order to avoid the legal implication of one product, it is always possible to pack it as another derivative product, while keeping the advantage the parties' intent camouflaged by the product. At the same time, this very plastic nature of products may create an issue when in a litigation, both parties attempt to define the nature and advantages of the product differently. This would lead to uncertainty as regards the benefits to be derived from these products as well as in the legal consequences of these products.

2. There is a high probability that these instruments can be interpreted as wagering agreements. Among participants in the swap markets, it is universally acknowledged that their products are not wagering agreements. In UK, the High Court has approved this stand in relation to interest rate swaps.¹²² However, the position in other countries could be different. Even in UK, except in the case of interest rate swaps, there is no guarantee that these instruments would not be held as purely speculative or wagering agreements.

¹²¹*Id* at p. 147.

¹²²See *Hazell v. Hammersmith & Fulham*, [1991] 1 All E.R. 545(H.L.), (1992) 2 A.C. 1.

3. According to Alastair Hudson,¹²³ under English law, the issue relating to capacity of the contracting party and relating to the capacity of the person entering into the contract to represent that party may arise with respect to a derivative contract. He contents the very fact that parties attempt to give representations as to their ability to act in a derivatives transaction themselves beg the question whether or not the entity has a capacity which it represents. He takes the discussions on I.S.D.A. Multi-Currency Master Agreement, 1992 as an example of this issue. Moreover, according to him, when dealing with the counterparties which are not recognised swaps dealers, careful consideration must be given to the capacity or power of the counterparty to enter into such transactions, as such capacity or power normally depends upon the laws under which it was organised and its constitutional documents.¹²⁴ If swap transactions are not within the powers of the counterparty, this contract may not be enforceable against the counterparty. According to him, in most common law jurisdictions, historically trading companies have had quite limited powers. Being a relatively new financial transaction, derivative transactions would not have been contemplated when the constitutional documents of these companies were framed. Moreover, there is little case law on derivatives and more importantly, these transactions are not classifiable in terms of older, better known transactions to create precedents. Moreover, the fact that in-cautious use of swaps might lead to sizeable losses for the company raises the

¹²³*Supra* n. 120, at p. 151.

¹²⁴*Id* at p. 152.

possibility that a shareholder or other interested party may seek to challenge these transactions as *ultra vires* of the powers of the company.¹²⁵

Furthermore, the question of capacity also comes in when the counterparty is an entity other than a company regulated by Companies Act, such as local authorities, building societies, insurance companies, etc.

4. The very nature of the international derivatives market created a situation where no particular system of law will necessarily reflect the intentions of parties to multi-currency, multi-jurisdictional transactions. As Hudson points out, the use of derivatives for asset arbitrage, regulatory arbitrage, and speculation on markets without need to participate physically in those markets all revolve around a desire to avoid municipal regulatory or legal constraints on transactions. Hence the extent to which municipal legal systems will and will not apply to derivative transactions are important. Moreover, as the I.S.D.A. Master Agreements use English law and New York law systems, problems may crop up when counterparties organised outside those jurisdictions and who would not ordinarily keep themselves informed of case law and statutory developments in these legal systems enter into such agreements. As common law systems developed their principles primarily keeping the impact on citizens within their jurisdiction in mind, the decisions of US and UK courts may not get approval of the market participants outside the jurisdiction, leading to confusion. For example in common law systems, the restitutionary remedy was not fully

¹²⁵Hudson points out that in *Hazell v. Hammersmith & Fullham*, the House of Lords had held that all swaps, even those entered for the purpose of hedging exceeds the powers of local authorities.

developed and such remedies evolved only very recently. On the other hand, in many countries outside the US and the UK, especially in India, this field of law has not evolved fully. This would create problems to counterparties from those countries unless the systems of rules which will cover the derivative contracts are isolated and the remedies which are available are listed in the contract itself. Furthermore, the concept of trust is not known outside the common law countries. However, trust is used as a flexible tool which may operate to provide or deny remedies in various types of derivative contracts. As this concept is relatively unknown in civil law countries, its enforceability in other systems of law is a cause of concern.¹²⁶

With these core issues in mind, we now turn to examine how the regulatory scenario in India looks like.

¹²⁶*Supra* n. 120 at p. 160.