Legal Framework for Regulation of Financial Instruments:
With Special Emphasis to Financial Derivatives

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By

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Under the Guidance of

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2016

DECLARATION

I do hereby declare that the thesis entitled: *"Legal Framework for Regulation of Financial Instruments: With Special Emphasis to Financial Derivatives*" for the award of the degree of Doctor of Philosophy is a record of original research work carried out by me under the guidance and supervision of Dr. M.C. Valson, Professor, NUALS, Kochi. I further declare that this work has not previously formed the basis for the award of any degree, diploma, associate-ship or any other title or recognition.

Kalamassery, Kochi
Dated: 30.06.2016

John Varghese

Certificate

This is to certify that the thesis entitled: *"Legal Framework for Regulation of Financial Instruments: With Special Emphasis to Financial Derivatives*" submitted by John Varghese, for the award of the degree of Doctor of Philosophy is to the best of my knowledge, a bonafide research work carried out by him, as a part-time research scholar, National University of Advanced Legal Studies, Kalamassery, Kochi, under my guidance and supervision. This thesis or any part thereof has not been submitted elsewhere for the award of any degree, diploma, associate-ship or any other title or recognition.

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This is to certify that the thesis entitled: *“Legal Framework for Regulation of Financial Instruments: With Special Emphasis to Financial Derivatives*” has been presented in a research seminar held at the National University of Advanced Legal Studies, Kalamassery, Kochi, on 23rd April, 2016.

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This is to certify that all relevant corrections and modifications suggested by the audience during the pre-submission seminar and recommended by the Doctoral Committee has been incorporated in the thesis entitled: *"Legal Framework for Regulation of Financial Instruments: With Special Emphasis to Financial Derivatives"* submitted by John Varghese for the award of Doctor of Philosophy.

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PREFACE

Financial sector has emerged as a major global force during the past century. 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. Finance as an industry has grown by crowd-sourcing i.e., from contribution from a number of small / retail investors, who form a cross section of the society. As in any industry, there were cycles of financial losses and gains and many investors suffered losses. 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.

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.

In this work a purely doctrinal approach is adopted as the study focuses on the regulatory regimes from a theoretical angle and also because the work is a comparative study of regulatory regimes in various countries which does not give any scope for an empirical study.

The work is divided into 7 chapters. Chapter I entitled “Introduction” gives a general introduction to the topic. Chapter II entitled “Financial Instruments: An Overview” explores the nature and history of financial markets and instruments. Third Chapter, named “Regulation of Financial

Instruments: A Comparative Analysis" explores the concept of regulation and regulatory framework of financial derivatives. Chapter IV entitled "Regulation of Financial Derivatives: Indian Scenario" makes a brief survey of regulatory framework in India. Chapter V with title "Judicial Response to Regulation of Financial Derivatives" examines how judiciary is accepting and interpreting these documents. A comparative study of the UK and the US position is also undertaken. In Chapter VI, entitled "Policy Framework for Regulation of Financial Derivatives", the essential features of an ideal policy framework for a future regulatory regime for financial instruments especially financial derivatives is explored. Chapter VII is the final chapter titled "Conclusion and Suggestions". In this chapter, the research findings are summarised. Some proposals for reform of regulatory system, in addition to Financial Sector Legislative Reforms Committee (FSLRC) proposals are considered.

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A.I.R.	All India Reporter
A.L.D.	Administrative Law Decisions
A.R.C.	Asset Reconstruction Company
AC	Appeal Cases
AD	Apex Decisions
All.	Allahabad
All. E.R.	All England Reports
BIS	Bank of International Settlements
Bom. L.J.	Bombay Law Journal
Bom.L.R.	Bombay Law Reporter
Bus. L.R.	Business Law Reports
C.B.	Common Bench Reports
C.L.R.	Calcutta Law Reports
C.T.C.	Current Tamilnadu Cases
Cal.	Calcutta
Cal.L.Rev.	California Law Review
CAL.L.T.	Calcutta Law Times
CFTC	Commodities Futures Trading Commission
Comp. L.J.	Company Law Journal
CPC	Code of Civil Procedure, 1908
DEA	Department of Economic Affairs

DICGC	Deposit Insurance and Credit Guarantee Corporation
DRT	Debts Recovery Tribunal
Ed./Eds.	Edited, Edition, Editor(s)
Et.al.	And others
EWHC (Ch)	England Wales High Court (UK) (Chancery Division)
FATF	Financial Action Task Force
FCRA	Forward Contracts (Regulation) Act, 1952.
FMC	Financial Markets Commission
FSA	Financial Services Authority (U.K.)
FSAT	Financial Sector Appellate Tribunal
FSLRC	Financial Sector Legislative Reforms Commission
GDP	Gross Domestic Product
Harv.Bus.L.Rev. Online	Harvard Business Law Review Online
I.L.R.	Indian Law Reports
IBA	Indian Banks' Association
Ibid	Same as Immediately above
Id.	Same source as mentioned above but different page
IFC	International Finance Corporation
IMF	International Monetary Fund
Infra	Same as mentioned below
INTOSAI	International Organisation for Supreme Audit Institutions
IRDA	Insurance Regulatory and Development Authority
J.T.	Judgements Today

K.B.	Law Reports, King's Bench Division
L.W.	Law Weekly
M.I.A.	Moors Indian Appeals
M.L.J.	Madras Law Journal
Mad.	Madras
MPC	Monetary Policy Committee
Nag.	Nagpur
NBFC	Non-Banking Finance Company
NPA	Non-Performing Asset
OTC	Over the Counter
RBI	Reserve Bank of India
S.C.	Supreme Court
S.C.C.	Supreme Court Cases
S.C.J.	Supreme Court Journal
S.C.L.	SEBI and Corporate Laws
S.C.N.	Supreme Court Notes
S.C.R.	Supreme Court Reporter
S.C.W.R.	Supreme Court Weekly Reporter
SARFAESI	The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
SBI	State Bank of India
SCALE	Supreme Court Almanac
SCRA	Securities Contract (Regulation) Act, 1956
SEBI	Securities and Exchange Board of India

SEC	US Securities and Exchange Commission
See	Authority cited is the basic source material supporting an opinion or conclusion
See also	Cited authority develops a question analogous to discussion in the text.
SSRN	Social Science Research Network
Supl.	Supplementary
Supra	Same as mentioned before or above.
T.L.R.	Times Law Reports
U.K.P.C.	United Kingdom Privy Council
U.Pa.L.Rev.	University of Pennsylvania Law Review
U.S.	United States of America
UFA	Unified Financial Agency
UK	United Kingdom
UK FSMA	United Kingdom Financial Services and Markets Act, 2000
ULIP	Unit Linked Insurance Plan
W.B.L.R.	West Bengal Law Reports
W.L.R.	Weekly Law Reporter

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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 Rome[1].

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 in-consequential 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 Zimbabwe[2].

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. I 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 business[3]. 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 warn[5]. All religions considered money as a necessary evil and have been cautioning its disciples against hoarding of money[6]. 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 2008[7] 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.

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[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

[8]See "*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 itself[9].

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 exchange[10].As David Kinley[11] 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

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[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 times[14]. 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 Hudson[15] 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 strategy[16]. 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 supervisors[17]. The report of the INTOSAI[18] identifies some of the causes of the financial crisis. The report divides these causes

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[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/gaohq4709242v1 finalsubgroup1paper.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 crisis[20].

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 failures[21].

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 Product[22].

Niall Ferguson[23] 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 on[24].

Even International Finance Commission[25], which belongs to the World Bank Group, is using derivative products to hedge the interest rate, currency, or

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[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 exposures[26]. 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

[26]See 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/ifcexternalcorporatesite /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.

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[27]See *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.

CHAPTER II

FINANCIAL INSTRUMENTS: AN OVERVIEW

In order to understand the need for regulation of financial instruments, and particularly financial derivatives, it is imperative that one should know the history and development of financial markets, as well as financial instruments. It would be interesting to note how these instruments evolved over time from a trade necessity to financial weapons of mass destruction, through financial innovation. Different forms of financial markets, financial instruments, and financial derivatives, as is necessary to understand the complexity of these products are also covered in this chapter.

FINANCIAL MARKETS

History:

Financial markets initially evolved from a location where buyers and sellers of securities congregated for transacting business. Initially the markets transacted in commodities, but occasionally some instruments or contracts evolved, which helped the traders face the risk while dealing with the perishable agricultural commodities[1].

[1]Capasso mentions that during the 12th century, medieval European merchants created a forward contract called a *lettre de faire* (letter of the fair). These letters allowed merchants to trade on the basis of a sample of their goods, thus relieving them of the need to transport large quantities of merchandise along dangerous routes with no guarantee of a buyer at the journey's end. The letter acted as evidence that the full consignment of the specified commodity was being held at a warehouse for future delivery. Eventually, the contracts themselves were traded among the merchants, Capasso, D. R, *Trading on the Seattle Merc* , J. Wiley, New York, USA (1995).

The evolution of financial markets dates back to 12th century France. *Courratier de Change* was the first recorded financial broker who managed and regulated the debts of agricultural communities on behalf of the banks.[2] In the late 13th century, commodity traders of Bruges (now Belgium) started the first Bourse[3], which was institutionalized in 1309 and it soon become a relevant idea leading to starting of similar bourses in Ghent and Amsterdam.

In 14th century Venice, the government made the first known issue of bonds, which incidentally also became the first traded security. Later the Dutch East India Company started trading its stocks in The Amsterdam Stock exchange. Around 1750's, this practice spread to England, where the traders in shares of companies used to meet in Jonathan's Coffee House to trade shares and make business deals. They used to write their share bids and offers on the walls of the Coffee House, and insider trading formed the basis of most investor decisions. By 1773, these informal exchanges became institutionalised in the form of trading clubs, which was further formalised when a group of traders started the London Stock Exchange in Capel Court by raising a capital of £20,000/-. In the US also the trading in stocks and shares started by the end of 16th century. Initially these traders used to meet in coffee houses, but in 1792, 24 brokers signed the "Buttonwood Tree Agreement" and paid $ 400/- for a trading seat, institutionalising stock trading in USA. In 1817, the New York Stock Exchange was formed.

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[2]Hemendra Aran, Alpesh B Patel, *Global Financial Markets Revolution,* Palgrave Macmillan, Great Britain, (2006), p. 1.
[3]Named after Van der Bourse, a Belgian trader who hosted the meetings of the traders in his house, and was called the "Bruges Bourse". These are exchanges where financial instruments were sold. See for details https://deutsche-boerse.com/dbg/dispatch/en/kir/dbg_nav/about_us/20_FWB_Frankfurt_Stock_Exchange/70_History_of_the_FWB, accessed on 11.06.2016 at 20.26 hrs.

Similarly, futures trading and commodities exchanges also have an interesting history, since the history of financial derivatives and scams are almost intertwined. There is evidence that trading in options and futures began in Amsterdam Stock Exchange as early as 1611, and in a period of 25 years the first major bubble which related to futures markets busted, with the burst of a speculative boom in Dutch Tulip futures. During the latter part of 17th century, Feudal Japanese landlords started shipping surplus rice to storage warehouses in the cities and issue tickets promising future delivery of the rice. The tickets represented the right to take delivery of a certain quantity of rice at a future date at a specified price. This was intended to protect the traders from inclement weather or war. These rice tickets, which provided flexibility to rice traders, were traded on the *Dojima* rice market near Osaka in and around 1730. These rice tickets can be rightly said to be the precursor of the modern derivative instruments, since, someone holding a rice ticket, who was not a holder of rice and who do not want to take delivery of rice could sell it in the market for a price. The rules governing the trading in *Dojima* market were similar to the modern day futures market.[4]

As in the case of Japanese markets, forward trading emerged in USA also as a result of extreme volatility in agricultural prices due to seasonal production. In early 1800's, forward arrangements began to appear to deal with the price volatility

[4] See "The Origins of Derivatives", http://highered.mheducation.com/sites/dl/free/007337590x /238719 /TheOriginsOfDerivatives.pdf, accessed on 02.10.2015 at18.25 hrs.) See also http:// finance.maps of world.com/finance/instrument/origins-of-derivative.html, accessed on 02.10.2015 at 17.09 hrs. See further: http://www. personal.ceu. hu/students/13/ Patrik_ Korda /files/Financial %20 Markets. pdf, accessed on 02.10.2015 at 17.09 hrs.

attached to availability of surplus food grains in particular seasons leading to extremely low prices and extremely high prices during the rest of the year due to shortage of the same items. A contract called "to arrive" contracts were devolved, which involved an agreement between a buyer and seller for the future delivery of grain. The quantity and grade of the grain would be specified as well as the delivery date, and also an agreed-upon price. Subsequently these contracts themselves began to be traded in anticipation of changes in prices of food grains. With the increase in trade of such documents in the place of food grains, the need for standardisation of the contracts and the need for an organized exchange to trade the documents emerged. Hence in 1848, Chicago Board of Trade was founded. In 1870, New York Cotton Exchange specialized in futures trade of cotton products and in 1885 New York Coffee Exchange which specialized in futures trade of coffee products were established in USA, to give a boost to trading on financial derivatives.

The first attempt to regulate the financial markets can be seen from the early 16th century ban on short selling in 1610. However in Antwerp, contracts for differences [5] were outlawed shortly after forward contracts had been made transferable, around 1541.[6] But it is unlikely that this restriction was effective because a forward contract does not show how it will be settled. Even if the

[5] A contract for differences (CFD) is an arrangement made in a futures contract whereby differences in settlement are made through cash payments, rather than the delivery of physical goods or securities. See: definition of Contract For Differences (CFD) in Investopedia http://www.investopedia.com/terms/c/contractfordifferences.asp#ixzz49VOPvZwz, accessed on 24.05.2016 at 00.09 hrs.

[6] Edward J. Swan, *Building the Global Market: A 4000 Year History of Derivatives*, The Hague: Kluwer Law International, (2000) at p.144.

contract requires the delivery of the underlying asset, the parties to the contract can informally agree on a cash payment at the delivery date. In Amsterdam, contracts for differences were not made illegal. Instead, in 1621, 1630 and 1636, three edicts were issued with the intention to undermine contracts for differences by making them unenforceable in the courts.[7] In 1734, the British Parliament passed the *Sir John Barnard's Act*, which declared contracts for the future delivery of securities to be "null and void". Fines amounted to £500/- for "refusals[8]" and "putts[9]" and £100/- for short-selling operations. The Act applied only to derivatives on securities because, as debated in Parliament, it was feared that commodity markets would move back to Amsterdam if contracts for the future delivery of commodities were outlawed in London. Hence for a long time, the trade in derivatives was based on reputation of traders rather than on the basis of legal backing. In France too the *Commercial Code* of 1807 outlawed the trading in securities otherwise than in authorized exchanges. A Police Order of January 24, 1823 again restricted the trading in securities and commodities to authorized dealers at stock exchanges. However the noted scholar Jureg[10] notes that this did not prevent trading in such commodities or derivative trading, but only took them out of the premises of stock

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[7] Ernst Juerg Weber, "A Short History of Derivative Security Markets" (June 2008). Available at SSRN: http://ssrn.com/abstract=1141689, accessed on 29.08.2015 at 20.51 at p. 17.

[8] During the South Sea Bubble, what is called today as "call options" were known as "refusals. "Refusals" were call options, given the buyer of the option the right to buy stock (or, to refuse to buy stock) at some future date. See Paul Harrison, "The Economic Effects of Innovation, Regulation, and Reputation on Derivatives Trading: Some Historical Analysis of Early 18th Century Stock Markets", http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.580.6697&rep=rep1&type=pdf, accessed on 11.06.2016 at 20.47 hrs.

[9] "Putts" were put options, giving the buyer of the option the right to sell stock at some future date. See Paul Harrison, "The Economic Effects of Innovation, Regulation, and Reputation on Derivatives Trading: Some Historical Analysis of Early 18th Century Stock Markets", http://citeseerx.ist.psu.edu/viewdoc/download? doi=10.1.1.580.6697 &rep=rep1&type=pdf, accessed on 11.06.2016 at 20.47 hrs.

[10] *Supra* n. 7 at p. 27.

exchange, based on reputation, with no recourse to court in case of breach of contract. In the 1820s, derivative trading with government bonds flourished in Paris. Contracts such as contracts for future delivery, forwards contracts and options, a call option called an "*achat à prime*", a put option called "*vente à prime*" and repurchase agreements which were called "reports" were greatly traded in Paris. By 1857 however, contracts of future delivery were made legal if the delivery date did not exceed 2 months (1 month for railway shares). In Germany, contracts for future delivery were called "*Zeitgeschäfte*", which were subdivided into Contracts for future delivery, and were further subdivided into forward contracts and options.

In 1885, derivative contracts became legally enforceable in France, although it was still possible to raise the objection against gambling under some circumstances. In Germany the regulatory framework was similar to that in France for most of the nineteenth century, i.e. derivatives were traded in a legal limbo. In Prussia, contracts for future delivery were outlawed for Spanish government bonds in 1836, for all foreign securities in 1840, and for securities of railways in 1844. After Bismark united Germany in 1871, it was up to the courts to decide whether a contract for future delivery was legitimate or whether it was motivated by illegal gambling. The courts took into consideration the contract's terms, the profession and wealth of each party and anything else that might shed light on the contract's purpose, which all gave rise to considerable legal uncertainties. In 1896, Germany passed a law that severely restricted derivative dealings. It became illegal to conclude contracts for the future delivery of wheat and milling products, and for

shares of mines and factories. The government also could regulate and prohibit contracts for all other goods and financial assets. These severe restrictions disrupted commodity markets and financial markets in Germany, diverting trade in commodities and securities to foreign exchanges.[11] The German law of 1896 also determined that contracts for future delivery were enforceable only if both parties had registered as dealers. However instead of facilitating any meaningful regulation, this law took the derivatives trade largely into the unregulated zone, since many traders opted not to register themselves and instead opted to carry on trade in derivatives on reputation basis.

In India also the financial markets evolved during the same time when the financial markets started evolving as an organised trading worldwide. During early 20th Century, there were a number of well-established commodity markets in India, trading in futures and other similar derivatives.[12] The history of futures trading in commodities in India dates back to the later part of 19th century when the first commodity exchange, viz. The Bombay Cotton Trade Association Ltd was set up for organising futures trading. The early 20th century saw the mushrooming of a number of Commodity Exchanges. They were regulated by social control of close-

[11] *Id* at p. 39.

[12] The principal commodity markets functioning in pre-independence era were the cotton markets of Bombay, Karachi, Ahmedabad and Indore, the wheat markets of Bombay, Hapur, Karachi, Lyallpur, Amritsar, Okara and Calcutta; the groundnut markets of Madras and Bombay; the linseed markets of Bombay and Calcutta; Jute and Hessian markets of Calcutta; Bullion markets of Bombay, Calcutta, Delhi and Amritsar and sugar markets of Bombay, Calcutta, Kanpur and Muzaffarnagar.

knit groups and whenever such control failed, there would be a crisis.[13] There were no uniform guidelines or regulations. These exchanges were essentially outcomes of needs of particular trade communities and operated based on mutual trust and faith. Some analysts are of the view that by the beginning of 1900's India had one of the world's largest futures' industry.[14]

Financial Markets: Purpose:

As can be seen from the detailed narration of history of financial markets, initially the market places evolved as a location where buyers and sellers congregated to buy and sell securities. Slowly these market places took the form of institutionalised exchanges, which took on the function of settling disputes that arose during the course of transactions, by formulating certain regulations to protect innocent investors from professional manipulators trading with insider information. This made the financial marketplace attractive to public and more and more people started coming into the market place (exchanges) to transact business in securities. This required more and more good players, or sellers, who were financially sound to come and place their securities in the exchanges, so that demand from the public could be met. To keep a balance between ethical playing and maximising profits, exchanges began to develop listing regulations so as to attract financially sound companies to the exchange. These listing regulations stipulated the minimum requirements a company should satisfy to enlist on the

[13] *Report of the Expert Committee to Study the Impact of Futures Trading on Agricultural Commodity Prices*, (Abhijit Sen Committee), Ministry of Consumer Affairs, Food & Public Distribution, Government of India, (2008), p. 2 para 2.1.
[14] Asani Sarkar, "Indian Derivatives Market" in Kaushik Basu (Ed.), *The Oxford Companion to Economics in India*, Oxford University Press, New Delhi (2007) at p. 100.

exchange. Later, with the development of technology, exchanges developed stock ticker - which enabled exchanges to effectively control and disseminate last sale information and other relevant market data, that served at the same time as advertisements and also provided transparency to the trading that made prospective investors comfortable with the fairness of the market. The volume of trade in each market increased and the markets started providing clearing and settlement functions first through third parties and then by themselves.

A financial market serves three economic functions. Firstly, it creates a *Price Discovery Process i.e.* interactions of buyers and sellers in the market place will determine the price, and consequently the return on traded asset. Secondly, it creates a *Liquidity Management Mechanism* i.e. it provides a mechanism for an investor to sell the financial instrument in his hand (Liquidity). While all markets provide some sort of liquidity, the degree of liquidity varies from various types of financial markets. Finally, it creates *Economy of Information* i.e., it reduces the search and information cost, and thereby the overall costs of transacting the financial instruments.

In addition to the above, the financial markets provides for a permanent system for exchange of goods and services, enables pooling of funds to undertake large scale operations, provides for a mechanism for spatial and temporal transfer of funds, provides a way for managing uncertainty and controlling risk, generates information that helps in coordinating decentralised decision making, helps in dealing with the problem of informational asymmetry, facilitates efficient life-cycle risk bearing by households and allows for separation of the providers of working

capital for real investments (i.e. personnel, plant and equipment) from the providers of risk capital who bear financial risk of those investments.

Types of Financial Markets

Financial markets are usually divided into two: Primary Markets and Secondary Markets. The Primary Market is the market for first or initial issuance of financial instruments. Primary Markets do not need a formal market place, and it is usually done through an investment banker who typically assembles a syndicate of financial market dealers who will sell the new stock. Once the company has issued shares to public, it has to ensure liquidity for the investing public. For this, the financial instruments need to be brought to a market place where the public who has shares or other financial instruments in their hands find prospective buyers for their instruments. This secondary sale of shares and other financial instruments happen in Secondary Market, which is usually institutionalised though not always necessary.

Financial markets can be divided by type of financial claim, such as debt markets (where debt based financial instruments are traded) and equity markets (where equity based financial instruments are traded).

Another way of classification of financial markets is by period of maturity of claim, such as (a) *Money Market*, being market for short term debt instruments and (b) *Capital Markets*, being market for long term debt instruments and equity instruments.

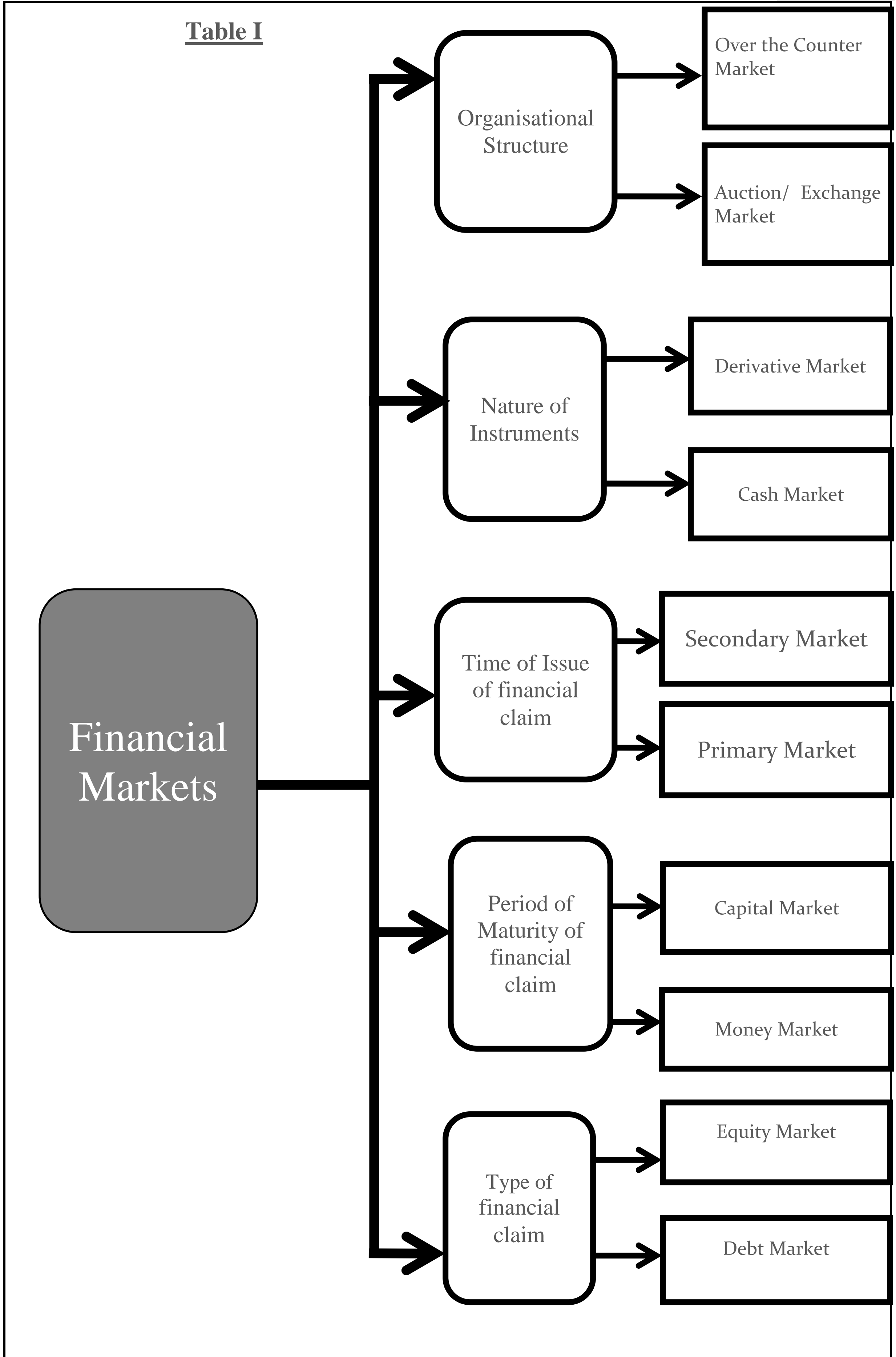
The financial markets can also be divided by nature of instruments (a) Cash Market, where the returns are in the form of cash and into (b) Derivatives Market, where financial derivatives are traded.

Financial markets are also divided sometimes by the method adopted by the organisation, or simply by organisational structure such as (a) Auction (Exchanges) Market where financial instruments are sold by auction and (b) Over the Counter Markets where financial instruments are sold over the counter or on the basis of contract between individual parties.[15]

A pictorial representation of different types of financial markets is given below as Table I:

[15]Frank J Fabozzi (Ed.), *A Handbook of Financial Instruments*, John Wiley and Sons, Inc., Hoboken, New Jersey, (2002) at p. 13.

Table I



Whatever be the type of markets, what are sold in these markets are financial instruments. Hence it is essential to understand the concept of financial instruments and their true nature.

FINANCIAL INSTRUMENTS

Definition:

Devoid of all technicalities, financial instruments are nothing but contracts. Financial instrument is defined as a real or virtual document representing a legal agreement involving some sort of monetary value[16]. They can be thought of as easily tradable packages of capital, each having their own unique characteristics and structure. The draft note on Financial Instruments issued by Public Sector Accounting Board of Canada[17]defines financial instrument as a contract between entities that gives rise to a financial resource (an asset) for one entity and a financial obligation (a liability) or equity interest for another entity. Another definition of financial instruments is that these are legal agreements that require one party to pay money or something else of value or a promise to pay under stipulated conditions to the other party in exchange for the payment of interest, for the acquisition of rights, for premiums, or for indemnification against risk. In exchange for the payment of the money, the other party hopes to profit by receiving

[16]http://www.investopedia.com/terms/f/financialinstrument.asp, accessed on 02.10.2015 at 16.54 hrs.
[17]"Exposure draft of Public Sector Accounting Board for Proposed Accounting Standards entitled Financial Instruments", dated September 2009.

interest, capital gains, premiums, or indemnification for a loss event.[18] International Accounting Standard defines a financial (markets) instrument as a contract that gives rise to a financial asset of one entity and a financial liability (or equity instrument) of another entity[19]. This definition highlights the fact that financial instruments represent a store of value without possessing an intrinsic value of its own. Another definition, featuring in the Dodd-Frank Act passed by US Senate in 2010 defines financial instruments as:

> A financial contract in which the terms and conditions are publicly available, and the roles of one or more of the counterparties are assignable without the consent of any of the other counterparties (including common stock of a publicly traded company, government bonds, or exchange traded futures and options contracts).[20]

It may be noted that this definition restricts the scope of application of the term financial instruments to financial contracts[21] whose terms and conditions are publicly available, thereby excluding a large variety of exotic privately traded financial instruments. Perhaps, this definition was adopted under the assumption that privately traded financial instruments do not affect the economy of the nation as much as Exchange Traded Derivatives affects the economy.

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[18]http://thismatter.com/money/banking/financial-instruments.htm, accessed on 02.10.2015 at 16.43 hrs.

[19] See International Accounting Standards, IAS 32.11 available at. http://www.iasplus.com /en/standards/ias/ias32, accessed on 17.06.2016 at 23.19 hrs.

[20]"Dodd Frank Wall Street Reform and Consumer Protection Act, 2010", popularly known as Dodd-Frank Act. S. 151(8).

[21] *Id* s.151(7) defines financial contracts as "a legally binding agreement between two or more counterparties, describing rights and obligations relating to the future delivery of items of intrinsic or extrinsic value among the counterparties.

Classification of Financial Instruments:

Typically the market place for sale of the financial instruments is stock exchanges, which permit sale in primary securities such as shares, government securities, gilts [22] and secondary securities like derivatives. Thus financial instruments can be basic, like an account receivable or an account payable, and also more complex, such as derivatives.

Financial instruments are classified on the basis of type of transaction, issuer of the instrument, underlying or backed up securities, nature of instrument, asset class, etc.

First type of classification of financial instruments is on the basis of type of transaction. This could be for exchange of money for (a) future interest payments and repayment of principal[23] (b) possible capital gains or interest[24] or (c) possible capital gains or to offset risk. [25] Financial Instruments where the underlying transaction is for exchange of money for future interest payments and repayment of principal are (1) *Loans and Bonds*, where a lender gives money to a borrower in exchange for regular payments of interest and principal, (2) *Asset backed securities*, where lenders pool their loans together and sell them to investors. The lenders receive an immediate lump-sum payment and the investors receive the payments of

[22] Gilts are bonds that are issued by the British government, and they are generally considered low-risk investments. Gilts are the U.K. equivalent of U.S. Treasury securities, and the name originates from the original certificates, issued by the British government, which had gilded edges. See www.investopedia.com/terms/g/gilts.asp, accessed on 25.06.2016 at 11.58 hrs.
[23] See http://www.bcci.bg/projects/latvia/pdf/7_Financial_markets.pdf accessed on 25.06.2016 at 12.15 hrs.
[24] *Ibid.*
[25] *Ibid.*

interest and principal from the underlying loan pool. Financial Instruments where the underlying transaction is for exchange of money for possible capital gains or interest, are (1) *Stocks:* A company sells ownership interests in the form of stock to buyers of the stock, and (2) *Funds*: Includes mutual funds, exchange-traded funds, Real Estate Investment Trusts, hedge funds, and many other funds. The fund buys other securities earning interest and capital gains which increases the share price of the fund. Investors of the fund may also receive interest payments. Financial Instruments where the underlying transaction is for exchange of money for possible capital gains or to offset risk, such as (1) *Options and Futures* (2) *Currency Trading*, which is done for capital gains or to offset risk and sometimes to earn interest, as is done in the carry forward trade. Financial Instruments where the underlying transaction is for exchanges of money for protection against risk, such as insurance contract, which promise to pay for a loss event in exchange for a premium. For instance, a car owner buys car insurance so that he will be compensated for a financial loss that occurs as the result of an accident.[26]

The second type of classification of financial instruments is based on the nature of issuer of such instruments, such as (a) Instruments issued by the ultimate borrower, as Primary Securities and (b) Instruments issued by the intermediaries on behalf of ultimate borrower, as Indirect Securities or Secondary Securities.

[26]See also http://thismatter.com/money/banking/financial-instruments.htm, accessed on 25.06.2016 at 12.20 hrs.

The third type of classification of financial instruments is based on the nature of underlying or backed up securities. These include (a) Primitive securities, which are based on real assets or on the promise or performance of the issuer,[27] (b) Financial derivatives, which are based on the underlying asset which consists of other financial instruments or some benchmark, such as stock indexes, interest rates, or credit events[28].

The financial instruments are also classified based on the nature of instrument into (1) Cash Instruments and (2) Derivative Instruments. Cash Instruments are financial instruments whose value is determined directly by markets. Cash Instruments include securities, which are readily transferable, and other cash instruments such as loans and deposits, where both borrower and lender have to agree on a transfer. Derivative Instruments, on the other hand, are financial instruments which derive their value from the value and characteristics of one or more underlying assets. Financial Derivatives include exchange-traded derivatives and Over The Counter (OTC) derivatives, the details of which are dealt with subsequently.[29]

Another method of classification of financial instruments is on the basis of asset class. There are (1) equity based instruments (Equity Instruments) which are financial instruments which reflect ownership of the issuing entity on the

[27] For example, bonds are based on the issuer's ability to pay interest and principal and stocks depend on the performance of the company that issued the stock.
[28] For example, the value of stock options depends on the price of the underlying stock, and mortgage-backed securities depend on an underlying pool of mortgages.
[29]Major part of this study will adopt this classification, and all references to financial derivatives will include all instruments other than cash instruments. See *infra.*

instruments. (2) Debt based Instruments (Debt Instruments) which are financial instruments which reflect the loan which the investor has made to the issuing entity, by subscribing to the instrument. Debt Instruments are further classified into short term debt based instruments (less than one year) and long term debt based instruments (more than one year). (3) Foreign Exchange Instruments, which are financial instruments based on foreign exchange. These are neither equity based nor debt based and are a separate category on its own. The above classification is pictorially shown in Table II below:

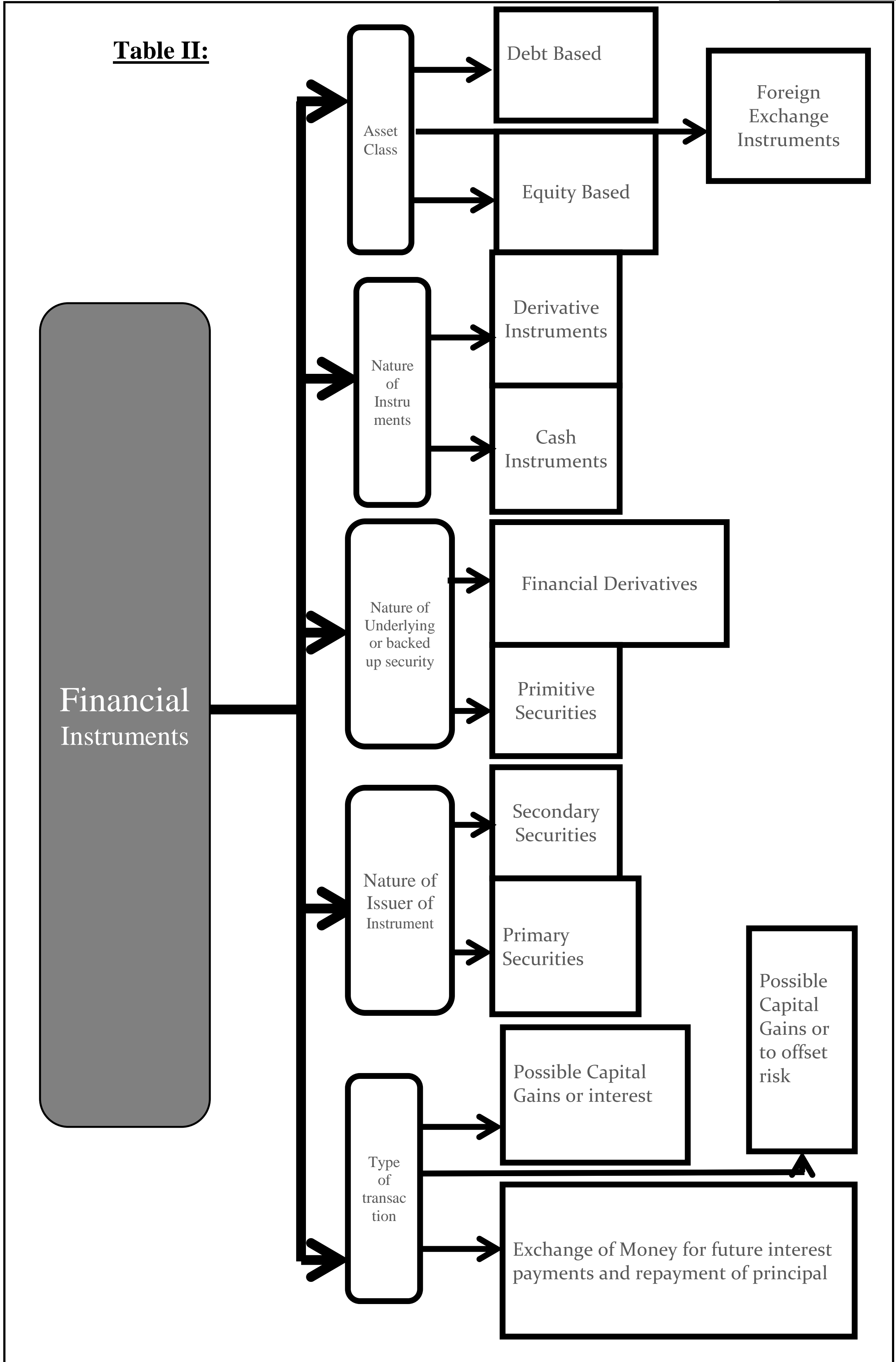
Table II:
Financial Instruments
Asset Class
Debt Based
Foreign Exchange Instruments
Equity Based
Nature of Instru ments
Derivative Instruments
Cash Instruments
Nature of Underlying or backed up security
Financial Derivatives
Primitive Securities
Nature of Issuer of Instrument
Secondary Securities
Primary Securities
Type of transac tion
Possible Capital Gains or interest
Possible Capital Gains or to offset risk
Exchange of Money for future interest payments and repayment of principal

Apart from these common forms of financial instruments, numerous instruments are getting invented in the financial sector by the day, and most of them remain unknown to the public until they start to make an impact. Many of the new generation instruments are often sold first to a closed circle of enthusiasts, and they become public only when they fail. It is difficult, therefore, to deal in the present work on all forms of financial instruments and hence the current work is focused mainly on derivative instruments.

FINANCIAL DERIVATIVES

Derivatives are a species of financial instruments. Derivatives are financial contracts, or financial instruments, whose values are derived from the value of some other thing (underlying security). The underlying security on which a derivative is based can be an asset (e.g., commodities, equities (stocks), residential mortgages, commercial real estate, loans, bonds), an index (e.g., interest rates, exchange rates, stock market indices, consumer price index (CPI) which are called inflation derivatives, or other items (e.g., weather conditions, or other derivatives). The word derivative is used here in in the restricted meaning as referring to modern day financial derivatives.[30]

History of Financial Derivatives:

It is not known when humans first started using financial derivatives. Neither derivatives nor their trading are a new phenomenon and the history of

[30]Every financial product is a derivative product also in so far as money is only a perception and all depictions of money is only a symbolisation and derivative of that perception.

institutionalised derivative trading began almost simultaneously with trading in securities.

It should be also kept in mind that though the known history of derivatives date back to 12th century AD, there is evidence of instruments which can properly be termed as financial derivatives in use in Ancient Greece. Siems[31] quotes Aristotle's story about Greek philosopher Thales who profited from the forecast that the next olive harvest would be an exceptionally good one. As a poor philosopher, he did not have many financial resources at hand. But he used what he had to place a deposit on the local olive presses. As nobody knew for certain whether the harvest would be good or bad, Thales secured the rights to the presses at a relatively low rate. When the harvest proved to be bountiful, and so demand for the presses was high, Thales charged a high price for their use and reaped a considerable profit. This is similar to what we call options in the modern financial jargon, though the option exercised by Thales was more in the nature of a betting than a shrewd financial calculation, since none was sure whether the crops could survive the harvest when the prediction was made.

Van de Mieroop[32] reproduces a cuneiform tablet[33] in which a supplier of wood, whose name was Akshak-shemi, promised to deliver 30 wooden planks to a client,

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[31] Aristotle, *Politics*, trans. Benjamin Jowett, Vol. 2, in Robert Maynard Hutchins(Ed.), *The Great Books of the Western World*, University of Chicago Press, Chicago (1952), Book 1, Chap. 11, p. 453.

[32]Marc Van de Mieroop, "The Innovation of Interest - Sumerian Loans" in William M. Goetzmann and K. Geert Rouwenhorst (Eds.), *The Origins of Value: The Financial Innovations that Created Modern Capital Markets*, Oxford University Press, Oxford, (2005).

[33] Cuneiform tablet is an instrument of writing. The name comes from the Latin word cuneus for 'wedge' owing to the wedge-shaped style of writing. In cuneiform, a carefully cut writing

called Damqanum, at a future date. This contract was written in the nineteenth century BC and is similar to a modern futures contract[34].

Swan[35] speaks of a cuneiform tablet from about 1700 BC, in which two farmers received from the King's daughter three kurru of barley, which had to be returned at harvest time. The farmers, who were brothers, probably used the barley, about 0.9 cubic meters, as seed stock for planting a field. The wordings of the contract were as follows:

> Three kurru of barley, in the seah-measure of Shamash, the mesheque measure, in storage, Anum-pisha and Namran-sharur, the sons of Siniddianam, have received from the naditu-priestess Iltani, the King's daughter. At harvest time they will return the three gur of barley in the seah-measure of Shamash, the mesheque measure, to the storage container from which they took it. Before two witnesses whose names are listed. Month Ulul, 19th day, year in which King Abieshuh completed the statue of Entemena as god[36].

This contract may either be viewed as a commodity loan or as a short-selling operation, in which the brothers borrowed barley, used it for planting the crop, and then returned it after harvest. This operation was less innocuous than it looks

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implement known as a stylus is pressed into soft clay to produce wedge-like impressions that represent word-signs (pictographs) and, later, phonograms or `word-concepts' (closer to a modern day understanding of a `word'). All of the great Mesopotamian civilizations used cuneiform (the Sumerians, Akkadians, Babylonians, Elamites, Hatti, Hittites, Assyrians, Hurrians and others) until it was abandoned in favour of the alphabetic script at some point after 100 BCE. See http://www.ancient.eu/cuneiform/, accessed on 25.06.2016 at 15.03 hrs.

[34] The wording of the contract is as follows: "Thirty wooden [planks?], ten of 3.5 meters each, twenty of 4 meters each, in the month Magrattum Akshak-shemi will give to Damqanum. Before six witnesses (their names are listed). The year that the golden throne of Sin of Warhum was made. See *Id* at p. 23.

[35] Edward J. Swan, *Building the Global Market: A 4000 Year History of Derivatives*, Kluwer Law International, Hague (2000), p. 28.

[36] *Ibid.*

because the brothers carried some risk. If the crop failed they were required to buy barley in order to be able to return it to the royal granary. This operation would not have been possible without the sophisticated Mesopotamian irrigation system, which reduced the risk of crop failure due to drought. It is also possible that the King's daughter, who represented the state, did not enforce the contract if a widespread crop failure due to climatic conditions or a locust plague, which led to famine. In that case the state carried the risk of general crop failure.

Zohary and Hopf[37] speak about a contract regarding sesame seeds interpreting a tablet from Indus valley. They maintain that the sesame plant was cultivated in the Indus Valley between 2250 and 1750 BC. The following tablet, which is from 1809 BC, shows that a Mesopotamian merchant borrowed silver, promising to repay it with sesame seeds "according to the going rate" after six months. He may have used the silver to finance a trading mission to the Indus Valley to obtain sesame seeds. This contract combines a silver loan with a forward sale of sesame seeds. The wording of the contract is as follows:

> Six shekels silver as a šu-lá loan, Abuwaqar, the son of Ibqu-Erra, received from Balnumamhe. In the sixth month he will repay it with sesame according to the going rate. Before seven witnesses (their names are listed). These are the witnesses to the seal. In month eleven of the year when king

[37]Daniel Zohary and Maria Hopf , *Domestication of Plants in the Old World: The Origin and Spread of Cultivated Plants in West Asia, Europe, and the Nile Valley*, , Oxford University Press, Oxford,(2000).

> Rim-Sin defeated the armies of Uruk, Isin, Babylon, Rapiqum and Sutium, and Irdanene, king of Uruk[38].

A tablet from 1750 BC was about providing a slave trader with funding and insurance. At the time when the contract was written, he received a certain measure of oil in return of a promise to deliver healthy slaves from Gutium after one month, with an option of paying a fixed amount of silver instead of delivering slaves. The wording of this contract is as follows:

> 204 $^{2}/_{3}$qu of oil in the measure of Shamash, to the value of $^{1}/_{3}$ mina $^{2}/_{3}$ shekels of silver, as the price for healthy slaves from Gutium, Warad-Marduk son of Ibni-Marduk has received from Utul-Ishtar the troop-commander on the authority of Lu-Ishurra son of Ili-usati. Within one month he shall bring healthy slaves from Gutium. If he does not bring them within one month, Lu-Ish (k) urra son of Ili-usati will repay $^{1}/_{3}$ mina $^{2}/_{3}$ shekels of silver to the bearer of this tablet. Before four witnesses whose names are listed. Month Ab, sixth day, year in which King Ammisaduqa etc.[39]

This contract provided the slave trader with capital to procure slaves from Gutium. The option to pay $^{1}/_{3}$ mina $^{2}/_{3}$ shekels of silver limited his loss if he was not able to buy slaves at a price that made the transaction profitable. It also provided insurance against all other hazards of the slave trade, including the risk that the slaves fell ill, they ran away, etc. The opposite party agreed to this transaction if the price of $^{1}/_{3}$ mina $^{2}/_{3}$ shekels of silver for 204 $^{2}/_{3}$ qu of oil exceeded the spot price of oil by an amount that was sufficient to adequately compensate for

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[38] *Id* at pp. 140-141. See also John C. Hull and Shankarshan Basu, *Options, Futures and other Derivatives",* Dorling Kindersley (India) Pvt. Ltd, New Delhi (2010), at p. 21.

[39] Wolfgang Hafner, Heinz Zimmerman (Eds.), *Vinzenz Bronzin's Option Pricing Models: Exposition and Appraisal,* Springer, Switzerland, (2009), at p. 436.

supplying the initial loan of oil and for the risks inherent in the slave trade. The cuneiform tablet gave the slave trader the option to pay silver to the *bearer* of the tablet. This suggests that the holder of the tablet could transfer the contract to a third party. But not enough is known on Mesopotamian trading practices to determine the significance of the transfer of tablets.

Sextus Pomponius a lawyer who wrote in the second century AD, distinguished between two types of contracts. The first, *vendito re speratae*, which was void if the seller did not have the goods at the delivery date, provided insurance against crop loss and the hazards of long-distance trade, including the loss of ships in maritime trade. The second, *vendito spei,* was a straightforward forward contract that did not provide for any reprieve to the seller in case he was unable to deliver the goods. It is unclear whether *vendito re speratae* involved the same rights as a modern put option[40] because the seller may have been obliged to deliver the goods if he had them.[41]

There were no corporations in Roman times, with one notable exception that is documented by Malmendier.[42] *Societas publicanorum*, which were private companies that tendered for government contracts, issued shares that were widely held by Romans. Cicero, who lived from 106 to 43 BC, commented on the trade in these shares, which is said to have taken place near the Temple of Castor on the

[40] A Put option is a right to sell without a corresponding obligation to buy in the other party. See for details *infra.*
[41] *Supra* n. 35.
[42] Ulrike Malmendier, "Roman Shares", in William M. Goetzmann and K. Geert Rouwenhorst (Eds.), *The Origins of Value: The Financial Innovations that Created Modern Capital Markets*, Oxford University Press, Oxford, (2005), at p. 40.

Forum Romanum. The fact that the subscriber to a share could sell it implies that there existed no exclusive relationship between the subscriber and the company.

As has been already mentioned when dealing with the history of financial markets, during the 12th century, medieval European merchants had created a forward contract called a *lettre de faire (*letter of the fair). These letters allowed merchants to trade on the basis of a sample of their goods, thus relieving them of the need to transport large quantities of merchandise along dangerous routes with no guarantee of a buyer at the journey's end. Pezzolo[43] provides a detailed account of the finances of Italian cities and their use of Monti shares. Monti shares were the first securities that were traded in secondary markets. They were followed by bills of exchange, which provided the medium of exchange in long-distance trade from the fifteenth century until the early twentieth century. The buyer of some commodity accepted a bill of exchange and passed it to the payee instead of sending gold or silver coins. The payee either held on to the bill until maturity or he sold it to a third party. In fact, bills of exchange, whose maturity typically ranged from a few days to 90 days, could pass through many hands. The holder of a bill earned interest because bills were traded at a discount that gradually diminished until maturity. The domestic currency price of foreign bills of exchange was the exchange rate. The main trading centres in northern Europe were Bruges from the twelfth to the fifteenth century, Antwerp in the sixteenth century, and Amsterdam in the seventeenth century. Bruges was a centre for the trade of wool, cloth and

[43] Luciano Pezzolo, "Italian Monti: The origins of Bonds and Government Debt", Provisional Paper, available in http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.201.5977 & rep =rep1& type=pdf, accessed on 10.06.2016 at 19.58 hrs.

other commodities. Around 1540, Antwerp legalized the negotiability of bills of exchange and a royal decree made contracts for future delivery transferable to third parties.

At about this time, an important innovation occurred in derivative markets. Merchants discovered that there is no need to settle forward contracts by delivering the underlying asset, as it is sufficient if the losing party compensates the winning party for the difference between the delivery price and the spot price at the time of settlement. Contracts For Differences were written on bills of exchange, government bonds and commodities. Although it is likely that similar deals had been done in Bruges and with Monti shares in Italy, Contracts For Differences were used on a large scale for the first time in Antwerp. During the 14th century there existed a type of Contract For Differences on bills of exchange, which was settled by a cash flow that depended on the exchange rate between bills of exchange in Antwerp and Spain. These Contracts For Differences were precursors of futures contract. After the unseating of Antwerp by Spanish troops, Amsterdam became the centre for European trade. Amsterdam was the first city where derivatives that were based on securities were used freely for a long period of time.

Later we see that during 17th century the Japanese Rice merchants also used such contracts to hedge the risk.[44] Hence it can be safely assumed that derivative

[44] See Steve Kummer, Christian Pauletto "The History of Derivatives: A Few Milestones", EFTA Seminar on Regulation of Derivatives Markets, Zurich, available at https://www.seco.admin.ch/dam/seco/de/dokumente/Aussenwirtschaft/Wirtschaftsbeziehungen/Handel%20mit%20Dienstleistungen/Artikel_Studien/History_of_Derivatives.pdf.download.pdf/10%20The%20History%20of%20Derivatives%20-%20A%20Few%20Milestones.pdf, accessed on 25.06.2016 at 15.37 hrs.

instruments are not products of 20th century economic revolution, but traditional products modified to suit the needs of time. However such instruments came to be collectively named as derivatives only much recently, in the latter part of 20th Century.

Definition of Financial Derivatives:

The word derivative is defined in *Black's Law Dictionary*[45] as coming from another or taken from something which has no origin in itself, and owes its existence to something foregoing, anything obtained or deduced from another. In law, derivative contracts are thus contracts derived from some preceding transaction or contract or conveyance.

However since financial derivatives have come to be regulated comparatively recently, traditional dictionaries do not have any definition of the term "financial derivatives". We need to look at online dictionaries for an understanding of the dictionary meaning of this term. *FindLaw's Online Law Dictionary* defines a financial derivative as:

> …a contract or security that derives its value from that of an underlying asset (as another security) or from the value of a rate (as of interest or currency exchange) or index of asset value (as a stock index).[46]

It has also given a note that derivatives often take the form of customized contracts transacted outside of security exchanges, while other contracts, such as

[45]Black's Law Dictionary, (1971) at p. 528.
[46]http://dictionary.lp.findlaw.com/scripts/results.pl?co=dictionary.lp.findlaw.com&topic=95/9596328a78e23d0974862a6f44b091bb, accessed on 04.05.2010 at 21.30 hrs.

standard index options and futures, are openly traded on such exchanges. Derivatives often involve a forward contract.[47]

Nolo Law Dictionary, another popular online law and financial terms dictionary defines derivative as:

> …a financial instrument whose value is based on the value of an underlying security, such as a commodity, currency, or bond[48].

The most common derivatives are futures[49], options[50], and swaps[51]. They are used to manage risk and fluctuations in the value of the underlying security but are often risky and complicated investments.

Another popular definition of derivative contract is from International Swaps and Derivatives Association,[52] an association of professionals dealing with derivatives and trying to bring in self-regulation in the arena of derivatives trading. They define derivatives as follows:[53]

> A derivative is a risk transfer agreement, the value of which is derived from the value of an underlying asset. The underlying asset could be an interest rate, a physical commodity, a company's equity shares, an equity index, a currency, or virtually any other tradable instrument upon which parties can agree.[54]

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[47] *Ibid.*
[48] http://www.nolo.com/dictionary/derivative-term.html, accessed on 01.10.2015 at 21.41 hrs.
[49] See *Infra.*
[50] See *Infra.*
[51] See *Infra.*
[52] Hereinafter referred to as I.S.D.A.
[53]See http://www.isda.org/educat/faqs.html#1, accessed on 02.09.2015 at 16.03 hrs.
[54] During 2010, the definition was slightly different. It read as "Derivative is a ***risk-shifting agreement***, the value of which is derived from the value of an underlying asset. The underlying

Another definition of derivatives is that derivatives are financial securities whose value is derived from another "underlying" financial security.[55] However there are many experts who say that such a definition is not acceptable since in derivatives such as those based on weather movements or on electricity, there is no underlying financial security.[56]

However some other analysts dispute even this definition as they fail to take account of the risk that the counter party derivative may default. Analysts of this school define derivatives as a "promise" whose market value depends, first, on the strength of the promisor's ability to perform and, second, on the value of the underlying asset or variable.[57] Ernst Juerg Weber in his article entitled "A Short History of Derivative Security Markets,"[58] opines that:

> …defining a derivative as a promise with a default option, is crucial in historical research because differences in legal institutions and customs created wide disparities in non-performance costs across places and time.[59]

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asset could be a physical commodity, an interest rate, a company's ***stock***, a ***stock*** index, a currency, or virtually any other tradable instrument upon which ***two*** parties can agree." This definition was available in http://www.isda.org/media/pdf/resourcesfaqs.pdf, accessed on 27.04.2010 at 13.03 hrs. (The website has since then been removed.) It may be noted that in the latest definition, the words "risk transfer" is used instead of risk shifting" which is more positive than the earlier word "risk shifting". The word "equity" has replaced "stock", and the words "two" has been omitted to denote that there could be more than two parties to a derivatives agreement.

[55] http://www.finpipe.com/derivatives.htm, accessed on 27.04.2010 at 12.50 hrs. Hedging is defined as a transaction that offsets an exposure to fluctuation in financial prices of some other contract or business risk. It may consist of cash instrument or derivatives.

[56] Edward J. Swan, *Building the Global Market: A 4000 Year History of Derivatives*, The Hague: Kluwer Law International, (2000) at p 142. Some financial textbooks like Hull (2006) defines derivatives as financial instruments whose value can depend upon almost any valuable.

[57] Ernst Juerg Weber, "A Short History of Derivative Security Markets" (June 2008). Available at SSRN: http://ssrn.com/abstract=1141689, accessed on 29.08.2015 at 20.51 hrs at p 18.

[58] *Ibid.*

[59] *Id* at p 4.

In India, there are two statutes which contain definition of derivative instrument - Securities Contracts (Regulation) Act, 1956[60] and Payments and Settlements Systems Act, 2007. S. 2 (ac) of SCRA gives an inclusive definition to derivatives in the following words:

> Derivative includes – (A) a security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security; (B) a contract which derives its value from the prices, or index or prices, of underlying securities.

S. 2(1) (b) of Payment and Settlement Systems Act, 2007 defines "derivative" as follows:

> Derivative means an instrument, to be settled at a future date, whose value is derived from change in interest rate, foreign exchange rate, credit rating or credit index, price of securities (also called "underlying"), or any other underlying or a combination of more than one of them and includes interest rate swaps, forward rate agreements, foreign currency swaps, foreign currency rupee swaps, foreign currency options, foreign currency rupee options or any other instrument, as may be specified by the Reserve Bank from time to time[61].

Before we move on to the nature of derivatives, it would also be pertinent to note how judiciary has attempted to define these complex instruments. In *Barings plc (in liquidation) and another* v. *Coopers & Lybrand (a firm) and others, Barings*

[60]Hereinafter referred to as SCRA.

[61] Apart from defining the term derivatives, the Payment and Settlement Systems Act, 2007 does not contain any clear provision for regulating these instruments. However, the terms "payment obligation under S. 2(1)(h) of the said Act includes indebtedness as a result of payment instructions relating to derivatives and "Settlement" in S.2(1)(n) of the said Act includes settlement of derivatives. Further S. 23 of the Act provides that settlement is final and irrevocable as soon as the derivatives payable as a result of such settlement is determined, whether or not they are actually paid.

Futures (Singapore) Pte Ltd (in liquidation) v. *Mattar and others*[62] the Chancellery Division of High Court of England defined derivatives as follows:

> A derivative is a contract or instrument which changes in value depending on price movements in another instrument or in an index. Futures contracts and options are derivatives[63].

Another definition of derivatives was adopted by the Court of Appeal in England in *Lomas and others (Together the Joint Administrators of Lehman Brothers International (Europe)* v. *JFB Firth Rixson Inc. & Others*[64], based on a definition proposed by Mr. Simon Firth of Linklaters[65]. The Court of Appeal chose to define derivatives as:

> …a transaction under which the future obligations of one or more of the parties are linked in some specified way to another asset or index, whether involving the delivery of the asset or the payment of an amount calculated by reference to its value or the value of the index. The transaction is therefore treated as having a value which is separate (although derived) from the values of the underlying asset or index. As a result, the parties' rights and obligations under the transaction can be treated as if they constituted a separate asset and are typically traded accordingly.[66]

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[62][2003] EWHC 1319 (Ch.).
[63] *Id* at p. 21.
[64] [2012] EWCA Civ 419, [2010] EWHC 3372 (Ch), [2011] EWHC 718 (Ch), [2011] EWHC 1692 (Comm) & [2011] EWHC 692 (Comm).
[65] Linklater's LLP is a global law firm which specialises in advising governments and financial institutions.
[66] *Supra* n.64 at p. 3.

In India, the Madras High Court in *Rajshree Sugars and Chemicals Limited* v. *AXIS Bank Limited and another*[67] has defined derivatives based on definition adopted by the International Accounting Standards as follows:

> In simple terms, derivatives are financial instruments whose values depend on the value of other underlying financial instruments. The International Accounting Standard (IAS) 39 defines "derivatives" as follows:
>
> A derivative is a financial instrument:
>
> (a) whose value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or similar variable (sometimes called the 'underlying');
>
> (b) that requires no initial net investment or little initial net investment relative to other types of contracts that have a similar response to changes in market conditions; and
>
> (c) that is settled at a future date.
>
> Actually, derivatives are assets, whose values are derived from values of underlying assets. These underlying assets can be commodities, metals, energy resources, and financial assets such as shares, bonds, and foreign currencies.[68]

Nature of Derivatives:

As can be seen from this statutory definition in India, the derivatives are given only an inclusive definition, due to the complex nature of these instruments. To understand derivatives better, it is necessary to understand that one of the purposes

[67] 2011 KHC 2472, A.I.R. 2011 Mad. 144, (2008) 8 M.L.J. 261, 2008 Bus. L.R. 908, 2009(1) C.T.C. 227. (Popularly known as *Rajshree Sugar's* Case).
[68] *Id* at p.4.

of financial instruments is liquidity, and unless an instrument is sufficiently clear as to the impact and the terms, the financial instrument cannot serve the purpose of liquidity. The solution is to create standardised financial instruments, which are nothing but contract with standard terms and conditions. Normally only such standardised financial instruments, otherwise called securities can be traded in financial markets such as organised exchanges and over the counter markets. The securities are classified as: (a) securities based on real assets (money or money's worth) like stocks, cheques, etc. and (b) securities whose value is derived from some other underlying asset like another financial instrument or some bench mark like stock indexes, interest rates or credit events. The value of any financial instrument depends on the returns it is expected to bring to the investor. The factors affecting the value are the amount of returns, the likelihood of payment, present value of payment and risk associated with the payment. The value of the instrument is inversely proportional to the risk associated with it. Derivatives can be used as insurance cover against certain types of business risks such as fluctuations in the rate of foreign exchange, fluctuations in the rate of interest on borrowings, fluctuations in the value of specified assets, etc. Derivatives can also be used for hedging, protecting against financial risk or can be used to speculate on the movement of commodity or security prices, interest rates or the levels of financial indices. The valuation of derivatives makes use of the statistical mathematics of uncertainty, which is very complex.

However in many cases the actual risk is either not communicated to the investor or the risk is communicated in such complex language that the investor does not get

a correct picture of the risk in subscribing to the financial instrument. This is especially true in the case of financial derivatives whose risk is extremely high compared to primary securities. Therefore the current study is mostly centred on the regulation of financial derivatives rather than other forms of financial securities.

Types of Financial Derivatives:

Alastair Hudson[69] puts forward a hypothesis that there are only three forms of financial derivative products - the swap, the option and the forward. According to him, all else is embroidery based on these building blocks. However there are different categories of derivatives like options, futures, swaps, swaptions, structured notes, etc. The derivatives are classified mainly based on:

1. **Classification based on Marketplace:** Some of the derivatives are traded through exchanges and they are known as Exchange-Traded-Derivatives (ETD). Others are traded directly between the parties and they are known as Over-The-Counter (OTC) derivatives. An OTC derivative transaction is a privately negotiated bilateral contract or payments exchange agreement whose value derives from the value of an underlying asset, reference rate or index. In contrast to exchange-traded derivatives such as futures contracts, OTC derivatives are customized contracts provided directly by dealers to end-users or to other dealers.

2. **Classification based on Content:** In this type of classification, the derivatives are classified into plain vanilla type and exotic derivatives. The classification is

[69] Alastair Hudson, *Law on Financial Derivatives*, Sweet & Maxwell, London, (1998), at p.1.

derived from classification of ice creams, and the plain vanilla type, as the name indicates are the ordinary old generation type of instruments whereas the exotic varieties are those which are of recent invention.

Plain vanilla derivatives: These are old generation financial derivatives and include forwards, futures, swaps and options.

1. *Forwards or Forward Contract:* A contract between two parties where one party agrees to buy a commodity or financial asset on a date in the future at a fixed price, while the other agrees to deliver that commodity or asset at the pre-determined price. These are not generally traded on exchanges because they are negotiated directly between two parties. Another way to define forwards are to define it as a privately negotiated investment contract in which a buyer commits to purchase something (as a quantity of a commodity, security or currency) at a pre-determined price on a set future date.

2. *Futures or Futures Contract:* Here the contract is essentially the same as a forward contract[70], except that the deal is struck via an organized and regulated exchange. Here a contract is purchased or sold on an exchange in which a party agrees to buy or sell a quantity of a commodity on a specified future date at a set price. In other words, a financial futures contract is an agreement to buy or sell a standard quantity of a specific financial instrument at a predetermined future date and an agreed price.

[70] There are three key differences between forwards and futures: (i) Futures contract is guaranteed against default. (ii) Futures are standardised and (iii) Futures are settled on a daily basis.

3. *Swaps:* A swap is an agreement made between two parties to exchange payments on regular future dates. Swaps are Over The Counter (OTC) products. Swaps are used to manage or hedge risk associated with volatile interest rates, currency exchange rates, commodity prices and share prices. Swaps can be considered as series of forward contracts. There are two types of swap contracts:

(i.) *Interest Rate Swaps:* These contracts allow swapping only the interest related cash flows between the parties in the same currency.

(ii.) *Currency Swaps:* These contracts allow swapping both principal and interest between the parties, with the cash flows in one direction being in a different currency than those in the opposite direction.

4. *Options:* An 'option' gives the holder the right to buy or sell an underlying asset at a future date at a predetermined price. There are two types or ways of exercising option, a call option and a put option. A 'call option' is the right to buy. The buyer of a "call option" has the right, but not the obligation to buy an agreed quantity of a particular commodity or financial instrument[71], from the seller[72] at a certain time[73] for a certain price.[74] The buyer pays a premium for this right. In contrast, a 'put option' is the right to sell. The buyer of a "put option" has the right, but not the obligation to sell an agreed quantity of a particular commodity or financial instrument to the seller at a certain time for a certain price). There are a variety of

[71] Called in technical terms underlying instrument.
[72] Called in technical terms writer.
[73] Called in technical terms expiration date.
[74] Called in technical terms strike price.

options such as American[75] and European[76] options, depending upon the time of exercise of the right. Both call option and put option can be combined to achieve "zero cost option".[77]

Exotic Derivatives: These are basically derivatives of derivatives or derivative products evolved out of a combination of plain vanilla derivative products.

1. *Swaptions:* Swaptions are options to buy or sell a swap that will become operative at the expiry of the options. Thus a swaption is an option on a forward swap. Rather than have calls and puts, the swaptions market has receiver swaptions and payer swaptions. A receiver swaption is an option to receive fixed and pay floating. A payer swaption is an option to pay fixed and receive floating.

2. *Warrants:* Options generally have lives of up to one year and the majority of options traded on options exchanges have a maximum maturity of nine months. Longer-dated options are called warrants and are generally traded Over The Counter.

3. *LEAPS:* The acronym LEAPS means Long-Term Equity Anticipation Securities. These are options having a maturity of upto three years.

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[75] An American option is an option that can be exercised anytime during its life. American options allow option holders to exercise the option at any time prior to and including its maturity date, thus increasing the value of the option to the holder. See http://www.investopedia.com /terms/a/ american option.asp#ixzz4CaRYsVQd, accessed on 25.06.2016 at 16.15 hrs.

[76] A European option is an option that can only be exercised at the end of its life, at its maturity. See http://www.investopedia.com/terms/e/europeanoption.asp, accessed on 25.06.2016 at 16.18 hrs.

[77] Zero Cost Option is a contract where one option is purchased and simultaneously a matching option of the same value is sold. See http://www.businessdictionary.com/ definition/zero-cost-option.html, accessed on 25.06.2016 at 16.12 hrs.

4. *Baskets:* Basket options are options on portfolios of underlying assets. The underlying asset is usually a moving average or a basket of assets.[78]

5. *Variance Swap:* This is an Over The Counter financial derivative that allows one to speculate on or hedge risks associated with the magnitude of movement, i.e. volatility of some underlying product like an exchange rate, interest rate or stock index. One leg of the swap will pay an amount based upon the realised variance of the price changes of the underlying product. Conventionally, these price changes will be daily log returns, based upon the most commonly used closing price. The other leg of the swap will pay a fixed amount, which is the strike, quoted at the deal's inception. Thus the net payoff to the counterparties will be the difference between these two and will be settled in cash at the expiration of the deal, though some cash payments will likely be made along the way by one or the other counterparty to maintain agreed upon margin.

6. *Contract For Difference[79] (CFD):* This derivative instrument is basically a contract between two parties, typically described as "buyer" and "seller", stipulating that the seller will pay to the buyer the difference between the current value of an asset and its value at contract time. If the difference is negative, then the buyer pays instead to the seller. In effect CFD’s are financial derivatives that allow investors to take advantage of prices moving up (long positions) or prices moving down (short positions) on underlying financial instruments and are often used to speculate on those markets. For example, when applied to equities, such a

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[78] Equity index options are a form of basket options.
[79] Hereinafter referred to as CFD.

contract is an equity derivative that allows investors to speculate on share price movements, without the need for ownership of the underlying shares.[80]

7. _Credit Linked Note[81]:_ This is a form of funded credit derivative. It is structured as a security with an embedded credit default swap allowing the issuer to transfer a specific credit risk to credit investors. The issuer is not obligated to repay the debt if a specified event occurs. This eliminates a third-party insurance provider. It is issued by a special purpose company or trust, designed to offer investors par value at maturity unless the referenced entity defaults. In the case of default, the investors receive a recovery rate. The trust will also have entered into a default swap with a dealer. In case of default, the trust will pay the dealer par minus the recovery rate, in exchange for an annual fee which is passed on to the investors in the form of a higher yield on their note. The purpose of the arrangement is to pass the risk of specific default onto investors willing to bear that risk in return for the higher yield it makes available. The CLN's themselves are typically backed by very highly-rated collateral, such as U.S. Treasury securities.

8. _Constant Proportion Portfolio Insurance[82]_: This is a capital guarantee derivative security. It is primarily used for hedging of risk. Simply stated, the investor maintains a portfolio of products with the manager, comprised of a mixture of different kinds of securities. The investor sets a limit on the dollar value of the

[80] CFD's are currently available in the United Kingdom, The Netherlands, Poland, Portugal, Germany, Switzerland, Italy, Singapore, South Africa, Australia, Canada, New Zealand, Sweden, France, Ireland, Japan Hong Kong and Spain. CFD's are not permitted in the United States, due to restrictions by the U.S. Securities and Exchange Commission on OTC financial instruments.

[81] Here in after referred to as CLN.

[82] Hereinafter referred to as CPPI.

portfolio and then structures asset allocation around the decision. This helps the investor a minimum guaranteed amount to the investor at the time of maturity. The manager allocates funds dynamically to a mixture of risky assets such as equities or stock indices and non-risky assets such as bonds and money market funds. The manager then defines a cushion, or a percentage of the assets which could be put at risk without any effect on the level of protection. The manager will then compute the multiplier to apply to the cushion to get the portfolios exposure to the risky underlying. The adjustment of indexing level will depend on the changes in the performance of the risky assets-the more risky assets performs, the stronger the indexing level will be and manager will increase exposure to risky assets and vice versa.[83]

9. ***Credit Derivatives:*** This is a securitised derivative whose value is derived from the credit risk on an underlying bond, loan or any other financial asset. In this way, the credit risk is on an entity other than the counter parties to the transaction itself. This entity is known as the reference entity and may be a corporate, a sovereign or any other form of legal entity which has incurred debt. Credit derivatives are bilateral contracts between a buyer and seller under which the seller sells protection against the credit risk of the reference entity. Where credit protection is bought and sold between bilateral counter parties, this is known as an unfunded credit derivative. If the credit derivative is entered into by a financial institution or a

[83] See http://www.next-finance.net/What-is-CPPI-Constant-Proportion, accessed on 25.06.2016 at 00.09 hrs.

Special Purpose Vehicle[84] and payments under the credit derivative are funded using securitization techniques, such that a debt obligation is issued by the financial institution or SPV to support these obligations, and this is known as a funded credit derivative. This synthetic securitization process has become increasingly popular over the last decade, with the simple versions of these structures being known as synthetic Collateralised Debt Obligations,[85] credit linked notes, single tranche CDOs, to name a few. In funded credit derivatives, transactions are often rated by rating agencies, which allows investors to take different slices of credit risk according to their risk appetite.

10. *Equity-Linked Note*[86]*:* This is a debt instrument, usually a bond that differs from a standard fixed-income security in that the final pay-out is based on the return of the underlying equity, which can be a single stock, basket of stocks, or an equity index. A typical ELN is principal-protected, i.e. the investor is guaranteed to receive 100% of the original amount invested at maturity but receives no interest. Usually, the final pay-out is the amount invested, times the gain in the underlying stock or index times a note-specific participation rate, which can be more or less than 100%.[87] Generally, the participation rate is better in longer maturity notes, since the total amount of interest given up by the investor is higher. ELN can be thought of as a combination of a zero-coupon bond and an equity option. Indeed,

[84] Hereinafter referred to as SPV.
[85] Hereinafter referred to as CDO.
[86] Hereinafter referred to as ELN.
[87] For example, if the underlying equity gains 50% during the investment period and the participation rate is 80%, the investor receives 1.40 dollars for each dollar invested. If the equity remains unchanged or declines, the investor still receives one dollar per dollar invested (as long as the issuer does not default).

the issuer of the note usually covers the equity pay-out liability by purchasing an identical option. In some ELN's, the pay-out structure is more complicated, resembling an exotic option. ELN's are one type of structured product. Most ELN's are not actively traded on the secondary market and are designed to be kept to maturity. However, the issuer or arranger of the notes may offer to buy back the notes. Unlike the maturity pay-out, the buy-back price before maturity may be below the amount invested in first place.

11. *Equity options:* These are the most common type of equity derivatives. They provide the right, but not the obligation, to buy (call) or sell (put) a quantity of stock (1 contract = 100 shares of stock), at a set price (strike price), within a certain period of time (prior to the expiration date).

12. *Convertible bonds:* Convertible bonds are bonds that can be converted into shares of stock in the issuing company, usually at some pre-announced ratio. It is a hybrid security with debt and equity like features. It can be used by investors to obtain the upside of equity like returns while protecting the downside with regular bond like coupons.

13. *Equity futures, options and swaps*: These equity derivatives derive their value from the price of the underlying stock or stocks.

14. *Stock market index futures*: Stock market index futures are futures contracts used to replicate the performance of an underlying stock market index. They can be

used for hedging against an existing equity position, or speculating on future movements of the index[88].

15. _Equity basket derivatives:_ Equity basket derivatives are futures, options or swaps where the underlying is a non-index basket of shares. They have similar characteristics to equity index derivatives, but are always traded OTC (Over The Counter), between established institutional investors. These are used normally for correlation trading[89].

16. _Single-stock futures:_ Single-stock futures are exchange-traded futures contracts based on an individual underlying security rather than a stock index. Their performance is similar to that of the underlying equity itself, although as futures contracts they are usually traded with greater leverage. Another difference is that holders of long positions in single stock futures typically do not receive dividends and holders of short positions do not pay dividends. Single-stock futures may be cash-settled or physically settled by the transfer of the underlying stocks at expiration, although in the United States only physical settlement is used to avoid speculation in the market.

17. _Equity Index Swaps:_ An equity index swap is an agreement between two parties to swap two sets of cash flows on predetermined dates for an agreed number of years. The cash flows will be an equity index value swapped, for instance, with

[88] Indices for futures include well-established indices such as S&P, FTSE, DAX, CAC40 and other G12 country indices.
[89] See http://www.investopedia.com/university/guide-pairs-trading/pairs-trading-correlation.asp?o= 40186 &l=dir&qsrc=999&qo=investopediaSiteSearch&ap=investopedia.com, at p. 26.06.2016. at 00.17 hrs.

LIBOR.[90] Swaps can be considered as being a relatively straightforward way of gaining exposure to an asset class you require. They can also be relatively cost efficient.

18. *Equity swap:* An equity swap, like an equity index swap, is an agreement between two parties to swap two sets of cash flows. In this case the cash flows will be the price of an underlying stock value swapped, for instance, with LIBOR. A typical example of this type of derivative is the Contract For Difference (CFD) where one party gains exposure to a share price without buying or selling the underlying share making it relatively cost efficient as well as making it relevantly easy to transact.

19. *Intellidex:* An Intellidex is a securities product created by and proprietary to the American Stock Exchange. Intellidexes are created by analysing groups of stocks and selecting specific stocks to include in an investment portfolio. These portfolios range from narrow to broad in scope and are usually created based on criteria matching the market as a whole, specific investment styles, or certain industry sectors. Intellidexes and similar products, like exchange-traded funds, are usually traded like normal listed or over-the-counter securities.

20. *Exchange Traded Fund[91]:* An ETF is an investment fund traded on stock exchanges, much like stocks. An ETF holds assets such as stocks or bonds and trades at approximately the same price as the net asset value of its underlying assets

[90] London Interbank Exchange Rate.
[91] Hereinafter referred to as ETF. Also known as Exchange-Traded Product (ETP).

over the course of the trading day. Most ETFs track an index prepared by rating agencies. ETFs may be attractive as investments because of their low costs, tax efficiency, and stock-like features. Only so-called authorised participants (typically, large institutional investors) actually buy or sell shares of an ETF directly from/to the fund manager, and also only in creation units, which are large blocks of tens of thousands of ETF shares, and are usually exchanged in kind with baskets of the underlying securities. Authorised participants may wish to invest in the ETF shares long-term, but usually act as market makers on the open market, using their ability to exchange creation units with their underlying securities to provide liquidity of the ETF shares and help ensure that their intra-day market price approximates to the net asset value of the underlying assets. Other investors, such as individuals using a retail broker, trade ETF shares on this secondary market. An ETF combines the valuation feature of a mutual fund or unit investment trust, which can be bought or sold at the end of each trading day for its net asset value, with the tradability feature of a closed-end fund, which trades throughout the trading day at prices that may be more or less than its net asset value. Closed end funds are not considered to be ETFs, even though they are funds and are traded on an exchange.[92]

21. *Binary options:* This is a type of option where the payoff is either some fixed amount of some asset or nothing at all. The two main types of binary options are the cash-or-nothing binary option and the asset-or-nothing binary option. The cash-or-nothing binary option pays some fixed amount of cash if the option expires

[92] ETFs have been available in the US since 1993 and in Europe since 1999. ETFs traditionally have been index funds, but in 2008 the U.S. Securities and Exchange Commission began to authorize the creation of actively managed ETFs.

while the asset-or-nothing pays the value of the underlying security. Thus, the options are binary in nature because there are only two possible outcomes.[93]

22. *Fund Derivative:* A fund derivative is a financial structured product related to a fund, normally using the underlying fund to determine the payoff. This may be a private equity fund, mutual fund or hedge fund. Purchasers might want exposure to a fund to get exposure to a star fund manager or management style as well as the asset class. Typical fund derivatives might be a call option on a fund, a CPPI on a fund or a leveraged note on a fund. More complicated structures might be a guarantee sold to a fund that ensures it cannot fall in value by more than a certain amount. Maturities might range from three to ten years.[94]

23. *Inflation Derivative:* inflation derivative (or inflation-indexed derivatives) refers to an over-the-counter and exchange-traded derivative that is used to transfer inflation risk from one counter party to another. Typically, real rate swaps also come under this bracket, such as asset swaps of inflation-indexed bonds (government-issued inflation-indexed bonds, such as the Treasury Inflation Protected Securities, UK inflation-linked gilt-edged securities (ILGs), French OATeis, Italian BTPeis, German Bundeis and Japanese JGBis are prominent examples). Inflation swaps are the linear form of these derivatives. They can take a similar form to fixed versus floating interest rate swaps (which are the derivative form for fixed rate bonds) but use a real rate coupon versus floating and also pay a

[93] They are also called all-or-nothing options, digital options (more common in forex/interest rate markets) and Fixed Return Options (FROs) common in the American Stock Exchange).
[94] 1. The major players in this field are BNP Paribas, Societe Generale, Barclays, Deutsche Bank, Citigroup, Credit Suisse, etc.

redemption pickup at maturity (i.e., the derivative form of inflation indexed bonds). Inflation swaps are typically priced on a zero-coupon basis [95] with payment exchanged at the end of the term. One party pays the compounded fixed rate and the other the actual inflation rate for the term. Inflation swaps can also be paid on a year-on-year basis[96] where the year-on-year rate of change of the price index is paid.[97] Options on inflation including interest rate caps[98], interest rate floors[99] and straddles can also be traded. These are typically priced against YOY swaps, whilst the swaption is priced on the ZC curve. Asset swaps also exist where the coupon payment of the linker (inflation bond) as well as the redemption pickup at maturity is exchanged for interest rate payments expressed as a premium or discount to LIBOR [100] for the relevant bond coupon period, all dates are co-terminus. The redemption pickup is the above par redemption value in the case of par/par asset swaps, or the redemption above the proceeds notional in the case of the proceeds asset swap. The proceeds notional equals the dirty nominal price of the bond at the time of purchase and is used as the fixed notional on the LIBOR leg. Real rate swaps are the nominal interest swap rate less the corresponding inflation swap.

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[95] In short ZC. An example is Zero Coupon Inflation Indexed Swap or ZCIIS.

[96] In short YOY basis. An example is Year on Year Inflation Indexed Swap.

[97] Exchange is made yearly in the case of most European YOY swaps, but monthly for many US notes. Even though the coupons are paid monthly, the inflation rate used is still the year-on-year rate.

[98] Interest rate cap is a series of call options with a particular interest rate. Each of these options will expire on the date when the floating loan rate will be reset. At each interest payment date, the holder decided whether the exercise the option or to let it expire.

[99] Interest rate floors are a series of European interest put options, with a particular interest rate. It works similar to Interest rate cap, and at each interest payment date, the seller agrees to compensate the buyer for a rate falling below the specified rate during the contract period.

[100] London Inter Bank Offered Rate.

24. *Interest Rate Derivative:* An interest rate derivative is a derivative where the underlying asset is the right to pay or receive a notional amount of money at a given interest rate. The interest rate derivatives market is the largest derivatives market in the world[101]. Types of Interest rate instruments are:

(i.) *Interest Rate Cap:* An interest rate cap is designed to hedge a company's maximum exposure to upward interest rate movements. It establishes a maximum total dollar interest amount the hedger will pay out over the life of the cap. The interest rate cap is actually a series of individual interest rate caplets, each being an individual option on the underlying interest rate index. The interest rate cap is paid for upfront and then the purchaser realizes the benefit of the cap over the life of the instrument.

(ii.) *Range Accrual Note:* Range Accrual Note pays interest only if the floating interest rate (i.e. LIBOR) stays within a pre-determined band. This note effectively contains an embedded option which, in this case, the buyer of the note has sold to the issuer. This option adds to the yield of the note[102]. In this way, if volatility remains low, the bond yields more than a standard bond.

(iii.) *Bermudan Swaption:* Suppose a fixed-coupon callable bond was brought to the market by a company. The issuer however, entered into an interest rate swap to

[101] The BIS estimates that the notional amounts outstanding in June 2009 were US$437 trillion for OTC interest rate contracts, which increased to US $505,454 billion by second quarter of 2014. Notional amounts outstanding for OTC interest rate swaps in June 2009 were US$342 trillion, which increased to US$ 381,028 billion by Second Quarter of 2014. According to the International Swaps and Derivatives Association, 80% of the world's top 500 companies as of April 2003 used interest rate derivatives to control their cash flows. This compares with 75% for foreign exchange options, 25% for commodity options and 10% for stock options.

[102] Suppose a manager wished to take a view that volatility of interest rates will be low, he or she may gain extra yield over a regular bond by buying a range accrual note instead.

convert the fixed coupon payments to floating payments (perhaps based on LIBOR). Since it is callable however, the issuer may redeem the bond back from investors at certain dates during the life of the bond. If called, this would still leave the issuer with the interest rate swap. Therefore, the issuer also enters into Bermudan swaption when the bond is brought to market with exercise dates equal to callable dates for the bond. If the bond is called, the swaption is exercised, effectively cancelling the swap leaving no more interest rate exposure for the issuer.

(iv.) *Power Reverse Dual Currency Note*[103]*:* A dual currency note (DC) pays coupons in the investors' domestic currency with the notional in the issuer's domestic currency. A reverse dual currency note (RDC) is a note which pays a foreign interest rate in the investor's domestic currency. A PRDC Note or Bond is an exotic financial structured product where an investor is seeking a better return and a borrower a lower rate by taking advantage of the interest rate differential between two countries. The power component of the name denotes higher initial coupons and the fact that coupons rises as the domestic/foreign exchange rate depreciates. The power feature comes with a higher risk for the investor. Cash flows may have a digital cap feature where the rate gets locked once it reaches a certain threshold. Other add-on features are barriers such as knockouts and cancel provision for the issuer.

[103] In short PRDC Note. Also called Power Reversal Dual Currency Bond or PRDC Bond.

25. <u>*Real Estate Derivatives:*</u> A Real Estate Option is a contract based on a time horizon and an expected property value. It is developed based on financial options contracts and adapted to individual real estate assets. The following are the different types of Real Estate Options:

(i.) *Call Option:* Buying real estate upside with the Real Estate Call Option, a property owner can sell an option in exchange for debt-free cash today. The investor, who buys the Real Estate Call Option, benefits from property price appreciation and price volatility.

(ii.) *Put Option:* Financing real estate price decline insurance with the Real Estate Put Option (Selling price decline insurance) an investor can sell an option. Thus an investor underwrites price decline insurance. A Property owner, who buys the option, is protected against price decline of the value of property.

Apart from these specific derivatives, there are a large number of small variants of these derivatives which are both innumerable and evolving. Since OTC derivatives are individual contracts, it only requires an innovative mind and a potential buyer to invent a new form of derivative. As such it would be both difficult and unnecessary to list out all possible types of derivatives as the thrust of this work is on the legal framework for regulation of derivatives.

I.S.D.A. has classified the financial derivatives into (a) Credit Derivatives/Credit Default Swaps (b) Equity Derivatives (c) Interest Rate Derivatives (d) Foreign Exchange Derivatives (FX Derivatives) (e) Energy, Commodities, Developing

Products[104]. (f) Structured Products and Other Products, and (g) Islamic Finance Derivative Products.[105] It needs to be kept in mind that this broad classification applies only to Over the Counter (OTC) derivatives and that there are a number of custom made derivatives which can have features that are different from those mentioned above. It should be also kept in mind that the financial markets are innovating rapidly and many a times innovations have the aim of overriding regulatory goals. For example, there would be products which are designed as swaps to meet the regulatory requirements but interpreted as options to satisfy cost of funding needs.

LEGAL ANALYSIS OF FINANCIAL DERIVATIVES

Alastair Hudson[106] has identified six analytical patterns for legal analysis of different types of derivative transactions, which are (i) Financial Forward Analysis (ii) Executory Contract Analysis (iii) Mutual Debt Analysis (iv) Repayment Analysis (v) Condition Precedent Analysis and (vi) Disjoined Option Analysis.

According to him, executory contract analysis and repayment analysis have arisen from the case laws dealing with financial derivatives in USA and UK. He points out that the complex transactions involving derivatives should actually be construed as being simple transactions packaged together. According to him, in the mind of the trader, a swap is often analysed as a series of forward transactions. The approach of the documentation is usually to create a Master Agreement which

[104]These include derivatives value of which is based on prices or futures of oil, gas, emissions, coal, gold, bullion etc.

[105] These include Profit Rate Swap (Mubadalatul Arbaah), Packaged Structured Investment Bonds etc.

[106]*Supra* n. 69 at p.62.

operates as an umbrella agreement. Each individual transaction is then expressly incorporated into the Master agreement. Hudson points out that this raises two possibilities: firstly, considering the entire swap as a single executory contract, it requires elements within it to be offset to reach the final payable amount. Secondly, it can also be viewed as a series of reciprocal debts which are capable of being offset individually under the terms of the central Master Agreement[107]. According to him, though the documentation would suggest that the individual interest rate swaps must be considered as separate contracts, the question remains whether these are individual debts or individual executory contracts. To him, rationally, there is no reason to consider these as individual executory contracts and that they should be properly considered as reciprocal debts linked by a Master Agreement for the purpose of set off. However, Hudson points out that Market Standards Swaps Contracts contain provisions for the early termination of the transaction either because of the default of one or other of the parties or as a result of the agreement of the party. In such circumstances, the early termination terminates all of the resulting transactions indicating a composite agreement requiring a series of payments. However losses or gains flowing from terminated executory contract can be categorised as ordinary debt[108]. In swap contracts, where each party is required to make periodical payments which will continue over a period of time till expiry, each payment made by either party should be seen as a distinct contractual debt obligation. In certain option and forward transactions, the obligation of payment is required only when some condition precedent is satisfied. This is the starting point

[107]*Id* at p.64.
[108]*Id* at p.65.

of condition precedent analysis. Thus an interest rate swap agreement can be read as being made up of a series of individual contracts all subject to a condition precedent.

Repayment analysis was evolved judicially. In simple terms, it only means that where reverse payments are involved in respect of the same swap, reverse payments *pro-tanto* reduce pre-existing equity. Since payments were made pursuant into the same void transaction, they are considered together. There is no equity in respect of one payment, independent of equity in respect of others[109]. In *Kleinwort Benson* v. *Birmingham City Council*[110], the Court of Appeal had declined the defence of "passing on"[111], on the basis of repayment analysis. The plaintiff bank had contended that the defence of passing on should be available to it on the basis that it had entered into further interest rate swap agreements with third parties to hedge its risk under the agreement with the local authority. According to the bank, this hedge constituted passing on. The Court of Appeals held that that the hedging agreement was not part of the main agreement and therefore the amounts paid under it would not attract the defence of passing on[112]. According to

[109]*Westdeutsche Landes bank Girozentrale* v. *Islington London Borough Council*, [1994] 4 All E.R. 890: [1994] 1 W.L.R. 938.
[110][1996] 4 All E.R. 733. In this case, the plaintiff bank had paid Birmingham City Council money under interest rate swap agreements that were later declared to be *ultravires* and void by House of Lords. The defendant City Council argued that it need not repay the money as the bank had passed on its losses through hedging transactions long before.
[111] The defence of "passing on" is a common law defence. It is recognised as a defence in Canada and European Court of Justice, and to a certain extent in England. Simply stated, the defence is that in a claim for restitution, the defendant can raise a defence that that it had passed on some or full gains to the plaintiff and hence the claim has to be reduced to the extent of the said gain passed on to the plaintiff.
[112]The Court of Appeal, speaking through Saville LJ, held that if restitutionary remedies were concerned with what the claimant has lost, the passing on defence would be highly relevant, because the fact that claimant had passed on his or her loss would mean that he or she would

Hudson,[113] this would give rise to certain practical problems. Usually in swap transactions, normally two payments are not made. In most cases, payment netting applies and only one payment is made. Therefore practically it would not make sense to say that a single payment is repayment of the payment which was never made. Moreover, since payments under the contract are amounts payable one way calculated after set off of simultaneous reciprocal obligations, even if the contract is considered as a series of executory contracts or as a single agreement with multiple obligations, the payment made under the contract will not be considered to be repayments of one another. *In Re Vandervell (No. 2)*[114], it was held that on exercise, the right represented by an option cease to exist. Therefore, there would be no automatic vesting of those rights in the subject matter of the option (the underlying security or cash settlement equivalent). These option rights would simply vanish. This is the disjoint analysis.

As Hudson aptly points out, the question of which approach is to be followed depends on the intention of parties and type of instrument. His last analysis, on the basis of the analysis of the litigation, is that there is no need to consider the questions how to analyse the derivatives. Where contracting parties need to protect themselves against insolvency of the counter party, and calculate their capital adequacy standards on that basis, it is of enormous systemic importance whether

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require less compensation from the defendant. But because law of restitution is concerned with the recovery of what the defendant has gained, it follows that the fact that the claimant has passed on his or her loss is irrelevant defence to a restitutionary claim.

[113] *Supra* n. 69 at p. 62-74.

[114] [1967]1 All E.R.1.

these contractual provisions will be given effect to by the courts in the event that one party cannot perform its obligations[115].

The crux of the above analysis is that so far as derivatives are considered, it is not that significant whether the derivative contracts are considered in law as a single contract or as a number of executory contracts, common terms or as mutual debts. At the same time, the readiness of the courts to give effect to the contractual terms, in terms of a contingency is of enormous systemic importance.

NEED FOR REGULATION OF FINANCIAL MARKETS

The next aspect we need to consider is why anybody should regulate financial markets. Generally, under the *laissez-faire* theory of economics, there is no need to regulate markets. They will work on their own. However, a number of factors would require governments to regulate the markets. Market failures including risk of monopolistic tendencies, requirement of better opportunities, demands for better and effective participation by a segment of the society, development of certain preferences at an aggregate level,[116] demands for professional etiquette and public welfare, desire to prevent certain conduct that would create irreversible harm to a different set of people including future generations and efforts by interest groups

[115] *Supra* n.69 at p. 75.

[116] See https://www.boundless.com/business/textbooks/boundless-business-textbook/business-ethics-and-social-responsibility-3/promoting-ethical-behavior-34/government-regulation-178-1954/, accessed on 14.06.2016 at 22.44 hrs. This is called endogenous preferences. See Samuel Bowls, "Endogenous Preferences: The Cultural Consequences of Markets and other Economic Institutions", Journal of Economic Literature, Vol. XXXVI (March 1998), pp. 75–111 at p. 78. See also, Cass R. Sunstein, *After the Rights Revolution: Reconceiving the Regulatory State*, Harvard University Press, USA, (1993) at p. 64, where the endogenous preferences are explained in detail. It means that over time, even with perfect information and perfect foresight, an economic unit with endogenous preferences would be forced to follow an action which is different by the standards of units themselves.

for redistribution of wealth are some of the common reasons that are cited as the grounds that necessitate regulation.

Looking specifically at financial markets, the following are the reasons why markets need to be regulated. Firstly, at several points in history, financial sector had exhibited market irregularities and failures that can have devastating consequences. Secondly, there are social externalities, which make the costs of failures of financial systems far in excess of the cost to the shareholder[117]. Thirdly free money available in the financial markets attracts fraudsters. Fourthly regulation helps to increase information available to investors thereby increasing transparency, soundness and better control over the financial system[118]. Fifthly there are a large variety of risks in financial markets based on knowledge of the players about the products and regulation, which can ensure better transparency and more knowledge to the players[119]. Sixthly financial markets have increased complexity detrimental to the political process[120], and the control of economic process will be taken fully out of the hands of government if the same is left unregulated. Seventhly, the process of governance requires that the government should be able to plan to manage markets during periods of exceptional

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[117] "The Warwick Commission on International Financial Reform: In Praise of Unlevel Playing Fields", Chapter I, "Why Regulate?" The Warwick Commission, University of Warwick, U.K., November, 2009 available in http://www2. warwick.ac.uk/ research/warwick commission/financialreform/report/chapter_1.pdf, accessed on 18.04.2015 at 13.34 hrs.

[118] See http://econc10.bu.edu/Ec341_money/exams/regulateornot.htm accessed on 22.04.2015 at 09.09 hrs.

[119] Alastair Hudson, *The Law on Financial Derivatives*, Sweet & Maxwell, London, (1998), at p. xi.

[120] *Id* at p. 353.

volatility.[121] Eighthly, after the liberalisation, the government has taken serious steps to attract retail investors into the financial sector, including by providing tax benefits. Thus, the government has a moral responsibility to protect unsuspecting retail investors in the financial sector from the unscrupulous elements operating in the financial sector, so that the retail investors do not stand to lose.

As all critics agree, financial markets need to be controlled. There is difference of opinion as to who should control i.e. whether it should be self-regulation, executive regulation or legislative regulation of financial markets.

A study of history of the financial markets would show that financial derivative were in existence from the very beginning of history of financial markets, or at least for a considerably long period. As has been examined, these are basically contracts, and their usefulness depends upon goodwill and trust between parties. In small markets, the parties know each other and there is no additional requirement for protection of buyers or sellers. However, in a big and complicated market, which is spread over different legal jurisdictions and with parties coming from different legal, political, economic and cultural settings, there is a dire need to ensure that all parties have a level playing field. This is not a requirement of the regulators or the governments, but an inherent requirement for the markets themselves to sustain its competitiveness in the long run. This necessitates regulation. Financial Action Task Force (FATF)[122] report of 1999-2000 refers to

[121] *Id* at p. 354.
[122] Financial Action Task Force is an inter-governmental body established in 1989 by the Ministers of its member jurisdictions. The objectives of the FATF are to set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering,

the possibility of the money laundering operations through the derivative markets[123], which also is a compelling reason for the governments to regulate derivative markets.

A comparative study of the regulatory regimes existing in various countries only could show the similarities and dis-similarities in the approach adopted by regulators in various national jurisdictions. Such a study that would also reveal the effectiveness of regulation is undertaken in the next chapter.

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terrorist financing and other related threats to the integrity of the international financial system. The FATF is therefore a "policy-making body" which works to generate the necessary political will to bring about national legislative and regulatory reforms in these areas.

[123] See the website of FATF containing Annual Report of FATF, 1999-00 http://www.fatf-gafi.org/media/fatf/documents/reports/1999%202000%20ENG.pdf, accessed on 23.04.2016 at 19.37 hrs.

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 India[1], 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

[1]Hereinafter 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 members[2].

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 Commissions[3], Bank for International Settlements,[4]Basel Committee on Banking Supervision[5] or by specialized agencies

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[2]In 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/cri/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.

[3]Hereinafter 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.

[4]Hereinafter 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 Regulation[6], Governance LABEX ReFi[7] , Group of 30[8], 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 Europe[12], British Bankers' Association[13], Associazione Italian a

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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/FinancialIndustry_ 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 Association[19] 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" model[20].

The multitude of the regulatory agencies[21] 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,

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[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 UNIDROIT[22], UNCITRAL[23], 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 system[28]. The Council is vested with very broad powers to monitor,

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[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 members[29]. 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 $^2/_3$ 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 agencies[32].

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 it[34].

Title V of the Act deals with Insurance Reform. It established The Federal Insurance Office[35]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 issues[36].

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

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[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.
[35]See S.313 of the Dodd Frank Act.
[36]See *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 IX[44], "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 Advocate[45], an Investor Advisory Committee composed of 12–22 members who serve 4-year terms[46], 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

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

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

[42]See 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,

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[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

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[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 article[54] 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

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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 Analysis [56] outlining the activities undertook 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.

[57]See http://www.sec.gov/about/commissioner.shtml, accessed on 10.11.2015 at 16.18 hrs.
[58] In short CFTC.

3. **Federal Reserve System:** The Federal Reserve System[59] (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.

[59]Also 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. Itis 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.

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[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 outlined[68] 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 risk[69] (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 Cyclicality". 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 Wipro[74], 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,

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[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.

[71] See "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.

[72] See 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.

[73] In 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.

[74] See 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.

Ashurst[75], 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.

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[75]See https://www.ashurst.com/doc.aspx?id_Content=10297, accessed on 05.11.2015 at 16.04 hrs.
[76]*Id* at p. 1.
[77] In 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 Report[78].

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/pra/Pages/about/default.aspx, accessed on 10.11.2015 at 18.24 hrs.

In addition, the UK Competition Network[81] 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' Network[83] 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 Union[84] the following regulatory authorities also control the financial markets in EU:

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[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 ECB[87].
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:** EIOPA[93] 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

[92]ESMA 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.
[93]See 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 Appeal[96] and Stakeholder Groups[97].

CHINA

Statutory Framework:

The legal system of China is different from other countries with which this comparative study is made. According to ADB report[98] 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 System[99] 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

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[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 divisions[103] 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,

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[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 Fund[106] (2003) as amended in 2004, revised in 2012, Law on Commercial Banks,[107] 1995 as amended in 2003, The Securities Law[108] (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 that concrete steps.

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[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 body[112] over

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[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 Council[113].

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

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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.csrc.gov.cn/pub/csrc_en/about/, accessed on 16.03.2016 at 17.14 hrs.

[113]See http://www.csrc.gov.cn/pub/csrc_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] CIRC[116] 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 Committee[119] 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:

[118] See: "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).

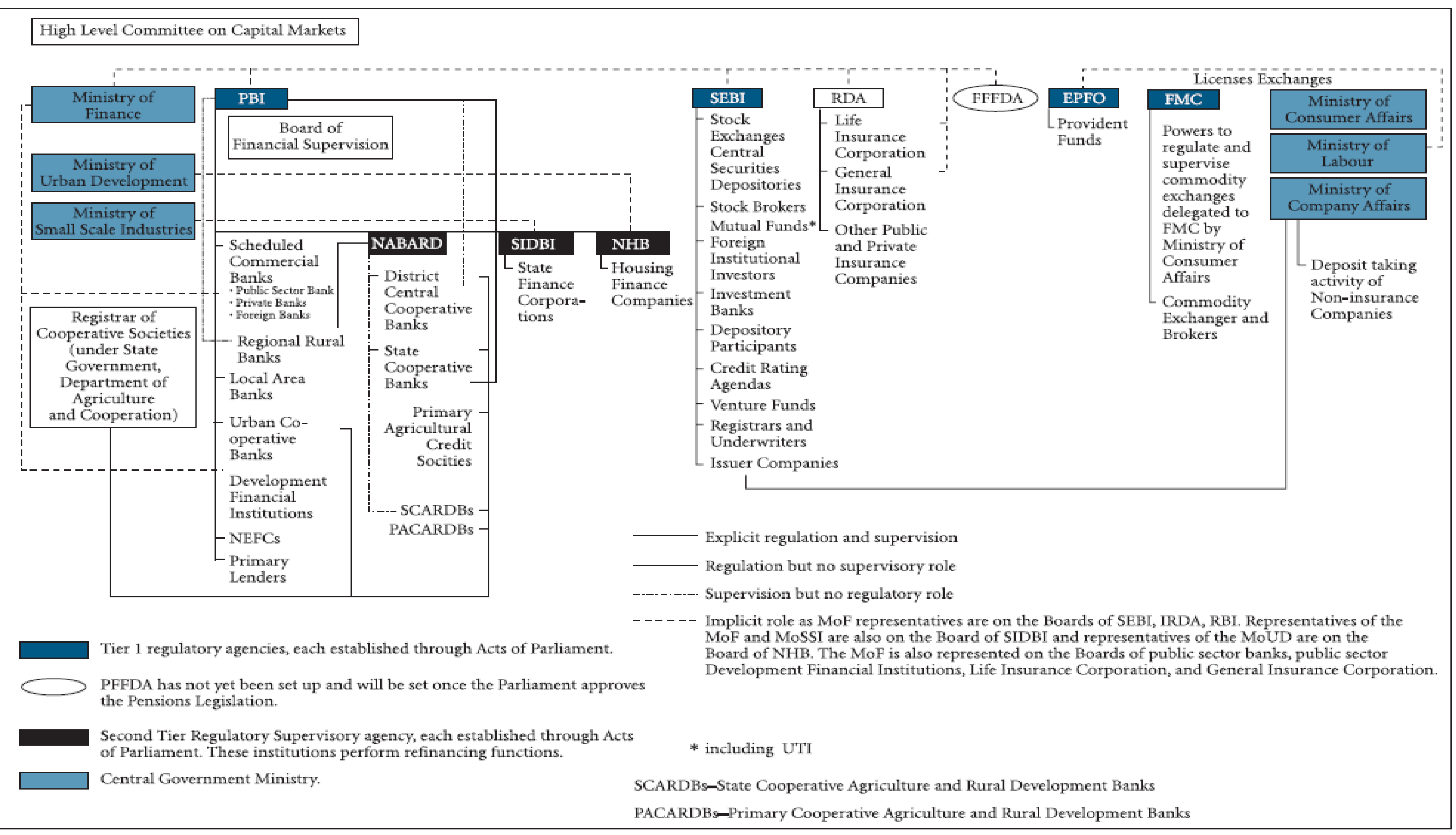

Figure 1: Current Regulatory Architecture

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 Hudson[120] has identified the following legal issues that pertain to the financial derivatives, which are almost equally applicable to most other new generation monetary instruments:

[120]Alastair 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 Hudson[121], 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.
[122]See *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

[125] Hudson 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.

CHAPTER IV

REGULATION OF FINANCIAL DERIVATIVES: INDIAN SCENARIO

In India, the regulation of financial instruments has a chequered history. India had its own unique derivative products such as "*Badla*s" and there were market-made rules governing the regulation of these products. The English, while dealing with Indian merchants were initially applying local law of India. However, with the increasing influence of English Common law, the principles of English Common law began to be applied to contracts which have the nature of financial instruments. Subsequently, when wagers fell in favour from Victorian ideals, the provincial Gaming Acts came to be enacted in India. In 1872, Indian Contract Act codified the law of contracts in India, and S. 30 of Indian Contract Act contain a prohibition of wagers, which was none other than an extension of ban on wager under provincial gaming statutes. After India became Independent, the socialistic ideals promoted promulgation of Forward Contracts(Regulation) Act[1], and Securities Contract (Regulation) Act[2], that would go on to ban the derivative products from the Indian scene. In the wake of liberalisation of 1990's the government policy changed, and these instruments became recognised through the various amendments to SCRA and FCRA. Payments and Settlements Act, 2007 also contain a definition of derivatives. The Impact of the regulation of financial instruments and the need for

[1] Hereinafter referred to as FCRA.
[2] Hereinafter referred to as SCRA.

evolving a better framework that the existing regulations prompted the Government of India to set up Financial Sector Legislative Reforms Committee to suggest comprehensive guidelines for regulation of these instruments. A bird's eye view of Indian regulatory scenario is undertaken in the following pages.

OVERVIEW OF REGULATORY FRAMEWORK AND AGENCIES IN INDIA:

As per the reference note published by Lok Sabha Secretariat for use of Members of Parliament entitled "Financial Sector in India: Regulations and Reforms"[3], India has over 60 Acts and multiple rules / regulations that govern the financial sector. According to the paper, many laws from the 1950s and the 1960s have an emphasis on banning certain financial activity, rather than on establishing regulatory structures. In fact, the article makes an interesting note about the legislations and the timely amendment process: "The result is frame works which is at times complex, ambiguous, and inconsistent and occasionally open to regulatory arbitrage." However, it has to be seen that of these 60 statutes, most of them are statutes establishing various financial institutions[4]. Some of these are substantive

[3] "Financial Sector in India: Regulations and Reforms", Reference Note .No. 15 /RN/Ref./August /2013, Lok Sabha Secretariat, Parliament Library and Reference, Research, Documentation and Information Service (LARRDIS), available in http://164.100.47.134/intranet/financialsectorinindia .pdf, accessed on 26.04.2015 at 16.10 hrs.

[4] Some of the statutes establishing financial markets are as follows: The Securities Contracts (Regulation) Act, 1956 (42 of 1956), The Depositories Act, 1996 (22 of 1996), The Public Debt Act, 1944 (18 of 1944), The Government Securities Act, 2006 (38 of 2006), The Foreign Exchange Management Act, 1999 (42 of 1999), The Banking Regulation Act, 1949 (10 of 1949), The Forward Contracts (Regulation) Act, 1952 (74 of 1952), The Payment and Settlement Systems Act, 2007 (51 of 2007), The Insurance Act, 1938 (4 of 1938), The Reserve Bank of India Act, 1934 (2 of 1934), The Securities and Exchange Board of India Act, 1992 (15 of 1992), The Deposit Insurance and Credit Guarantee Corporation Act, 1961 (47 of 1961), The Insurance Regulatory and Development Authority Act, 1999 (41 of 1999), The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970(5 of 1970), The Acts establishing bodies corporate involved in the financial sector (for example, The State Bank of India Act, 1955 (23 of 1955) and The Life Insurance Corporation Act, 1956 (31 of 1956).

legislations. Others are promulgated for establishment of various regulatory agencies, and more or less lays down the institutional framework for the financial market regulations in India. Apart from these there are several state legislations like the Gaming Acts which is making inroads into financial markets by preventing certain specific activities. According to Financial Sector Legislative Reforms Commission,[5] the current Indian laws relating to financial markets are sectorial in nature and are organized around sub-sectors of finance such as securities, insurance or payments[6].

Regulatory Agencies:

In India, the regulatory bodies that work in the financial regulatory scheme are Reserve Bank of India,[7] Securities and Exchange Board of India,[8] Forward Markets Commission,[9] Insurance Regulatory and Development Authority,[10] Pension Fund Regulatory and Development Authority,[11] Ministry of Corporate Affairs,[12] Ministry of Finance[13] and High Level Coordination Committee.[14]

These bodies work primarily within the constitutional scheme and also within the framework of general law of contracts in addition to the statutory framework mentioned above. In fact, it would be interesting to note that one of the very first

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[5]Hereinafter referred to as FSLRC.
[6] *Report of the Financial Sector Legislative Reforms Commission*, Vol. I, available at http://finmin.nic.in/fslrc/fslrc_index.asp, accessed on 10.05.2015 at 20.39 hrs, at p. 12.
[7] Hereinafter referred to as RBI.
[8] Hereinafter referred to as SEBI.
[9] Hereinafter referred to as FMC.
[10] Hereinafter referred to as IRDA.
[11] Hereinafter referred to as PFRDA.
[12] Hereinafter referred to as MCA.
[13] Hereinafter referred to as MoF.
[14] Hereinafter referred to as HLCC.

cases that went to the Judicial Committee of Privy Council from India was regarding the Opium wager popularly known as the Opium cases[15], where the Privy Council considered Hindu Law relating to wager. Erskin Perry in his classic work *Cases Illustrative of Oriental Life*[16] provides the complete text of these cases. While in a 1847 case *Ramlal Thakursidas* v. *Sujanmal Dhondmal*[17], Supreme Court of Bombay, through Pollock C.J. and Perry J, had held that though time bargains for goods may be enforced even if they are admitted by parties to be mere wagers; provided they do not come within established exceptions, quoting *Bryan* v. *Lewis*[18] the tendency of the wagers, being to create ruinous loss and to disturb the opium trade make them void as opposed to public policy.[19] Subsequently when the matter was taken to Privy Council, the Privy Council speaking through Lord Langdale, Lord Campbell, Dr. Lushington and Mr. Pemberton Leigh, held that the wagers in question were legal and not opposed to public policy, and also opined that the legislature at Calcutta may consider incorporating into statute a ban on such contracts if required. Consequent to these cases, when the Indian Contract Act was drafted, Sections 23 and 30 were incorporated to create a statutory ban on wagers. Most often the defence taken by the opposite side would be based on the fact that these types of agreements are wagering agreements and hence they are void and

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[15]See Erskine Perry, *Cases Illustrative of Oriental Manners Decided in the H.M. The Supreme Court at Bombay: The Application of English Law to India*, Asian Educational Services, Bombay (1988).
[16]*Id at p. 178.*
[17]Contract between the parties amounted to a be a wager up on average price which Opium should fetch at the next government sale at Calcutta, so that if the price falls below an agreed price, one party will have to pay the other party, the difference between this price and the sum fixed, and vice versa, if the price comes above the agreed price.
[18] See *Supra* n. 15 at p. 188.
[19]*Id* at p. 192.

unenforceable by a court of law. Indian law is replete with examples of such contracts. This makes it imperative to understand the law relating to Contract Act and the interpretation given by court to derivative contracts. Before going to that, it is also essential to understand a more basic theme: Legislative Competency, for which a clearer understanding of the Constitutional Provisions relating to the power to legislate about financial markets and products is a must.

CONSTITUTION AND FINANCIAL MARKET REGULATION

Indian Constitution provides for a framework within which the regulatory agencies have to operate in the country. The legislative scheme outlined by Art. 246[20] of the Constitution of India states that the appropriate legislative body has power to regulate the "matters enumerated in" the relevant List of 7th Schedule. Part XI read with 7th Schedule of the Constitution provides the guidelines for legislative process. According to this Constitutional scheme, Parliament of India have exclusive authority to make laws on subjects coming in List I and State Legislatures shall have exclusive authority to make laws regarding any matter which comes within List II of the 7th Schedule. Both the Parliament of India and State Legislatures have concurrent power to make laws regarding the matters enumerated in List III of the 7th Schedule of the Constitution of India.

[20]Art. 246 read as follows: "(1) Notwithstanding anything in clauses (2) and (3), Parliament has exclusive power to make laws with respect to any of the matters enumerated in List I in the Seventh Schedule (in the Constitution referred to as the "Union List). (2) Notwithstanding anything in clause (3), Parliament, and, subject to clause (1), the Legislature of any State also, have power to make laws with respect to any of the matters enumerated in List III in the Seventh Schedule (in this Constitution referred to as the "Concurrent List"). (3) Subject to clauses (1) and (2), the Legislature of any State has exclusive power to make laws for such State or any part thereof with respect to any of the matters enumerated in List II in the Seventh Schedule (in this Constitution referred to as the "State List"). (4) Parliament has power to make laws with respect to any matter for any part of the territory of India not included in a State notwithstanding that such matter is a matter enumerated in the State List.

Articles 249-255[21] provides guidelines in case of conflict between the legislative powers. Entry 43 of List I of Schedule 7 of Constitution of India reads as follows: "Incorporation, regulation and winding up of trading corporations, including banking, insurance and financial corporations, but not including co-operative societies. Entry 47 mentions "insurance" whereas Entry 48 mentions "stock exchanges and futures market." A perusal of the legislative scheme under which SEBI and IRDA works would make it clear that these bodies are established to regulate the "securities market" and "insurance business" and "re-insurance business". The term "securities market" is not defined in SEBI Act, but Sub Clause (2)(a) of Section 11 of SEBI Act gives an indication that it means any marketplace dealing in securities similar to stock exchanges. The other provisions of Section 11 also gives an indication that SEBI Act deal with entities and not the business of securities, though SEBI can regulate the market through regulation of entities which play in the market. Entry 34 of List II states "Betting and Gambling". Entry 7 of List III reads as "Contracts, including partnership, agency, contracts of carriage and other special forms of contracts, but not including contracts relating to agricultural land" and Entry 8 is "Actionable Wrongs" and Entry 9 and 10 are "Bankruptcy and Insolvency" and "Trusts and Trustees" respectively. Thus, it can

[21]Article 249 deals with the Power of Parliament to legislate with respect to a matter in the State List in the national interest. Article 250 deals with the Power of Parliament to legislate with respect to any matter in the State List if a Proclamation of Emergency is in operation. Article 251 deals with Inconsistency between laws made by Parliament under articles 249 and 250 and laws made by the Legislatures of States. Article 252 deals with the Power of Parliament to legislate for two or more States by consent and adoption of such legislation by any other State. Article 253 provides for Legislation for giving effect to international agreements. Article 254 provides to deal with situation of Inconsistency between laws made by Parliament and laws made by the Legislatures of States. Article 255 provides for Requirements as to recommendations and previous sanctions to be regarded as matters of procedure only.

be seen that there is no clear indication in the constitutional scheme regarding the regulation of financial derivatives, though by virtue of the entries nos.43, 47 and 48 of List I, Parliament of India has got the exclusive legislative power to legislate regarding the financial markets. At the same time, in case financial derivatives are considered as a type of betting, their regulation comes within the exclusive domain of respective states, and if they are contracts or actionable wrongs, the responsibility of making legislation on them are shared by both Central and State governments. To sum up, there is clear ambiguity in the Constitutional scheme regarding the regulation of financial derivatives, and SEBI or RBI can regulate these instruments only if they come within their respective domain.

CONTRACT LAW AND REGULATION OF FINANCIAL DERIVATIVES

Indian Contract Act, 1872, deals almost comprehensively with the general law of contracts in India. S. 23 of Indian Contract Act states that

> "The consideration or object of an agreement is lawful, unless-
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> it is forbidden by law; or is of such a nature that, if permitted, it would defeat the provisions of any law; or is fraudulent; or involves or implies, injury to the person or property of another; or the Court regards it as immoral, or opposed to public policy.

In each of these cases, the consideration or object of an agreement is said to be unlawful. Every agreement of which the object or consideration is unlawful is void.

The main contention that is being raised before the courts is that contracts creating such monetary instruments, being wagering agreements are opposed to public policy. This in turn takes us to the question as to what is wagering agreements.

S. 30 of the Indian Contract Act, 1872 states as follows:

> Agreements by way of wager are void; and no suit shall be brought for recovering anything alleged to be won on any wager, or entrusted to any person to abide the result of any game or other uncertain event on which any wager is made.

It is to be noted that the Indian Contract Act does not define what is a wagering agreement, but only makes it void.

OTHER STATUTES

Securities Contracts (Regulation) Act, 1956

SCRA provides that the central government has power to declare certain contracts, either in general or those executed in certain areas as illegal or void, as the case may be.[22] It also vests power in the Central Government to license dealers in certain areas and in respect of certain securities. However, by virtue of S. 18 of the said Act, Spot delivery contracts were brought outside the purview of regulations under S. 13 to 17 of the said Act. More important to our context, S. 18A reads as follows:

> Notwithstanding anything contained in any other law for the time being in force, contracts in derivative shall be legal and valid if such contracts are-
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> (a) traded on a recognised stock exchange;
>
> (b) settled on the clearing house of the recognised stock exchange, in accordance with the rules and bye-laws of such stock exchange

[22] See Ss. 13, 14 and 16 of the SCRA, 1956.

Section 18A was introduced in the statute book by the amendment to Securities Laws with effect from 22.02.2000. Though in the original statute, there was a prohibition in trading in options in Section 20 of the Act, the same was repealed by Securities Laws Amendment Act, 1995.

In the context of our discussion on regulation, it is also pertinent to keep in mind that Section 12A[23] deals with the power of SEBI to give directions, Section 21[24] lays down the conditions for listing, Section 31[25], provides the power of SEBI to

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[23]S. 12A: Power to Issue Directions: If, after making or causing to be made an inquiry, the Securities and Exchange Board of India is satisfied that it is necessary--
(a) in the interest of investors, or orderly development of securities market; or
(b) to prevent the affairs of any recognised stock exchange or clearing corporation, or such other agency or person, providing trading or clearing or settlement facility in respect of securities, being conducted in a manner detrimental to the interests of investors or securities market; or
(c) to secure the proper management of any such stock exchange or clearing corporation or agency or person, referred to in clause (b),
it may issue such directions,-
(i) to any stock exchange or clearing corporation or agency or person referred to in clause (b) or any person or class of persons associated with the securities market; or.
(ii) to any company whose securities are listed or proposed to be listed in a recognised stock exchange, as may be appropriate in the interests of investors in securities and the securities market.
[24] S. 21: Conditions for Listing: Where securities are listed on the application of any person in any recognised stock exchange, such person shall comply with the conditions of the listing agreement with that stock exchange.
[25] S.31: Power of Securities and Exchange Board of India to Make Regulations: (1) Without prejudice to the provisions contained in section 30 of the Securities and Exchange Board of India Act, 1992 (15 of 1992), the Securities and Exchange Board of India, may, by notification in the Official Gazette, make regulations consistent with the provisions of this Act and the rules made thereunder to carry out the purposes of this Act.
(2) In particular, and without prejudice to the generality of the foregoing power, such regulations may provide for all or any of the following matters, namely:--
(a) the manner, in which at least fifty-one per cent. of equity share capital of a recognised stock exchange is held within twelve months from the date of publication of the order under sub-section (7) of section 4B by the public other than the shareholders having trading rights under sub-section (8) of that section;
(b) the eligibility criteria and other requirements under section 17A.
(3) Every regulation made under this Act shall be laid, as soon as may be after it is made, before each House of Parliament, while it is in session for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the regulation or both Houses agree that the regulation should not be made, the regulation shall thereafter have effect only in such modified form or be of no effect,

make rules and Section 9 deals with the power of recognised stock exchanges to create rules, In addition to the above, Sections 23A to H of the Act, provide for punishment of the members of the recognised stock exchanges for failure to comply with the disclosure requirements mentioned in the bye laws of such stock exchanges, and performance of the fiduciary duty cast on them as members of these stock exchanges.

A perusal of the said legal provisions would show that as per the existing legal framework, SEBI is vested with the role of supervision over the Stock Exchange Brokers and other participants in the derivatives market. It is also seen, that by virtue of Section 18A[26] of SCRA, exchange traded derivative products have been made perfectly legal in India. As the wording of this Section is couched in a positive terminology, even over-the-counter derivatives cannot be said to be illegal, after the introduction of Section 18A to this statute.

Forward Contracts (Regulation) Act, 1952

There is one more statute that deals with regulation of derivative products- FCRA. The purpose of the Act was to regulate the commodity futures trade in India. Till it was repealed, Section 19 of FCRA read as follows:

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as the case may be; so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that regulation.

[26] 18A. Contracts in derivative: Notwithstanding anything contained in any other law for the time being in force, contracts in derivative shall be legal and valid if such contracts are - (a) traded on a recognised stock exchange; (b) settled on the clearing house of the recognised stock exchange, in accordance with the rules and bye-laws of such stock exchange.

(1) Notwithstanding anything contained in this Act or in any other law for the time being in force, all options in goods entered into after the date on which this Section comes into force shall be illegal.

(2) Any option in goods which has been entered into before the date on which this Section comes into force and which remains to be performed, whether wholly or in part, after the said date shall, to that extent, become void.

Further, Forward contracts in certain commodities can be regulated by notifying those commodities under Section 15[27] of the Act; forward trading in certain other

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[27] 15. *Forward contracts in notified goods illegal or void in certain circumstances*. - (1) The Central Government may, by notification in the official Gazette, declare this section to apply to such goods or class of goods and in such areas as may be specified in the notification, and thereupon, subject to the provisions contained in Section 18, every forward contract for the sale or purchase of any goods specified in the notification which is entered into in the area specified therein otherwise than between members of a recognised association or through or with any such member shall be illegal. (2) Any forward contract in goods entered into in pursuance of sub-section (1) which is in contravention of any of the bye-laws specified in this behalf under clause (a) of sub-section (3) of Section 11 shall be void- (i) as respects the rights of any member of the recognised association who has entered into such contract in contravention of any such bye-law and also, (ii) as respects the rights of any other person who has knowingly participated in the transaction entailing such contravention. (3) Nothing in sub-section (2) shall effect the right of any person other than a member of the recognised association to enforce any such contract or to recover any sum under or in respect of such contract: Provided that such person had no knowledge that such transaction was in contravention of any of the bye-laws specified under clause (a) of sub-section (3) of Section 11. (3A) Any forward contract in goods entered into in pursuance of sub-section (1) which at the date of the contract is in contravention of any of the bye-laws specified in this behalf under clause (aa) of sub-section 3 of Section 11 shall be illegal. (4) No member of a recognised association shall, in respect of any goods specified in the notification under sub-section (1), enter into any contract on his own account with any person other than a member of the recognised association unless he has secured the consent or authority of such person and disclose in the note, memorandum or agreement of sale or purchase that he has bought or sold the goods, as the case may be, on his own account: Provided that where the member has secured the consent or authority of such person otherwise than in writing he shall secure a written confirmation by such person of such consent or authority within three days from the date of such contract: Provided further that in respect of any outstanding contract entered into by a member with a person other than a member of the recognised association, no consent or authority of such person shall be necessary for closing out in accordance with the bye-laws for outstanding contract, if the member discloses in the note, memorandum or agreement of sale or purchase in respect of such closing out that he has bought or sold the goods, as the case may be, on his own account.

commodities can be prohibited by notifying these commodities under Section 17[28] of the Act.

It should be noted that despite this prohibition, both RBI and SEBI guidelines refer to Options in Interest Rates and Foreign Exchange. While an argument can be taken that these are not goods per se, it has been recognised in SEBI guidelines that there are options on indices, including commodity indices.

Originally the Act had its own regulatory body namely Forward Markets Commission. Very recently, with effect from 28.09.2015, Forward Markets Commission has been merged with SEBI, and the FCRA stood repealed from that date. The powers that were vested with Forward Markets Commission are now vested with SEBI.

REGULATORY BODIES

As noted in previous sections, there are the following nine regulatory bodies in India to regulate financial sector. These are: (1) RBI (2) SEBI (3) FMC (4) IRDA (5) PFRDA (6) MCA (7) MoF and (8) HLCC. The regulatory role of each of these agencies is examined next.

[28] 17. Power to prohibit forward contracts in certain cases. - (1) The Central Government may, by notification in the official Gazette, declare that no person shall save with the permission of the Central Government, enter into any forward contract for the sale or purchase of any goods or class of goods specified in the notification and to which provisions of Section 15 have not been made applicable, except to the extent and in the manner, if any, as may be specified in the notification. (2) All forward contracts in contravention of the provisions of sub-section (1) entered into after the date of publication of the notification thereunder shall be illegal. (3) Where a notification has been issued under sub-section (1), the provisions of Section 16 shall in the absence of anything to the contrary in the notification, apply to all forward contracts for the sale or purchase of any goods specified in the notification entered into on or before the date of notification] and remaining to be performed after the said date as they apply to all forward contract for the sale or purchase or any goods specified in the notification under Section 15.

Securities and Exchange Board of India:

The SEBI was created on April 12, 1992 in accordance with the provisions of the Securities and Exchange Board of India Act, 1992.[29] It is aimed to protect the interests of investors in securities and to promote the development of and to regulate the securities market and for matters connected therewith or incidental thereto. It consists of a Chair Person and eight member of which four, including Chairman are permanent and four members are part time. The part time members include two members nominated by the Central Government, under S. 4(1) (b) of SEBI Act from officials of the Finance Ministry and Company Affairs and one member from amongst the officials of RBI.

By virtue of the powers vested in it, SEBI has come out with its own guidelines for dealing in derivative products, by its Master Circular on Matters relating to Exchange Traded Derivatives.[30] A perusal of the said of Master Circular would show that it provides for near comprehensive guidelines with respect to (a) Index-Futures and Options (b) Stock- Futures and Options (c) Currency- Futures and Options (d) Interest rate futures on 10 year GOI Security(e) Interest Rate Futures on 91-Day Government of India (GoI) Treasury-Bill (TBill) (f) Interest Rate Futures on 2 Year Notional Coupon Bearing Government of India (GoI) Security (g) Interest Rate Futures on 5 Year Notional Coupon Bearing Government of India (GoI) Security and (h) Derivative Contracts on Foreign Indices.

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[29]Hereinafter referred to as SEBI Act.
[30]Dated 1.04.2013 available in http://www.sebi.gov.in/sebiweb/home/list/1/6/0/0/Master-Circulars, accessed on 17.05.2015 at 22.49 hrs.

In the case of Index, Stock and Currency based products the regulations cover the broad areas such as (1) Product Design (2) Risk Management and (3) Surveillance and Disclosures.

In the case of futures products, in addition to the above three, eligibility criteria for participants such as Derivative Exchange / Derivative Segment of the Exchange, Trading Members, Clearing Corporation/House for equity derivatives is also defined through these guidelines.

Under the product design criteria, the guidelines cover (a) Underlying (b) Eligibility Criteria (c) Trading Hours (d) Size of the Contract (e) Quotation (f) Tenor of the contract (g) Available Contracts (h) Settlement Mechanism (i) Settlement Price (j) Final Settlement Day and (h) Application of money.

In Currency Options Contracts, the guidelines also cover the exercise at expiry of the contract is also laid down.

Under the Risk Management aspect, guidelines are laid down by SEBI for the requirement of (a) Liquid Assets[31](b) Bank Guarantees (c) Securities (d) Initial Margin Computation (e) Margins for Calendar Spreads (f) Exposure Limits (i) Real Time Computation (g) Cross Margining (h) Margin Collection and Enforcement and (i) Reporting and Disclosure.

[31]The guidelines require that the clearing members Liquid Net Worth at any point of time shall not be less than Rs. 50 Lakhs, and the marked to market value of gross open positions (notional value in respect of Index Features at any point of time of all trades cleared through the clearing member shall not exceed 33 1/3 times (1/4) of his liquid net worth). See 1.2 of SEBI Master Circular, *Supra* n. 30.

For currency futures, in addition to above, additional guidelines regarding (a) Formula for determining standard deviation (b) Portfolio based margining (c) Extreme Loss margin (h) Liquid net worth (i) Liquid assets (j) Mark to market settlement (k) Margin collection and enforcement (l) Safeguarding client's money and (m) Periodic risk evaluation report.

Under the Surveillance and Disclosure topic the guidelines deal with (a) Unique client code (b) Position Limits (c) Monitoring of Position Limits and (d) Surveillance System.

SEBI guidelines regarding the Interest Rate Futures under the head Product Design, Margins and Position Limits, the guidelines exist regarding (1) Underlying (2) Coupon (3) Trading Hours (4) Size of the Contract (5) Quotation (6) Tenor of the Contract (7) Available Contracts (8) Delivery Month and Delivery Period (9) Daily Settlement Price (10) Settlement Mechanism (11) Deliverable Grade Securities (12) Conversion Factor (13) Invoice Price (14) Delivery Schedule and Delivery Process/Mechanism (15) Last Trading Day (16) Last Delivery Day (17) Initial Margin (18) Extreme Loss Margin(19) Calendar Spread Margin (20) Model for Determining Standard Deviation (21) Formula for Determining Standard Deviation and (22) Position Limits.

Under the head Risk Management Measures the SEBI guidelines contain (1) Introduction (2) Portfolio Based Margining (3) Real-Time Computation (4) Liquid Net worth (5) Liquid Assets (6) Mark-to-Market (MTM) Settlement (7) Margin

Collection and Enforcement (8) Safeguarding Client's Money and (9) Periodic Risk Evaluation Report.

SEBI guidelines on derivative contracts on Foreign indices cover (1) Underlying (2) Criteria (3) Failure to meet Eligibility Criteria (4) Currency Denomination (5) Risk Management Framework (6) Position Limits (7) Information Sharing (8) Legal Compliance (9) Enforcement (10) Trading, (11) Corporate Action Adjustments (12) Reporting and Disclosure including Monthly Activity Report and Reporting of derivative transactions to the media and the newspapers (13) straight through processing,[32] (14) Certification (15) Introduction of Volatility and Bond Index, which includes In Volatility Index, Derivatives on Volatility Index , bond Index, modification of client codes and penalty structure (16) modification of client codes of Non-institutional Trades Executed on Stock Exchanges (All Segments). (17) Short-collection/Non-collection of client margins, (18) Liquidity Enhancement Schemes for Illiquid Securities in Equity Derivatives Segment and (19) Requirement of Base Minimum Capital for Trading Member.

It has to be noted that in the guidelines, mention is made under the head Regulatory and Legal Aspects, about SEBI-RBI Coordination committee. SEBI-RBI Coordination Committee has an interesting back ground, related to regulation of financial derivatives. In 1969, Government of India, by a notification banned forward trading in exercise of the powers conferred under Section 16 of the SCRA.

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[32]A mechanism that automates the end to end processing of transactions of financial instruments. See page 106 of Master Circular on Matters relating to Exchange Traded Derivatives, available in http://www.sebi.gov.in/cms/sebi_data/attachdocs/1364810013011.pdf, accessed on 07.06.2016 at 21.18 hrs.

However, in 1972, Bombay Stock Exchange evolved an informal system of "forward trading" with the tacit approval of SEBI, to prevent decline of traded volumes on stock markets. This system allowed carry forward between two settlement periods, which resulted in substantial increase in the turnover of the exchange. During December 1982 - January 1983, the Government, in exercise of the powers under S. 10 of SCRA, amended the bye-laws of stock exchanges to facilitate performance of contracts in "specified securities". In pursuance of this policy the stock exchanges at Bombay, Calcutta and Ahmedabad introduced a system of trading in "specified shares" with carry forward facility after amending their bye-laws and regulations. Subsequently, in the light of a report of Joint Parliamentary Committee on Irregularities in Securities and Banking Transactions, 1992 (JPC of 1992), SEBI issued a directive in December 1993 prohibiting the carry forward of transactions. In 1995, and thereafter in 1997, SEBI reviewed this prohibition, permitting such transactions with a number of restrictions. On the other hand, in June 1992, RBI banned all repo transactions except treasury bills. This led to an anomalous situation, where some carry forward transactions were allowed, even when there was a general ban on all forward transactions. At this time, it was thought fit to amend the SCRA to give power to RBI along with SEBI to regulate these transactions. However, the question as to what powers in respect of which transactions in which securities should be delegated to RBI, since SEBI was already exercising delegated powers under SCRA, irrespective of type of transactions/securities, remained unanswered. After the passing of Securities Laws Amendment Bill in 1999, the government lifted the ban on derivative products by

notification on 01st March 2000. Subsequently, the government issued a notification delineating regulatory responsibility of RBI and SEBI. In this notification, the contracts for sale and purchase of Government securities, gold related securities, money market securities and securities derived from these securities and ready forward contracts in debt securities were to be regulated by RBI. As per the notification, such contracts if executed on stock exchanges would be regulated by SEBI in a manner that is consistent with the guidelines issued by RBI. Initially, it was believed that SEBI and RBI were acting in different turfs, with no common regulatory objectives. At a time when these regulatory agencies were viewed as departments of government, there was no issue. Subsequently, when the regulatory agencies started working as independent regulators, regulatory conflicts arose. In order to resolve such conflicts, initially RBI-SEBI Coordination Committee was created. Subsequently, further regulatory disputes evolved between other regulators also. In 2009-10 a dispute arose between IRDA and SEBI regarding Unit Linked Insurance Products (ULIP). The main point of dispute was whether the ULIPs are insurance products or “collective investment scheme” as defined in Section 2(ba) read with Section 11 AA of SEBI Act, 1992. In order to resolve the dispute, the High Level Coordination Committee was formed.

In any case, the extent SEBI guidelines recognise that there is overlapping jurisdiction of the currency futures, and leaves the same to a SEBI-RBI Constituted Committee to sort out such issues.

The term “securities market” is not defined in SEBI Act, but Sub clause (2)(a) of Section 11 of SEBI Act gives an indication that it means any marketplace dealing

in securities similar to stock exchanges. The other clauses of Section 11 also gives an indication that SEBI Act deal with entities and not the business of securities, though SEBI can regulate the market through regulation of entities which play in the market. Similarly IRDA Act also provides for regulation of entities playing in the insurance market. While it is true that these regulatory bodies also gets the power to regulate specific products through the entities floating the products, the thrust of regulation is always on the activities of the bodies which are regulated by these bodies. Thus, it is clear that the role of agencies like SEBI and IRDA are more generic in nature, viz, to control the market place rather than the specific products, which come within the purview of regulatory regime of SEBI. Only those entities venturing into any of the activities mentioned in the SEBI Act could be regulated by SEBI. Similar is the case of IRDA. As such it should be seen that those entities carrying on a business or activity that comes within the purview and already regulated by one of such authority should not normally come within the regulatory regime of the other.

These provisions have been responsible for non-overlapping of the regulatory powers in India. Further unlike many other countries, regulation through specialized agencies is a relatively new phenomenon in India. Till very recently regulation was mainly done through the various departments of the government itself. This is also one good reason why regulatory overlapping was not very frequent in India. However even during the time regulation was handled by the various departments of government, there were disputes as to the jurisdiction and powers of various departments. In most of these cases resolution was possible

without going for a legal battle since the matter involved the same branch of the government. However since the evolution of regulation through self-sustaining corporate bodies, the dispute resolution has become more difficult especially since jurisdiction means power and no regulatory body would be willing to forgo the power that comes along with the jurisdiction. In order to avoid such regulatory dispute, Raghuram Rajan Committee on Financial Sector Reforms has proposed establishment of a Financial Stability and Development Council which the planning commission has said would solve most of the issues relating to regulatory competition. However, the government, in its wisdom initially set up High Level Coordination Committee (HLCC) on financial and capital markets, which had the all regulators as members, chaired by the RBI Governor. Subsequently, the Government thought it fit to introduce Securities and Insurance Laws (Amendment and Validation) Ordinance, 2010, which replaced HLCC with Financial Stability and Development Council (FSDC) - a joint committee headed by the Finance Minister, with the financial sector regulators (such as the RBI, the SEBI, the IRDA and the Pension Fund Regulatory and Development Authority) and Finance ministry officials as members. At present, there is a move to amend the RBI Act to take away money market regulatory powers from the RBI and bring it under the purview of market regulator SEBI[33]. There is also a proposal for merger of SEBI and FMC[34]. According to Financial Sector Legislative Reforms Committee

[33] See "SEBI Needs More Powers to Deal with FMC Issues: FSLRC Chief", March 10, 2015, http://www.moneycontrol.com/news/business/sebi-needs-more-powers-to-dealfmc-issues-fslrc-chief_1324670.html, accessed on 18.05.2015 at 23.00 hrs.
[34] *Ibid.*

Chairman Justice B.N. Srikrishna[35], the move is welcome as it would make both the regulators more autonomous and SEBI needs more power than at present at hand with it to deal with Forwards Market Commission issues.

Reserve Bank of India:

RBI, as the central banker of the country as well as the formulator of monetary policy guidelines for the financial sector is also involved in the regulation of these financial products. The role of RBI in regulating these products are in two dimensions: firstly as a central banker and secondly as the regulator of foreign exchange dealings. RBI has in place a Comprehensive Guidelines on Derivatives,[36] as modified in 2011, and the same is currently undergoing revision. At present RBI is circulating a Draft Comprehensive Guidelines on Derivatives,[37] intended to replace the present guidelines.

Draft RBI Guidelines start with defining derivatives, markets, participants, purpose and eligibility criteria. What is important about the definitions in comparison with SEBI guidelines is that while SEBI guidelines cover only exchange traded products, RBI guidelines recognise and brings Over the Counter Derivatives into the regulatory capture. It also recognises two types of participants in the derivatives transactions: (1) User, who participates in the derivatives market to manage an underlying risk and (2) Market Maker, who provides continuous bid and offer prices to users and other market-makers, even without having an underlying risk,

[35] *Ibid.*
[36] Circular DBOD No.BP.BC.86/21.04.157/2006-07 dated April 20, 2007.
[37] See RBI website at https://rbi.org.in/scripts/Bs_viewcontent.aspx?Id=457, accessed on 18.05.2015 at 23.24 hrs.

and specifies that at least one party to a derivative transaction should be a market maker. RBI guidelines also puts eligibility criterion for both market makers (Scheduled Commercial Banks (excluding RRBs) & Primary Dealers (PDs)) and users (any entity with identified underlying risk exposure). Market makers need to have RBI approval to operate as market makers in the desired markets. The draft guidelines provide for the following broad principles while undertaking derivative transactions, of which the six are mandatory and two optional.

1. Market-makers may undertake any derivative structured product (a combination of permitted cash and generic derivative instruments) as long as it is a combination of two or more of the generic instruments permitted by RBI and the market-makers should be in a position to mark to market or demonstrate valuation of these constituent products based on observable market prices. Hence, it may be ensured that structured products do not contain any derivative, which is not allowed on a stand-alone basis. Moreover, second order derivatives, like swaption, option on future, compound option, etc. are not permitted.
2. A user should not have a net short options position, either on a stand-alone basis or in a structured product, except to the extent of permitted covered calls and puts.
3. All permitted derivative transactions, including roll over, restructuring and novation shall be contracted only at prevailing market rates. Mark-to-market gain/loss on roll over, restructuring, novation, etc. should be cash-settled.

4. All risks arising from derivatives exposures should be analysed and documented.

5. The management of derivatives activities should be an integral part of the overall risk management policy and mechanism. It is desirable that the board of directors and senior management understand the risks inherent in the derivatives activities being undertaken.

6. Market-makers should have a 'Suitability and Appropriateness Policy' vis-à-vis users in respect of the products offered, on the lines indicated in these guidelines.

7. Market-makers and users regulated by RBI should not undertake any derivative transaction involving the rupee that partially or fully offset a similar but opposite risk position undertaken by their subsidiaries/branches/group entities at offshore location(s).

8. Market-makers may maintain cash margin/liquid collateral in respect of derivative transactions undertaken by users on mark-to-market basis, irrespective of the latter's credit risk assessment[38].

RBI guidelines recognise only the following types of derivative instruments at present:

These regulations also cover in detail risk management and corporate governance aspects, such as (a) Corporate governance (b) Board and senior management oversight, (c) Suitability and Appropriateness Policy (d) Documentation (e)

[38]See *Supra* n. 37

Identification of risk (f) Risk measurement (g) Risk Limits (h) Management Information Systems (i) Independent risk control (j) Operational controls (k) Internal audit (l) Prudential norms relating to derivatives (m) Prudential limits on derivatives and (n) Regulatory reporting and balance sheet disclosures.

The Master Circular identifies and defines seven types of risk in monetary instruments being such as derivatives, including (1) Credit Risk, which includes (a) Settlement Risk and (b) Pre-settlement Risk (2) Market Risk (3) Liquidity Risk, including market liquidity risk and funding risk (4) Operational Risk (5) Legal Risk (6) Regulatory Risk and (7) Reputation Risk and attempts to mitigate these risks.

So far as guidelines is that it gives clear recommendations on operational control is concerned, the RBI guidelines direct the entities to ensure complete operational control by (1) Segregation of duties (2) Trade Entry and Transaction Documentation (3) Confirmation Procedure that provide for a documentation trail, (4) Settlement and Disbursement Procedures [39] (5) Reconciliation Procedures [40] (6) Revaluation Procedure[41] and (7) Exception Reports[42].

A comparison of the guidelines issued by SEBI and RBI reveal that SEBI guidelines are more sector-specific whereas the RBI guidelines are more product-specific. In fact the regulatory understanding in India is that RBI's power of

[39] These provide for specific procedure for fund transfer and independent reconciliation of transferred funds with NOSTRO accounts and general ledger

[40] It requires audit trail and reconciliation of unusual items and any items outstanding for inordinately long period

[41] It require full documentation of revaluation rates and calculations, which need be obtained from or verified by a source independent of dealers, representative of market levels.

[42] These reports would track frauds, errors and losses

regulation is restricted to currency based or monetary derivatives[43], whereas SEBI is the regulator for all other types of derivative instruments. While SEBI guidelines speak to the consumer, RBI guidelines are intended to ensure that market players such as banks and Primary Dealers should comply with prudential norms and regulates behaviour of the market agents.

Forward Markets Commission:

Under the FCRA, the Forward Markets Commission (FMC) was the chief regulator of commodity futures markets in India. It consisted of not less than two but not exceeding four members appointed by the Central Government, out of them one being nominated by the Central Government to be the Chairman of the Commission. Initially the commission was acting as a department under Ministry of Consumer Affairs, Food and Public Distribution, but since September 2013, the Commission was moved under Ministry of Finance recognizing its importance in the monetary policy of the country.

Forward Markets Commission used to provide regulatory oversight in order to ensure financial integrity (i.e. to prevent systematic risk of default by one major operator or group of operators), market integrity (i.e. to ensure that futures prices are truly aligned with the prospective demand and supply conditions) and to protect and promote interest of customers /non-members.

The Forward Markets Commission used to prescribe the following regulatory measures:

[43]See page 179

a) Limit on net open position as on the close of an individual operator and at Member level to prevent excessive speculation.
b) Circuit-filters or limit on price fluctuations to allow cooling of market in the event of abrupt upswing or downswing in prices.
c) Imposition of margins to prevent defaults by Members/clients.
d) Physical delivery of contracts and penalty for default/delivery obligations.
e) Daily mark to marketing of the contracts[44]

The Commission had also prescribed simultaneous reporting system for the Exchanges following open out-cry system, to facilitate audit trail and make it difficult for the members to indulge in malpractices such as trading ahead of clients.

In the Finance Act, 2015, the Government of India has announced that FCRA will be repealed and the regulation of Commodity Derivatives Market will shift to SEBI under SCRA, 1956[45]. Accordingly in a press release[46], Ministry of Finance, Government of India has announced September 28, 2015 as the date on which FCRA, 1952 will get repealed. As on date, the FMC became merged with SEBI.

Other Regulatory Agencies in India:

Other than SEBI, RBI and FMC, there are bodies like SEBI-RBI Coordination Committee, HLCC, MoF and Ministry of Corporate Affairs in India in the area of

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[44]See http://fmc.gov.in/index2.aspx?slid=143&sublinkid=685&langid=2, accessed on 19. 05. 2015 at 10.15 hrs.
[45]See S. 131, 133 of Finance Act, 2015(Act 20 of 2015).
[46]See http://finmin.nic.in/press_room/2015/FCRAcommodityDerivatiesSEBI2015.pdf, accessed on 03.09.2015 at 8.32 hrs.

regulation of these instruments. These are basically regulatory coordination bodies to smoothen out differences between regulatory bodies.

In a paper entitled "*Unit Linked Insurance Products and Regulatory Tangle,"*[47] examining the regulatory framework for regulation of such products, a perusal was made of the legislative scheme under which SEBI and IRDA works. It would make clear that these bodies are established to regulate the "securities market" and "insurance business" and "reinsurance business." Further the SEBI Act mentions certain specific type of entities.

Apart from the above, there are other regulatory agencies in such as IRDA,[48] PFRDA[49] that deal with specific areas of financial markets. There are also other sector specific laws, such as cooperative society's laws, and other state laws, that govern these areas. They are not dealt with in detail for two reasons: (1) They do not deal with monetary instruments as their primary focus, and (2) The activities, within their regulatory capture is also covered by any of the major regulators.

[47] (2011) PL February S-12.
[48]Established under Insurance Regulatory and Development Authority of India Act, 1999.
[49]Established under Pension Fund Regulatory & Development Authority Act, 2013.

CHAPTER V

JUDICIAL RESPONSE TO REGULATION OF FINANCIAL DERIVATIVES

While dealing with judicial response to financial instruments including derivative instruments, we need to focus on how the judiciary has viewed individual instruments rather than how it has viewed institutional regulation. The very reason for this is that litigation has never been instituted against institutional regulation, and much work in this area has been done through advocacy and policy interventions by players, individually as well as through groupings of dealers and players such as I.S.D.A. At the same time, as has been seen in earlier chapters, from quiet early days traders used to indulge in creation of this exotic variety of financial products. When the understanding between the parties to the instruments fell foul the losing party used to appear before courts seeking intervention. Eddy Wymeersch in his working paper entitled "Regulation and Case law relating to Financial Derivatives,"[1] has categorised cases relating to financial derivatives as follows: The cases dealing with (a) Judicial Competence[2] (b) Contractual Illegality and (c) Risk arising out of incomplete disclosure.[3] If we refer to a single jurisdiction, it will be difficult to find litigations in all these categories. In Indian context, the question of judicial competence arose with respect to expertise and the

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[1] http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1988925, accessed on 21.01.2016 at 01.08 hrs.

[2] In this head, the major issue dealt with in the paper is how far UK courts can exercise jurisdiction over bodies outside its territorial jurisdiction. UK courts generally conclude to UK competence, while in several cases the court of the debtor has found ways to affirm their own jurisdiction.

[3] The article mainly analyses decisions of European Court, Belgium, Germany and Italy.

courts have generally found against competence of Indian Courts in cases where there is an arbitration clause. We need to take a closer look at the judicial response to get a clear picture.

INDIAN COURTS AND FINANCIAL INSTRUMENTS

In India, in most of the cases relating to contracts creating monetary instruments, the challenge to the transaction is under Sections 30 and 23 of Indian Contract Act. In fact the legal development relating to the financial instruments can be divided into five phases[4] as follows:

First Phase: Period upto 1848, when the law relating to such contracts were governed by Common law of England and personal law.

Second Phase: From 1848 to 1917, when the law relating to financial derivatives was governed initially by the Provincial Gaming statutes and then by Section 30 of Indian Contract Act. Judicial attitude was towards accepting the wagers as void contracts. During this phase, the strength of Indian futures industry started weakening.

Third Phase: From 1917 to 1950's, when judicial pronouncements started opening up ways for maintaining the financial market for derivatives contracts.

Fourth Phase: From 1950s till 1996, when FCRA and SCRA put a ban on financial derivatives, pushing the financial derivatives industry in India to the grey market.

[4]The periods are not delineated on the basis of year on which the case was reported, but on the basis of the period on which the contract was entered into. It may also be kept in mind that the periods are not calculated exactly but roughly.

Fifth Phase: In 1996 when SCRA was amended to allow derivatives trading in India, judicial recognition of financial derivatives followed through.

A detailed analysis of the above five phases are undertaken below:

First Phase: Open Phase

During the initial period of development of judicial precedents relating to financial derivatives, the courts considered instruments that are today considered as financial derivatives as acceptable contracts. Hence this period can be generally considered as an open phase, where there was no statutory restriction on these instruments, and the courts were liberal in giving legal validity to these contracts on the basis of the personal law of different communities in India.

In 1848, while dealing with one of the earliest reported cases on wager based on a financial contract which can be termed similar to a modern day options contract namely; *Ramlal Thakursidas* v. *Sujanmal Dhondmal*[5], the Privy Council analysed the law relating to wager in Hindu Law. It was held that there is no provision dealing with wagers in Hindu Law. Therefore the Privy Council applied common law of England and held that the wagers are not illegal[6]. Judicial Committee of the Privy Council expressly ruled that the common law of England was in force in India and under that law an action might be maintained on a wager. The wager dealt with in that case was upon the average price which opium would fetch at the next Government sale at Calcutta. Lord Campbell in rejecting the plea that the wager was illegal observed:

[5] (1848) 4 M.I.A. 339.

[6] *Id* at p. 127.

> The Statute, 8 & 9 Viet. c. 109[7], does not extend to India' and although both parties on the record are Hindoos, no peculiar Hindoo law is alleged to exist upon the subject; therefore this case, must be decided by the common law of England.[8]

Within two years, in 1850, the Privy Council was again seized of another dispute relating to a derivatives contract. In *Doolubdass Pettamberdass* v. *Ramloll Thackoorseydass and others*[9], the court had to consider a contract based on the price that the Patna opium would fetch at the next Government sale at Calcutta. The plaintiff had instituted a suit in the Supreme Court of Bombay in January, 1847, to recover the money won on a wager. After the suit was filed, Act for Avoiding Wagers, 1848 was passed by the Indian Legislature. Under this Act all agreements whether made in speaking, writing or otherwise, by way of gaming or wagering, would be null and void and no suit would be allowed in any Court of Law or Equity for recovering any sum of money or valuable thing alleged to be won on any wager. This Section was similar in terms to that of Section 18 of the Gaming Act, 1845 of England. Their Lordships at Privy Council held that the contract was not void and the Act for Avoiding Wagers, 1848 would not invalidate the contracts entered into before the Act came into force.

Subsequently in *Raghoonauth Sahoi Chotayloll* v. *Manickchund and Kaisreechund*[10] also, the Judicial Committee of the Privy Council held that a wagering agreement in India upon the average price opium would fetch at a

[7] English Gaming Act of 1845.
[8] Id. at p. 349.
[9](1850) 5 M.I.A. 109.
[10](1856) 6 M.I.A. 251.

future Government sale, was legal and enforceable before the passing of the Act for Avoiding Wagers, 1848.

An analysis of these decisions show that in the first phase of development of law relating to wagers, i.e., before the enactment of the Act for Avoiding Wagers, 1848, wagering agreements were governed by the common law of England and were not void and therefore enforceable in Courts. They also held that the Hindu Law did not prohibit any such wagers.

A close analysis of the historical perspective of these cases further show that, these cases arose in a period during the last days when the English East India Company was at the helm of affairs in India. English East India Company, being a trading company, had to indulge in futures trading and at times into options trading to keep its profitability up. Hence the English Courts could not have turned a blind eye to the necessity of keeping these contracts legal. Even while the courts found on facts that such a contract, which has already stated, have all the trappings of a modern day options contract, was a wagering agreement. It was also consistently held that an action might be maintained on a wager. However, such a contract is enforceable if it was not against the interest or feelings of third persons did not lead to indecent evidence and was not contrary to public policy.

Second Phase: From 1848 to 1917: Prohibition Days

In 1848, the Gaming Acts were passed and subsequently the Indian Contract Act, 1872 incorporated a ban on wagering agreements in Section 30 of the said Act. The

anti-gaming movement[11] in England that culminated in the passing of Gaming Act, 1845 also found its resonance in India, whose governance was taken over from the English East India Company by the British Government in 1848. In 1848 itself, the Gaming Act was introduced in India in the model of English Gaming Act. Act 21 of 1848 named an Act for Avoiding Wagers, 1848 was passed by the Indian Legislature. The said Act was based principally on Section 18 of the English Gaming Act of 1845, and it was repealed by the Contract Act, 1872. During this period, the Indian Courts followed the legislative intention and the English Courts by taking a position that when a certain class of agreement has indisputably been treated as a wagering agreement in England it ought to receive the same treatment in India.

However, it was during this period, that the English Courts started holding that contracts collateral to the wagering agreements are legal and hence enforceable. Hence in *Pringle* v. *Jafar Khan*[12] wherein an agent who paid the amount of betting to the principal was allowed to recover the same from the principal, holding that:

> There was nothing illegal in the contract; betting at horse-races could not be said to be illegal in the sense of tainting any transaction connected with it. This distinction between an agreement which is only void and one in which the consideration is also unlawful is made in the Contract Act. Section 23

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[11] During the 1830's, a concerted effort was made by various anti-gambling groups to demand legislation. Well publicised betting frauds, the publication of anti-gambling literature or fictional literature which portrayed lower class gambling as immoral (such as Nimrod's Anatomy of Gaming), resentment at the corrupt lotteries held from 1793, and the mass losses of the South Sea Bubble affair in 1720 culminated in House of Lords setting up a Select Committee on Gaming in 1844 and the introduction of Gaming Act, 1845: See http://www.gamblingconsultant.co.uk/ articles/a-history-of-gambling-in-the-uk-until-1960, accessed on 27.09.2015 at 11.13 hrs.

[12](1883) I.L.R. 5 All. 443.

> points out in what cases the consideration of an agreement is unlawful, and in such cases the agreement is also void, that is, not enforceable at law. Section 30 refers to cases in which the agreement is only void, though the consideration is not necessarily unlawful. There is no reason why the plaintiff should not recover the sum paid by him…[13]

Later in *Beni Madho Das* v. *Kaunsal Kishor Dhusar*[14] the plaintiff who lent money to the defendant to enable him to pay off a gambling debt was given a decree to recover the same from the defendant. Similarly in *Shibho Mal* v. *Lachman Das*[15], an agent who paid the losses on the wagering transactions was allowed to recover the amounts he paid from his principal.

Following these cases, in 1901 itself, the Privy Council, in *Kong Lee Lone and Company* v. *Lowjee Nanjee (Rangoon),*[16] after examining Section 30 of Indian Contract Act had held that two parties may enter into a formal contract for the sale and purchase of goods at a given price and for the delivery at a given time, but if the circumstances are such as to warrant a legal inference that they never intended any actual transfer of goods at all, but only to pay or receive money between one another accordingly as market price of the goods should vary from the contract price at the given time, that is not a commercial transaction at all, but a wager on the rise or fall of the market. In this case, the Privy Council examined the classes of the contract between the parties and held that there is a common intention to wager considering the fact that out of the two classes of contract entered into

[13]*Id* at p. 445.
[14](1900) I.L.R. 22 All. 452.
[15](1901) I.L.R. 23 All. 165.
[16] [1901] UKPC 26 (13 June 1901).

between the parties to the said suit, the consideration of the promissory notes sued was a number of wagering agreements within the meaning of the Indian Contract Act and hence void. This stand brought out the category of instruments that are currently classified as swaps[17] from the purview of law and made them void and un-enforceable by law. At the same time, the law in a way recognised that futures contract, with an intention to buy and sell, at the future date, will not be considered as a wager.

Thus it can be seen that the general trend of the second phase was that most financial derivative transactions of this period, characterised by *Badla* and futures transactions in opium and cotton were held to be wagers and hence pushed off to the grey market. The courts also started a new trend of recognizing as valid, collateral agreements which were entered for the purpose of facilitating the contracts which were termed as wagering agreement. In this phase itself, the courts started giving legal recognition to a pure futures contract as legal, and the contracts which had options and swaps element in it were considered as wager and hence were declared void.

Third Phase: From 1917 to 1950's: The Partial Reopening

In fact the seeds of third phase was marked with the decision of *Kong Lee Cone*[18] itself, but the same was clearly established in 1917 when in *Bhagwandas Parasram (a firm)* v. *Burjorji Ruttonji Bomanji since deceased, (now represented by*

[17] See Chapter II for a detailed discussion on swaps.
[18] *Supra*.n. *16.*

Dulichand Shivlal) (Bombay)[19], the Privy Council held that speculation does not necessarily involve a contract by way of wager and to constitute such a contract a common intention to wager is essential. Privy Council, in this case, clearly set a distinction between speculative investments and contracts of wager. According to the Privy Council, only where there was a common intention of wager, a contract would become wager and therefore void. Where there was one sided speculation, these contracts are enforceable and the plaintiff can recover the amount from the defendant. [20]

Subsequently in *Md. Gulam Mustafakhan* v. *Padamsi*[21], where two partners entered into a contract of wager with a third party and one partner had satisfied his own and his co- partner's liability under the contract, the Hon'ble Nagpur High Court held that the partner who paid the amount could legally claim the other partner's share of the loss. The Court held that Section 30 of the Indian Contract Act does not affect agreements or transactions collateral to wagers.[22]

[19] [1917] UKPC 97 (26 November 1917).
[20]The facts of the case are as follows: The plaintiffs were a large firm carrying on mercantile business in Bombay and the defendant was a speculator. In June and July 1910 the defendant instructed the plaintiff to sell for him several lots of linseed amounting in all to 4000 tons for September delivery. On the strength of this order, the plaintiff sold linseed to this amount by separate contracts to 39 buyers. Though the transactions took the form of sales by defendant to the plaintiffs followed by resale by the plaintiffs to 39 buyers, the plaintiffs acted throughout as mercantile agents (Pakkaadatias), and to secure against them against loss, the defendant was made to deposit Rs. 61,000/- as margin money with the plaintiff. The market went against the defendant, and at the end of August, the plaintiff asked him, either to give delivery of the linseed or to authorise them to purchase linseed on his behalf. The defendant had neither of these, and therefore the plaintiff, acting within their rights, discharged their obligation to the 39 buyers by delivering 300 tons of linseed, and by making cross contracts, and paying differences as to the balance of linseed as a result Rs. 90,000/- was due from the defendant to the plaintiff. When the plaintiff sued the defendant for recovery of this money, the defendant set up a claim that the contract being a wagering contract is void ab initio and he is not liable to make payments on the said contract.
[21] A.I.R. 1923 Nag. 48.
[22]*Id* at p. 49.

An analysis of these decisions in the historical context would show that during the 1900's the British trade had got a huge competition from the European and US counter parts. In fact, this period saw the financial markets turning to be a major player in the world economy. The two World Wars needed huge funds and the business needs of the time might have forced judicial thinking into finding of ways to recognise these contracts, so that financial innovation and flow of funds is not hampered by the legislative propositions of an earlier period. Thus evolved settling the principle that a wagering agreement was only void, but not illegal, and therefore a collateral contract could be enforced. It may be noted in this context that futures trading in raw Jute and Jute goods began in Kolkata with the establishment of the Calcutta Hessian Exchange Ltd. in 1919, and futures markets in wheat were in existence at several centres in Punjab and Uttar Pradesh; the most notable among them being the Chamber of Commerce at Hapur, which was established in 1913. Futures market in Bullion began in Mumbai as early as 1920. The volumes of trade in these derivatives markets were reported to be extremely large during this period. All this would show that during this third phase, the futures market thrived in India on account of judicial recognition of collateral contracts, and recognition of futures contract as legal.

Fourth Phase: The Regulation Phase

The Socialistic fervour of the Nehruvian era in the first few decades of Independence marked the beginning of this new phase in the derivative regulation. Right from 1930's itself the British rulers of India felt that the derivatives trading in food commodities were responsible for the inability of the government to control

its flow. In The Defence of India Act, 1935, there were provisions aimed in part to restrict and directly control food production. This included the ability to restrict or ban the trading in derivatives on those food commodities. With this, futures trading became subject to restrictions/prohibitions from time to time. After Independence, the Union Government enacted the Forward Contracts (Regulation), 1952. This Act provided for prohibition of options in commodities, and the regulation and prohibition of futures trading. By the mid-1960s, the Government imposed a ban on derivatives contracts on most commodities, except very few not so important commodities like pepper and turmeric. The apprehensions about the role of speculation, particularly under scarcity conditions, prompted the Government to continue the prohibition till very recently[23].

In 1959, in *Gherulal Parakh* v. *Mahadeodas Maiya And Others*[24], the Hon'ble Supreme Court of India considered the question whether an agreement of partnership with the object of entering into forward contracts for the purchase and sale of wheat with two other firms, was illegal within the meaning of Section 30 of Indian Contract Act, 1872. The Hon'ble Supreme Court, after considering the various legal texts based on Indian Contract Act, 1872 as well as Gaming Acts of 1845 and 1892, which laid down the law relating to such contracts in England, held that at common law, wagers were not illegal, and were only made null and void by the statutory provision. Hence a partnership entered into for a collateral purpose and not for a wagering agreement will be enforceable in law.

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[23]See Suchismita Bose, "The Indian Derivatives Market Revisited", *Money & Finance*, (ICRA Bulletin), (Jan-Jun 2006), at p. 89.
[24] A.I.R. 1959 S.C. 781, 1959 S.C.R. Suppl. (2) 406.

In the said case, the agreement in question was assailed on the ground that it was void under Section 23 of Indian Contract Act, 1872, and that engaging in forward contracts being speculative, the consideration is opposed to public policy, and hence unlawful and therefore void. The Hon'ble Supreme Court after adverting to the earlier decisions relating to Section 23 of Indian Contract Act, 1872, held that:

> Although the rules already established by precedent must be moulded to fit the new conditions of a changing world, it is no longer legitimate for the Courts to invent a new head of public policy. A judge is not free to speculate upon what, in his opinion, is for the good of the community. He must be content to apply, either directly or by way of analogy, the principles laid down in previous decisions. He must expound, not expand, this particular branch of the law.[25]

Even though the contract is one which *prima facie* falls under one of the recognised heads of public policy, it will not be held illegal unless its harmful qualities are indisputable[26]. There upon the court moved forward to examine each of these individual cases and again coming back to wagering agreements held:

> Courts under the common law of England till the year 1845 enforced such contracts even between parties to the transaction. They held that wagers were not illegal. After the passing of the English Gaming Act, 1845 (8 & 9 Vict. c. 109), such contracts were declared void. Even so the Courts held that though a wagering contract was void, it was not illegal and therefore agreement collateral to the wagering agreement could be enforced. Only after the enactment of the Gaming Act, 1892 (55 Vict. c. 9), the collateral contracts also became unenforceable by reason of the express

[25] *Id* para 44.
[26] *Id para* 44.

> words of that Act. Indeed, in some of the decisions cited *supra* the question of public policy was specifically raised and negatived by Courts.... It is therefore abundantly clear that the common law of England did not recognise any principle of public policy declaring wagering agreements illegal. The legal position is the same in India. The Indian Courts, both before and after the passing of the Act 1 of 1848 and also after the enactment of the Contract Act have held that the wagering agreements are not illegal and the collateral contracts in respect of them are enforceable.[27]

Thereafter the Hon'ble Supreme Court summarized the position as regards to public policy in respect to such agreements:

> To summarize: The common law of England and that of India have never struck down contracts of wager on the ground of public policy; indeed they have always been held to be not illegal notwithstanding the fact that the statute declared them void. Even after the contracts of wager were declared to be void in England, collateral contracts were enforced till the passing of the Gaming Act of 1892, and in India, except in the State of Bombay, they have been enforced even after the passing of the Act 21 of 1848, which was substituted by s. 30 of the Contract Act. The moral prohibitions in Hindu Law texts against gambling were not only, not legally enforced but were allowed to fall into desuetude. In practice, though gambling is controlled in specific matters, it has not been declared illegal and there is no law declaring wagering illegal. Indeed, some of the gambling practices are a perennial source of income to the State. In the circumstances it is not possible to hold that there is any definite head or principle of public policy evolved by Courts or laid down by precedents which would directly apply to wagering agreements. Even if it is permissible for Courts to evolve a new head of public policy under extraordinary circumstances giving rise to incontestable harm to the society, we cannot say that wager is one of such instances of

[27] *Id para* 64.

exceptional gravity, for it has been recognised for centuries and has been tolerated by the public and the State alike. If it has any such tendency, it is for the legislature to make a law prohibiting such contracts and declaring them illegal and not for this Court to resort to judicial legislation[28].

Again on the question of immorality of these transactions, the Hon'ble Supreme Court held:

> Decided cases and authoritative text-book writers, therefore, confined it, with every justification, only to sexual immorality. The other limitation imposed on the word by the statute, namely; "the court regards it as immoral ", brings out the idea that it is also a branch of the common law like the doctrine of public policy, and, therefore, should be confined to the principles recognised and settled by Courts. Precedents confine the said concept only to sexual immorality and no case has been brought to our notice where it has been applied to any head other than sexual immorality. In the circumstances, we cannot evolve a new head so as to bring in wagers within its fold.[29]

In 1956, SCRA was enacted. In 1969 by virtue of notification[30] issued under Section 16 of the said Act, the Central Government banned with immediate effect all forward trading in shares at all the stock Exchanges in the country by declaring:

> No person, in the territory to which the said Act extends, shall, save with the permission of the Central Government, enter into any contract for the sale or purchase of securities other than such spot delivery contract or contract for cash or hand delivery or special delivery in any securities as is permissible under the said Act and the rules, bye laws and regulations of a recognised Stock Exchange.

[28] *Id para* 64.
[29] *Id para* 69.
[30] No. S.O. 2561 dated June 27, 1967.

However, it was directed with regard to the forward contracts which remained outstanding as on the date of the said notification that these could be closed or liquidated in the normal manner.

Later in *Shivnarayan Kabra* v. *State of Madras*[31], the Hon'ble Supreme Court had occasion to deal with applicability of S. 15 r/w S. 21 of FCRA which imposed penal liability of any person trading in forward contracts without being member of a recognised association. The contention of the appellant was that contracts in this case were not really meant for delivery of goods but were speculative in character. The Court, after applying the mischief rule[32], held that:

> …the Act was passed in order to put a stop to undesirable forms of speculation in forward trading and to correct the abuses of certain forms of forward trading in the wide interests of the community and, in particular, the interests of the consumers for whom adequate safeguards were essential. In our opinion, speculative contracts of the type covered in the present case are included within the purview of the Act.

What makes the case contextual to our present discussion is that the court acknowledged the need for the legislation by referring to the following passage from the report of expert committee to which the Forward Contracts (Regulation) Bill was referred to prior to its enactment, to approve the concerns behind passing of the statute as valid:

[31] 1967 KHC 613, A.I.R. 1967 S.C. 986, 1967 Cri. L.J. 946, 1967(1) S.C.R. 138.

[32] The mischief rule was established in Heydon's Case [1584] EWHC Exch J36. Under the mischief rule the court's role is to suppress the mischief the Act is aimed at and advance the remedy.

> To the extent to which forward trading enables producers, manufacturers and traders to protect themselves against the uncertainties of the fixture, and enables all the relevant factors, whether actual or anticipated, local or international, to exercise their due influence on prices, it confers a definite boon on the community, because, to that extent, it minimises the risks of production and distribution and makes for greater stability of prices and supplies. It thus plays a useful role in modern business. At the same time, it must be admitted that this is an activity in which a great many individuals with small means and inadequate knowledge of the market often participate, in the hope of quick or easy gains and consequently, forward trading often assumes unhealthy dimensions, thereby increasing, instead of minimising the risks of business. There are forms of forward trading for example, options, which facilitate participation by persons with small means and inadequate knowledge. ......It is, therefore, necessary to eliminate certain forms of forward trading, and permit others under carefully regulated conditions in order to ensure that, while producers, manufacturers and traders will have the facilities they need for the satisfactory conduct of their business the wider interests of the community, and particularly, the interests of consumers, will be adequately safeguarded against any abuse of such facilities by others.[33]

In *Firm of Pratapchand Nopaji* v. *Firm of Kotrike Venkata Setty and Sons*[34] the Supreme Court again had occasion to consider the validity of a contract of agency for the purpose of entering into what is known as *Badla* transactions, which involves speculations on the rise and fall in the prices of goods in the market[35].

[33] *Id* at pp. 3-4.
[34] A.I.R. 1975 S.C. 1223, 1975 KHC 565, 1975(2) S.C.C. 208.
[35] The defendants are big merchants and have been carrying on trade outside Dhone, even in places like Bombay. They wanted to do the business of purchasing and selling groundnut seeds and oil seeds in Bombay market and for this purpose engaged the plaintiffs as commission agents to contact with Bombay Commission Agents, who were entering into contracts with customers for

The Court held:

> If an agreement is merely collateral to another or constitutes an aid facilitating the carrying out of the object of the other agreement which though void, is not in itself prohibited, within the meaning of Section 23 of the Contract Act, it may be enforced as a collateral agreement. If on the other hand, it is part of a mechanism meant to defeat what the law has actually prohibited, the Courts will not countenance a claim based upon the agreement because it will be tainted with an illegality of the object sought to be achieved which is hit by Section 23 of the Contract Act. It is well established that the object of an agreement cannot be said to be forbidden or unlawful merely because the agreement results in what is known as a "void contract". A void agreement, when coupled with other facts, may become part of a transaction which creates legal rights, but this is not so if the object is prohibited or *mala in se*.[36]

purchasing or selling groundnut seeds and custom oil seeds, according to the orders of the defendants which the plaintiffs were communicating to them. The Bombay commission agents used to give intimation to the plaintiffs of the fact of having executed the orders (the contracts of sale or purchase) and the terms, the rate, etc., of the contracts. The plaintiffs were immediately communicating the information to the defendants. The business was according to the custom prevailing in the Bombay Market, viz. the custom of *Badla*. The defendants not only agreed in general to abide by the custom of *Badla*, but specifically consented to every such *Badla*. At the request of the defendants the transactions were settled after undergoing a few *Badla*. Such settlement were beneficial to the defendants as the market was falling and delay would have meant greater loss: when the market was falling the Bombay agents were pressing for cash settlement on pain of declaring them as defaulters which will result in a disability to do any further business. The defendants knew this state of affairs and they realised that a settlement was the only course beneficial to them. So they specifically told the plaintiffs that they must at any cost preserve their reputation in the Bombay market and with plaintiffs. The defendants hence agreed to pay the amount and on their request and on their behalf the plaintiffs paid all amounts due to the Bombay Commission Agents according to the patties sent by the Bombay Agents in respect of the transactions relating to the defendants. The defendants also agreed to pay to the plaintiff interests on the amounts so advanced by the plaintiffs for payment to the Bombay agents. The Bombay Commission agents were sending patties of transaction to plaintiffs. As already stated, these payments were made at the request of the defendants to repay all such amounts to the plaintiffs with interest. The extracts of the accounts filed with the plaint show the transaction and the amount paid by the plaintiffs at the request of and on behalf of the defendants. The defendants refused to honour the transactions claiming that these are speculative contracts and therefore illegal and not enforceable.

[36] *Id* at para 7.

In this case, the court held that the contract between the plaintiff and defendant was not wager. At the same time, the court held that where a collateral contract to a wager is tainted with illegality, and hence unenforceable, the same cannot be enforced relying on the decision of *Gherulal Parakh's* case. The Hon'ble Supreme Court found that even in *Gherulal Parakh's* case, the harmful effects of permitting such illegal contracts, in terms of injury to the public at large are evident and undisputable.

It can be seen that during this period, interest rate swaps and forward contracts were considered as void as being statutorily prohibited. The Courts would not enforce these contracts, if the transactions which directly relate to these contracts fail. However, the courts were open to the fact that such instruments were being used by businesses for trade. Hence while keeping with the statutory position, the Courts refused to recognise the contracts of these instruments as such and have declared the action brought by one of the parties to such instruments as not maintainable, they devolved the mechanism of "Collateral transactions" and recognised the presence of these instruments obliquely. At the same time, the courts also did not hesitate to refuse to recognise the collateral contracts, if these collateral contracts themselves were found to be illegal.

This discussion brings out the judicial reasoning about transactions on monetary instruments such as financial derivatives that was predominant during the period upto 1980's. Three points evolved from this discussion:

1. Law considered financial derivatives are wagering agreements.

2. They were so considered, not because they were opposed to public policy or were immoral but because statute said that they are void.
3. Despite considering these instruments as wagering agreements and hence void, the law did not hesitate to recognise collateral agreements formed to transact in such agreements as valid.

<u>Fifth Phase: Liberalisation</u>

During 1990's the Indian economic scenario entered a phase which is popularly known as Liberalisation, Privatisation and Globalisation[37] Phase. During this phase, India signed General Agreement on Trade and Tariff's[38] to enter the World Trade Organisation[39]. The World Bank and United Nations Conference on Trade and Development[40] submitted a joint report to the Government of India recommending revival of futures trading in farm commodities and their products to render trade in such commodities competitive in the world markets after the envisaged removal of trade and non-trade barriers. The Government of India also set up the Kabra Committee in 1993 to review the futures trading for other commodities. As an outcome of these developments, the SCRA was amended in 1999[41] and derivative trading was allowed.

However, the judicial recognition of derivative instruments delayed as no cases involving these transactions came up for judicial interpretation. One main reason

[37] Popularly known as LPG.
[38] Known as GATT.
[39] Known as WTO.
[40] Known as UNCTAD.
[41] Act 31 of 1999, which inserted S. 18A into the Act.

was the emphasis on arbitration as a means of dispute resolution that evolved during the liberalisation era. Moreover, since the modern day financial instruments become more and more complex, the judicial mind was also in favour of leaving the complex technicalities involved in these instruments to the expert arbitrator. The Hon'ble High Court of Madras in *Sundaram Brake Linings Ltd.* v. *Kotak Mahindra Bank Ltd.*[42] took a similar stand when it had the occasion to go through similar contentions, in a case relating to financial derivatives. The main question was whether the arbitration clause in I.S.D.A. Master Agreement was enforceable or not. It was argued on behalf of the petitioner that I.S.D.A. Master Agreement is void *ab-initio* on the ground that it is opposed to public policy and therefore hit by Section 23 of the Indian Contract Act, and also that it being a wagering agreement is hit by Section 30 of the Indian Contract Act. On the other hand, on behalf of the respondent, it was contended that the I.S.D.A. Master Agreement is neither a wagering agreement nor an agreement opposed to public policy and that it is authorised by the RBI and adopted and entered into by several nationalised banks. The Hon'ble High Court of Madras, acknowledging that it is a grey area, thought it fit not to enter into the said grey area and left it to the arbitrator to decide on that question finding that under S. 8 of the Arbitration and Conciliation Act, 1996, the arbitrator has the power to decide that issue and therefore judicial authority cannot go into the question as to whether the agreement is null and void, inoperative or incapable of being performed.

[42] 2008 (7) M.L.J. 1296.

In 2009, the Hon'ble High Court of Madras had another occasion to go into the same question as to whether options contract violates S. 30 of Contract Act and RBI guidelines in *State Bank of India* v. *M/s. P.R.P. Exports.*[43] However, the court only considered the arbitration clause in the I.S.D.A. Agreement and did not go into the substantive questions posed regarding the validity of the agreement.

It was only in *M/s. Rajshree Sugars & Chemicals Limited* v. *M/s Axis Bank Ltd & others*[44] the Hon'ble High Court of Madras seized the opportunity to consider the nature of the derivative transactions. It is interesting to note that this case brought to fore almost all issued highlighted by Alastair Hudson.[45] The dispute in this case was with regard to an I.S.D.A. Master Agreement entered into by the petitioner with the UTI Bank Limited.[46] In pursuance of the I.S.D.A. Master Agreement dated 14.5.2004, at least 10 deals[47] were struck between the plaintiff and UTI Bank and 9 out of those 10 deals have already matured without any dispute on either

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[43]http://indiankanoon.org/doc/699214/ accessed on 15.05.2015 at 21.39 hrs.
[44] 2011 KHC 2472: A.I.R. 2011 Mad. 144.
[45]See Alastair Hudson, *Law on Financial Derivatives*, Sweet & Maxwell, London, (2nd Ed., 1998).
[46] Renamed as the Axis Bank Ltd.
[47] The disputed deal was a USD-CHF (U.S.Dollars-Swiss Franc) Option Structure entered into by the one P.K.Viswanathan on behalf of the plaintiff on 22.6.2007 with the UTI Bank. The structure of the deal was as follows:-

1. The plaintiff would receive USD 100,000 on 23.6.2008 if spot never trades at 1.2385 from trade date namely, 22.6.2007 till fixing date namely; 19.6.2008.
2. During the reference period from 22.6.2007 to 19.6.2008, if USD-CHF never touches 1.1250 and 1.2385 and if it ever touches 1.2385, there is no exchange of principal, but if it ever touches 1.1250 and never touches 1.2385, the plaintiff should buy USD 20 million against paying CHF at 1.3300. During the reference period from 22.6.2007 to 15.6.2009 if USD-CHF never touches 1.1200 and 1.2385 or if it ever touches 1.2385,there is no exchange of principal, but if it ever touches 1.1200 and never touches 1.2385, the plaintiff should buy USD 20 million against paying CHF at 1.3300.
3. If the USD-CHF touches the level of 1.2385 ever during the period starting from 22.6.2007 to 15.6.2009, then the entire structure gets knocked out with no subsequent liability and the plaintiff would receive USD 100,000 on the spot date of touch. However if spot touches 1.2325, then the plaintiff would receive instant payment of USD 100,000 though the structure will not get knocked out.

side. In terms of the above deal, entered into on 22.06.2007, the defendant paid USD 100,000 to the plaintiff on 27.06.2007. The plaintiff received the said amount. However, after 6 months, the plaintiff sent a letter dated 12.12.2007 claiming that the entire structure as per the contract dated 22.6.2007 got knocked out with no liability to either of the parties. But, by a reply dated 07.01.2008, the Bank challenged the claim and contended that the contract was still alive and that the Bank was prepared to work out suitable risk mitigation structures. Dissatisfied with the stand taken by the bank, the plaintiff filed the above suit to declare this derivatives contract as void *ab initio*. The questions that were raised before the Hon'ble High Court of Madras were the following:

1. Whether the said contract was a wager and hence hit by S. 30 of Indian Contract Act?
2. Whether the said contract is opposed to public policy and hence hit by S. 23 of Indian Contract Act?
3. Whether the person who entered into contract on behalf of the company had authority to do so?

The Court extensively considered the history of the derivatives trading and held that the essential features of a wagering agreement as formulated by the English Courts were:

1. There must be 2 persons or 2 sets of or 2 groups of persons holding opposite views touching a future uncertain event. It may even concern a past or present fact or event.

2. In a wagering agreement, one party is to win and the other to lose upon the determination of the event. Each party must stand either to win or lose under the terms of the contract. It will not be a wagering agreement if one party may win but cannot lose or if he may lose but cannot win or if he can neither win or lose.
3. The parties have no actual interest in the occurrence or non-occurrence of the event but have an interest only on the stake.

Applying the above guidelines the court held that the contracts in *Grizewood* v. *Blane*[48] and *Richards* v. *Starck*[49] were considered to be wagers as there was an understanding of the parties that the subject matter should neither be transferred nor paid for on the settlement day, but that on that day, one party should pay to the other, the difference between the market price on that day and the price on the day of the contract. Where a series of contracts for the sale and purchase of shares gave the buyer an option to demand delivery on payment of an extra sum, it was held that they were wagers, since it was only when the option was exercised, they would become genuine transactions of sale and purchase. However, the Court found that all speculation does not amount to wager and laid down the following principles to distinguish wagering agreements with other legally enforceable contracts:

1. If one party to the transaction undertakes a real liability to give or take delivery, the mere fact that the other party intends by a subsequent

[48] (1851) 11 C.B. 526.
[49] [1911] 1 K.B. 296.

transaction to arrange that delivery under the first transaction shall not take place, does not turn the transaction into a wager.

2. A genuine purchase of shares followed by a separate and genuine sale creates enforceable obligations, even though the original purchaser never intended to take delivery of the shares and was in fact merely speculating upon their value. However, if there is an agreement to the effect that sales and purchases of stocks and shares shall not be actually carried out but shall end only in the payment of differences, the transaction will be a wager notwithstanding the fact that the ostensible terms of business gave a right to insist on delivery.
3. Though every wagering agreement is speculative in nature, every speculation need not necessarily be a wager. In a wagering agreement, there has to be mutuality in the sense that the gain of one party would be the loss of the other on the happening of the uncertain event which is the subject matter of wager.
4. The mere fact that the parties never intended to take delivery at the end would not also make a transaction a wager.

After extensively considering the dictum of Hon'ble Supreme Court in *Gherulal Parakh* case[50], the Hon'ble High Court of Madras also found that even though a contract of wager is void, it is not opposed to public policy and hence will not come within the ambit of S. 23 of Indian Contract Act, 1872. Thereupon the court delved into the specifics of the impugned contract and found that under the said contract,

[50]*Supra* n. 24.

there are some contingencies in which USD 100,000 becomes payable by the Bank to the plaintiff, making the plaintiff the gainer and there are other contingencies when the plaintiff becomes obliged to buy USD 20 million at the rate of 1.3300 Swiss Franc per 1 USD from the Bank, making the bank the gainer. It was also found that the payment of USD 100,000 prescribed under the deal is to hedge the plaintiff against the risk of depreciation in the value of USD, comparable to the sum assured under a contract of insurance, though the transaction cannot exactly be compared to an insurance transaction. It was also found that merely because the plaintiff is obliged to purchase USD 20 million at the rate of 1.3300 CHF per Dollar from the bank, and this would put the plaintiff to a huge loss, will not make the transaction a wager, as the contract confers on the plaintiff a right to seek actual delivery and if actual delivery can be compelled, it will not be a wagering transaction. Moreover, the court also found that the records do not show that the plaintiff and the Bank shared a common intention to enter into a wagering transaction. After going through the entire correspondence in the case, the court also found that the person who had entered into transaction on behalf of the plaintiff had the requisite authority to enter into such a transaction, and the court held as follows:

> …three tests are to be satisfied if a contract is to be termed as a wager. The first test is that there must be two persons holding opposite views touching a future uncertain event. The second test is that one of those parties is to win and the other is to lose upon the determination of the event. The third test is that both the parties have no actual interest in the occurrence or non-occurrence of the event, but have an interest only on the stake. The first test

> is satisfied in this case as there are 2 parties. But, the second test may not be satisfied in this case since the plaintiff may not always stand to lose. If the plaintiff loses in the underlying contract on account of currency fluctuation, it may get compensated by the hedging and vice versa. Therefore both parties cannot be taken to be winners or losers in absolute terms. Even if we take for the sake of argument that the first two tests are satisfied in this case, the third test is certainly not satisfied in the case on hand. Both the parties definitely have an actual interest in the rate of exchange hitting a high or low. This is because of the fact that the very intention of the transaction is to hedge an underlying exposure. It is like a contract of insurance, where, on the happening of an uncertain event, the sum assured becomes payable.[51]

Through this decision, the court was laying the foundation stone for legalising derivative transactions in India and bringing the same out of the question whether they are wagering transactions, once and for ever, provided there is an element of hedging and also where both the parties have an actual interest in the trigger value hitting a high or low. The court held that none of the parties can be held to be winners or losers in the absolute sense; where the plaintiff loses, his loss may get compensated by hedging and vice versa. The Court also brought the derivative contract to the level of an insurance contract, which also in fact is a wagering agreement, if looked from one angle, as it speculates on the happening of an uncertain event. The court thereafter went to affirmatively proclaim as follows:

> As a matter of fact, the prices of derivatives is now scientifically determined on the basis of a mathematical model (or formulae) developed by 2 men by name Fischer Black and Myron Scholes in 1973. The formulae itself was named after them, as Black-Scholes Model. The application of the model,

[51] *Id* para 71.

> led to the award of the Nobel in Economics. The derivatives prices are determined by feeding certain inputs into this model. These inputs are (i) stock price of the underlying asset (ii) amount of time until expiration (iii) strike price of the option (iv) volatility of the underlying asset (how much it moves up or down during a given period) (v) risk free rate of return (usually the interest rate paid by Government to the banks on guaranteed investments). After Black-Scholes model, several models were developed, the noted among them being the Garman-Kohlhagen model designed to arrive at the price of Foreign Exchange (FX) options. Therefore derivatives transactions ceased to be purely speculative deals, long time ago. The pricing of the deals, follows a scientific pattern on the basis of Financial Mathematics. Just as Actuaries scientifically determine the value of insurance risks and the premium payable, Financial Mathematicians (or Portfolio Managers) evaluate the price of these derivatives. Hence they cannot be termed as wagers.[52]

This was to remove the doubt, if any that remained, as to whether the derivative transactions are still speculative in nature. The court further sealed the question as to whether the derivative transactions are opposed to public policy by holding thus:

> Thus the transactions in derivatives are age old, in so far as commodities and stocks and securities are concerned. These transactions are at least about a couple of decades old in so far as foreign currencies (and forex options) are concerned. Therefore it is futile on the part of the plaintiff to contend that the transactions are either prohibited by law or opposed to public policy. What is expressly permitted by law cannot be held to be opposed to public policy. The Master Circulars issued by RBI from time to time and the Regulations framed by RBI under the FEMA, 1999 permit such transactions. Such transactions have the sanction of law the world over, despite the

[52] *Id* para 81.

mishaps such as Orange County, Barings Bank, Long Term Capital Management, Lehman Brothers, AIG etc. Admittedly, the Nationalised Banks in our country also offer such products, though their marketing strategy is not so aggressive, on account of conservative outlook. Therefore, the contention of the plaintiff that the deal is opposed to public policy is archaic.[53]

The Court also considered the objection that the transaction violated the RBI and SEBI guidelines and Foreign Exchange Regulations and found that there was no such violation. Moreover, it was also found that the existing regulations permit such transactions. The court held that the SEBI master circular allowed companies to invest in call or put options and even though writing of options is not permitted, zero cost options were permitted[54].

In a way, *M/s Rajshree Sugars*[55] case marked the beginning of a new era in the judicial recognition of these instruments. In this case, the High Court of Madras had the opportunity to examine almost all the grounds in which the derivatives could be assailed and negatived all of these grounds. In fact, this case settled the most contentious issues regarding derivative transactions and moved these transactions from a grey area of law to the clear zone.

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[53] *Id* para 100.
[54] Master Circular bearing No. SEBI/CFD/DIL/CG/1/2004/12/10 dated 29-10-2004, wherein the Securities Exchange Board of India directed all Stock Exchanges to amend the Listing Agreements by replacing the existing clause 49, as quoted in *M/s Rajshree Sugars* Case, *supra* n. 44.
[55] *Supra* n. 44.

JUDICIAL REVIEW: APPROACH OF INDIAN COURTS

Another area where the judicial response was robust was regarding the role of regulatory agencies. In *M/s Rajshree Sugars* Case[56] the Court has considered with approval the recognition given to trading in options by SEBI and RBI. Subsequently in *Kotak Mahindra Bank Ltd*. v. *Hindustan National Glass and Industries Ltd. and others,*[57] the Hon'ble Supreme Court of India had the occasion to consider the applicability of RBI circular on wilful defaulters in respect of a party to a derivative transaction. The core issue in dispute was whether the act of the bank in terming a defaulter in derivative transactions as a "wilful defaulter", enabling the Bank to initiate recovery proceedings under SARFAESI Act[58] is legal. There was a conflict in the decisions of Hon'ble High Court of Bombay and Hon'ble High Court of Calcutta as to the applicability of RBI Master Circular on Wilful Defaulters to defaulters in derivative transactions.

In the case before Hon'ble High Court of Calcutta, appellant-bank sanctioned Derivatives/Forward Contracts facility to Hindustan National Glass & Industries Ltd., upto a limit of Rs.2,00,00,000/- (Rupees Two Crores) only for the purpose of hedging foreign currency exposures. The parties thereto subsequently entered into derivative transactions, for the purpose of hedging adverse foreign exchange fluctuations, in which a sum of Rs.2,43,12,000/- (Rupees Two Crores Forty Three Lakhs and Twelve Thousand only) had become due and payable from the said

[56] *Supra* n. 44

[57] 2013(2) A.D. (S.C.) 113, 2013 (2) A.L.D. 72 (S.C.), (2013) 2 CAL. L.T. 1 (S.C.), 2013 (2) C.D.R. 555(S.C.), (2013) 1 Comp. L.J. 225(S.C.), J.T. 2013 (1) S.C. 60, 2013-1-L.W. 785, 2012 (12) SCALE 144, (2013) 7 S.C.C. 369, [2013] 117 S.C.L. 521(SC), (2014) 1 WB.L.R. (SC) 765

[58] Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

company to the appellant bank. The company however did not pay the sum as above. In the meanwhile by Master Circular on Wilful Defaulters, RBI instructed all banks and financial institutions regarding reporting of wilful defaulters to other banks and financial institutions and the measures to be imposed on wilful defaulters by such banks and financial institutions. Consequently, the appellant bank informed Hindustan National Glass and Industries Ltd. that it had classified the company as wilful defaulter. The Hindustan National Glass and Industries Ltd. countered the said classification by its correspondences with the Bank that it was neither a borrower nor bank a lender, within the meaning of "wilful default" in the Master Circular and therefore, action under the Master Circular cannot be taken against the company. The bank thereupon gave the company a chance to represent its position before the Grievance Redressal Committee of the Bank, and after hearing the company, the Committee upheld the classification of the Company as a "wilful defaulter".

Aggrieved by the said order, the company filed a writ petition before the Hon'ble High Court of Calcutta, where in the Hon'ble High Court of Calcutta *inter alia* held that the Master Circular applied only to lending transactions of a bank or financial institution and as in the foreign exchange derivative transactions between the bank and company, there was no such lending transactions, Kotak Mahindra Bank was not the lender and Hindustan National Glass and Industries Ltd. was not the borrower. Hence it was held that Hindustan National Glass and Industries Ltd. could not be declared as a wilful defaulter in terms of the Master Circular and

accordingly no action could be taken against Hindustan National Glass and Industries Ltd under the Master Circular.

On the other hand in a similar before the Hon'ble High Court of Mumbai, *M/s Emcure Pharmaceuticals Ltd.* v. *ICICI Bank Ltd.*[59], the Hon'ble High Court of Bombay held that the very same Master Circular covers the outstanding claims of ICICI Bank Ltd. against Emcure Pharmaceuticals Ltd. arising out of the foreign exchange derivative transactions.

The Hon'ble Supreme Court, after considering the rival contentions as well as the stand of RBI has held that:

> the purpose of the Master Circular being to caution banks and financial institutions from giving any further bank finance to a wilful defaulter, credit information cannot be confined to only the wilful defaults made by existing borrowers of the bank, but will also cover constituents of the bank, who have defaulted in their dues under banking transactions with the banks and who intend to avail further finance from the banks[60].

It was also held that the term "wilful defaulter" in the said Master Circular would mean not only a wilful default by a unit which has defaulted in meeting its repayment obligations to the lender, but also to mean a unit which has defaulted in meeting its payment obligations to the bank under facilities such as a bank guarantee. Hence the court held that on interpretation of the Master Circular, the Master Circular covers not only wilful defaults of dues by a borrower to the bank but also covers wilful defaults of dues by a client of the bank under other banking

[59] Company Petition No. 431 of 2010, decided on 9th December 2011, per S.C. Dharmadhikari, J.
[60] *Supra* n. 57, para 34.

transactions such as bank guarantees and derivative transactions. By holding so, the court struck down the decision of Hon'ble High Court of Calcutta and upheld the view taken by Hon'ble High Court of Bombay.

This decision is important, since in this case, the decision of Hon'ble High Court of Madras in *M/s Rajshree Sugars*[61] case was noted with approval and recognised derivative transactions by banks and further increased the capability of banks to take action against non-funded facilities like derivative transactions also. However, the general approach of the Indian Courts to the derivative contracts is to construe them as instruments that require domain expertise to interpret and leave the interpretation of contractual clauses to domain experts and confining itself to an overseer of arbitration proceedings.

JUDICIAL APPROACH IN THE UNITED STATES OF AMERICA

The approach of courts in the US to these instruments is also noteworthy.

In Korea Life Ins. Co., Ltd. v. *Morgan Guar. Trust Co. of NY*[62] the US Court has held that derivatives transactions at issue were not evil in themselves (malum in se)," and although the parties' attempted to "evade Korean regulation and to enter into an inappropriate transaction may have been questionable. It did not amount to moral turpitude.

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[61] *Supra* n. 44.
[62] 269 F Supp 2d 424, 438 [SD NY 2003].

The general trend of the US courts is to give recognition to the contracts in financial derivatives, and to interpret them in accordance with the original intention of the parties.

As opposed to Indian Courts, which leave interpretation of the agreement to arbitrators, the courts in the US interpret the clauses in these agreements themselves. The major area where such interpretation becomes crucial is where one party to the agreement raises a claim of misrepresentation by the other party. In contracts where the parties have agreed that they will not rely on the expertise of the other party, the US Courts have always considered both parties at equal status, and has refused to give judgement in favour of the party which claims to be misled by the other party in a derivative transaction.

For example, in *JP Morgan Chase Bank, N.A*. v. *Controladora Commercial Mexicana S.A.B. De C.V.*[63], the Supreme Court of New York held that the existence of non-reliance clause in the agreement would preclude the parties there to from claiming that there was misrepresentation. It was also held that where parties, particularly sophisticated business entities enter into an arm's- length business transaction, the terms of their contract govern their relationship[64]. In this case, the court had an occasion to consider validity of foreign exchange currency swap contracts. The parties had entered into a contract based on I.S.D.A. Standard form Master Agreement and Credit Support Annex.

[63] 2010 NY Slip Op 52066(U) [29 Misc 3d 1227(A)].
[64] See *Northeast Gen. Corp.* v. *Wellington Adv., Inc*., 82 NY 2d 158, 160 [1993].

In *ADM Investor Services Inc*. v. *Mark W. Collins*[65] Court of Appeals of the Seventh Circuit, while considering a Contract of Differences, the Court of Appeal held that a contract does not become illegal just because a party fails to put down a deposit (margin in futures market). The Court further held that failure to post security as required enables the other side to rescind the contract but does not enable the party at fault to earn benefits out of his fault[66].

Similarly, the decisions in *Republic Natl. Bank* v. *Hales*[67] *and CDO Plus Master Fund Ltd*. v. *Wachovia Bank, N.A*[68] also follow this trend. In the former, the District Court New York, USA has interpreted a *non-reliance* clause in an I.S.D.A Swap Agreement and has held that in the existence of such a clause in the agreement the opposite party cannot claim that they have reasonably relied on the expertise of the other party. Similarly in the latter case, the Court had held the parties are bound by the provisions of I.S.D.A. Schedule and Credit Support Annex which are specific to the parties, and one of the parties cannot claim the said agreement to be invalid merely because the standard form of I.S.D.A Master Agreement have been followed. The Court considered the annexure to the I.S.D.A. Master Agreement as agreed after specific negotiation and held that they not boilerplate terms i.e., terms which are relatively standardised clauses that are often agreed with little or no negotiation and found towards the end of an agreement. Similarly in *Gray* v. *Seaboard Sec., Inc.*[69], the court had held that Securities

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[65] MANU/FEVT/0452/2008.
[66] *Ibid*.
[67] 75 F Supp 2d 300 [SD NY 1999], affd 4 Fed Appx 15 [2d Cir 2001].
[68] No. 07 Civ. 11078(LTS) (AJP), 2009 WL 2033048, *6 [SD NY July 13, 2009].
[69] 14 AD3d 852 [3d Dept]

transactions between parties are duly negotiated contracts, and cannot be looked into from the angle of interpreting a standard form contract, where the focus of the court is protection of the consumer.

The approach of US courts is to view the parties to these instruments at equal terms and the courts generally construe the terms of the contract between parties as valid. In general, the approach of the US court is to uphold the contractual terms[70].

JUDICIAL APPROACH IN UNITED KINGDOM

While on this topic, it would be worthwhile to consider the approach of courts in U.K to these instruments.

In *Titan Steel Wheels Limited* v. *The Royal Bank of Scotland Plc*[71], the High Court of Justice (Queen's Bench Division Commercial Court) had to consider a curious case where the petitioner alleged misspelling of derivative products. The case of Titan was that these products were so unusual and complex that (a) Titan's financial controller had no actual or implied authority to enter into them and the facts were such that the Bank knew this; (b) the Bank advised Titan to take these products which were in fact unsuitable to its needs and thus is liable in negligence; (c) the Bank had a duty under the FSA rules to deal “fairly” with Titan including a duty to ensure that communications or descriptions of the products were accurate and not misleading and that although the information provided by the Bank contained some health warnings, they did not go far enough. The Court, after going through the

[70] See also *Finance One Public Co. Ltd.* v. *Lehman Bros. Special Fin., Inc.,* No. 00 CIV 6739(CBM), 2001 WL 1543820, * 1 [SD NY December 4, 2001]

[71] [2010] EWHC 211 (Comm):2010 WL442366

terms of the contract, came to a conclusion that where there are specific terms which exclude responsibility, the bank or investment advisor, which has been expressly retained to furnish advice, would not be liable for the failed investment advice. It was also held that where the parties have purported to allocate by contract their respective roles and the risks involved in their relationship, it will in the normal run to preclude any wider obligation arising from a common law duty of care. In arriving at this decision, the Court relied on *Vales Holdings* v. *Merrill Lynch International Bank*[72], *Henderson* v. *Merrett*[73] and *IFE Fund* v. *Goldman Sachs Int.*[74]

In *Peekay* v. *Australia and New Zealand Banking Group*[75] a bank employee had misrepresented the nature of an investment product. But the relevant terms and conditions contained provisions to the effect that the customer knew the true nature of the contract he was entering into and had determined that it was suitable. There was also a notice that the customer had taken independent advice and was not relying on the bank. The Court, after relying on the decisions in *Colchester Borough Council* v. *Smith,*[76] held that where parties express an agreement of that kind in a contractual document, they cannot subsequently deny the existence of the facts and matters upon which they have agreed, at least so far as it concerns those aspects of their relationship to which the agreement was directed. The contract itself gives rise to an estoppel.

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[72] [2004] EWHC 2471*(*Comm*)*.
[73] [1995] 2 AC 145.
[74] [2007] EWCA Civ 811.
[75] [2006] 2 Lloyd's Rep. 511.
[76] [1991] Ch 448, affirmed on appeal [1992] Ch 421.

Similarly *Standard Chartered Bank* v. *Ceylon Petroleum Corporation*[77] is a case in which when the claimant (plaintiff) bank claimed the remaining payments which are due to it under the terms of a derivative transaction, the counterparty respondent put up a counter claim stating that (a) it had no capacity to enter into derivatives transactions being outside the scope of its general objectives, (b) the officials who entered into the transactions on behalf of the respondents do not have the actual or ostensible authority to enter into the transactions, (c) the obligations of the respondent got washed away by a supervening impossibility, since by a letter from the Central Bank of Srilanka, the further performance of payment obligations under the transactions were rendered unlawful. It also set up a counter claim for damages on account of loss due to breach of fiduciary duty, to advice the respondent, when it had made misrepresentations. In fact, the disputed transactions were part of a series of transactions entered into between the respondent, which is a state owner importer of petroleum products. In an attempt to protect itself from the rise in oil price, the respondent began to enter into oil derivative transactions with the claimant from 2007. Between February 2007 and October 2008, respondent entered into about 30 such transactions, including 10 transactions with claimant. The dispute arose in two transactions, where respondents incurred huge loss. The High Court of Justice (Queens Bench Commercial Division) has held that since there was no breach of obligations by claimant and there was no misrepresentation, the parties are bound to honour terms of their contract.

[77] 2011] EWHC 1785 (Comm):2011 WL 2649362.

In *City Index Ltd (trading as Fin Spreads)* v. *Romeo Baldacci*[78], the England and Wales High Court (Chancery Division) while approving a claim on a debt incurred by the defendant in "spread betting"[79] on the price of heating oil over a period of two and a half years, held that spread betting is regulated by the Financial Services Authority, and even while holding that spread betting is essentially betting, the court considered the betting contract enforceable as it is the will of the parties.

Thus, it can be seen that the general trend of UK courts is to uphold the contractual terms, and where ever the banks or financial institutions, which sell the contracts have expressly excluded their responsibility, the courts are not inclined to find a breach of duty where the advice fails due to change in commercial conditions[80].

SUMMING UP

It can be seen that the Indian judicial response to the contracts, which are currently known as derivative transactions have passed through five phases. In the first phase, the courts were applied basic principles of contract and recognised these contracts. The courts found that even if it were wagers, the public policy in England or in India did not require to make these contracts void. In the second phase, these were found to be wagers and were considered to be void, especially in

[78] [2011] EWHC 2562 (Ch).

[79] Spread betting is defined in *Spreadex* v. *Battu* [2005] EWCA Civ 855 at [2]-[4] as follows: "Spread betting is not so much or not merely a bet, although it can be described as such, as a form of contract for differences. It enables a customer to take a position on a market (or an event) for a very small stake… The spread betting operator who accepts these trades does not bet against the customer, but lays off the trade elsewhere. Ultimately, I suspect, the trade is accumulated in some form of derivative transaction on a futures exchange, but I do not know. The operator, however, by laying off the bet elsewhere, seeks to profit by means of the spread. The means by which it does that, and the terms on which it does that, however, are not a matter for the operator's customer: or, in the present case, have the applicable terms been disclosed."

[80] See also *Sucden Financial Limited (Formerly Sucden (UK) Limited)* v. *Fluxo-Cane Overseas Limited, Manoel Fernando Garcia*, [2010] EWHC 2133 (Comm): 2010 WL 3166471.

the light of S.30 of Indian Contract Act. In the third phase, though the main contracts were found to be void, the courts were willing to recognise collateral contracts, as they are not wagers. This way, the courts were recognising that though wagers, these contracts were entered by both parties in their free will and one party should not be allowed to unjustly enrich claiming that the entire contract and its collateral arrangements are unenforceable. Fourth phase was marked with stricter legislative provisions banning products which are presently categorised as derivatives, and the courts followed the legislative directive and refused to give effect to these contracts. In the fifth and on-going phase, the courts have explicitly recognised the derivative transactions. Starting from *Rajshree Sugars* case[81], the courts have straight away addressed the issue whether these contracts are wagers, and found that they are not wagering agreements. On comparison, it can be seen than at the level of individual players; both the US and the UK courts have been taking a strictly contractual approach. At this level, the courts construe contracts strictly, so that the terms of the contract are given importance and effect. It can be seen that Indian courts are also taking a similar approach. From the angle of institutional regulation, it can be seen that the approach of courts in these entire jurisdiction is in recognising institutional regulators and following an approach of non-interference in their regulatory duties, recognising their domain expertise.

The above analysis also brings out the need for a specialised judicial body in India, with expertise to deal with complex contractual issues, with deep financial implications, which can help the parties to take a decision in case of real conflict.

[81] See *supra* n. 44.

Arbitration, and for that matter all alternative dispute resolution mechanisms which are preferred by Indian business entities that engage in derivative transactions have the danger of taking an ad-hoc approach in providing solutions. Though arbitral tribunals may be effective in settling technical matters, their effectiveness in properly applying the legal principles and evolving new principles is minimal. Hence there is a need for Specialised Judicial bodies, with adjudicatory power, to decide on matters relating to derivative contracts. These bodies can also be entrusted with the task of judicial review over regulators.

FSLRC has recommended creation of Financial Sector Appellate Tribunal (FSAT), with jurisdiction to review all decisions passed by the financial regulators, and can also strike down subordinate legislation (regulations) if they are ultra vires the parent statute.

There have been dissenting opinions[82] from the regulators regarding this power, as the regulators do not want judicial interference in policy matters. However, it is ideal that the specialised judicial body envisaged by FSLRC, which has the primary duty to pass judicial orders based on subordinate legislations should also have the power to strike down subordinate legislations, which are found to be *ultra vires* the parent statute. This power as envisaged by FSLRC is similar to the power of

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[82] See Talk by Dr. Raghuram Rajan at the First State Bank 'Banking and Economic Conclave' held at Mumbai on June 17, 2014, entitled "Financial Sector Legislative Reforms Committee Report (FSLRC): What to do and when?" available in https://rbi.org.in/SCRIPTS /BS SpeechesView.aspx?*Id*=900, accessed on 23.05.2016 at 22.40 hrs. *See also,* "The Curious case of MCA: A live example that illuminates the Rajan Critique of FSLRC" by Pratik Dutta available in http://www.derivativesinvesting.net/article/ 5065111218/the-curious-case-of-the-mca-a-live-example-that-illuminates-the-rajan-critique-of-fslrc/, accessed on 23.04.2016 at 22.42 hrs, for a contra opinion.

judicial review of High Courts and Supreme Court under the Constitution of India. These judicial bodies shall have special rules of procedure, to enable speedy disposal of the matters, since matters of finance have a sense of urgency, as otherwise financial advantage would be lost.

CHAPTER VI

POLICY FRAMEWORK FOR REGULATION OF FINANCIAL DERIVATIVES

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

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

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

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

REGULATORY APPROACHES

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

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

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

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

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

REGULATORY STYLES

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

COMPARATIVE ADVANTAGES OF DIFFERENT MODELS OF REGULATION:

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

[9] *Supra* n. 1 at p. 26.
[10]*Id* at p 27.
[11] In India, Foreign Exchange Dealers Association of India (FEDAI) is a recognised self-regulatory body in respect of foreign exchange swaps and International Swaps and Derivatives Association (ISDA) is the international self-regulatory body in respect of derivatives and currency swaps in general. The ISDA draft agreements have helped to bring in uniformity in contracts relating to derivative transactions and currency swap agreements world over and have been helping the derivative industry to function independent of governmental interference of any particular country in a self-regulatory mode.

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

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

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

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

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

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

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

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

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

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

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

[19] *Id* at p. 21.

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

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

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

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

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

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

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

[26] New York Stock Exchange, New York.

[27] Tokyo Stock Exchange, Japan.

[28] Osaka Securities Exchange, Osaka, Japan.

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

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

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

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

[33] The Mutual Fund Dealers Association.

[34] The Korea Financial Investment Association.

[35] Financial Industry Regulatory Authority.

[36] The National Futures Association.

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

[38] International Capital Markets Association

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

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

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

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

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

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

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

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

[46] *Supra* n.20.

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

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

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

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

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

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

Similarly he notes:

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

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

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

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

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

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

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

The authors further argue that:

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

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

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

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

[55] *Id* at p. 13.

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

OBJECTIVES OF DERIVATIVE REGULATION

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

a) Ensuring that the underlying instruments are transactionally, informationally and functionally efficient.

b) Regulation should not hinder or have negative impact on financial innovation.

c) Steps should be taken to avoid regulatory arbitrage.

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

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

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

the regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance programme. Eighthly, the regulator should have authority to share both public and non-public information with domestic and foreign counterparts. This means that the regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts. Ninthly, the regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers. Tenth, the regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme. Eleventh, regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme. This would mean that (1) there should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions (2) the holders of securities in a company should be treated in a fair and equitable manner (3) accounting and auditing standards should be of a high and internationally acceptable quality. Twelfth, regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme. Thirteenth, the regulation should provide for minimum entry standards for market intermediaries. This would mean that (a) there should be initial and on-going capital and other prudential requirements for

market intermediaries that reflect the risks that the intermediaries undertake (b) Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters and (c) There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk. Fourteenth, the establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight. To ensure this, there should be on-going regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants. Regulation should promote transparency of trading, should be designed to detect and deter manipulation and other unfair trading practices and should aim to ensure the proper management of large exposures, default risk and market disruption. The systems for clearing and settlement of securities transactions should be subject to regulatory oversight and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk[58].

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

[58] *Ibid.*

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

DERIVATIVES REGULATION IN INDIA

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

[59] Foreign Exchange Dealers Association of India.

REGULATORY OBJECTIVES IN INDIA

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

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

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

a) consistent with minimum best practice derivatives market standards and
b) designed to ensure a market that is open and competitive (free from manipulation and other forms of trade practice abuse).

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

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

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

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

i). **Investor Protection:** This includes rules relating to ensuring fairness and transparency in market dealings, guidelines for safeguarding client's money, ensuring competent and honest service and market integrity.
ii). **Quality of Markets:** aims at enhancing important market qualities such as cost efficiency, price-continuity and price-discovery.

[64] *Id* at p. 6.

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

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

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

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

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

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

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

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

c) Ensuring proper documentation of the derivatives product.

d) Identification of risk.

e) Risk measurement and setting proper risk coverage limits.

f) Ensuring independent risk control mechanism.

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

h) Audit requirements.

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

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

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

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

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

(a) There is lack of de jure independence across financial sector.

(b) There is lack of framework for consolidated supervision of financial conglomerates.

(c) Large Exposures and related party lending regime in banks which needs to be contained.

(d) Valuation and solvency requirements in insurance are not up to the mark.

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

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

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

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

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

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

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

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

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

[68] In short CCP.

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

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

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

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

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

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

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

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

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

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

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

LESSONS FROM 2008 MARKET CRASH

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

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

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

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

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

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

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[75] *Id* at p. 6.

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

[77] *Id* at p. 7.

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

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

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

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

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

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

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

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

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

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

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

ISSUES OF DERIVATIVES REGULATION IN INDIA

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The Committee's proposals therefore seek to create:

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

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

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

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

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

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

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

have unified regulators separate from Central Bank, whereas 28 countries have a partly unified regulatory structure and 37 countries including India has institutional regulator.

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

A Snapshot of International Regulatory Architecture

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

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

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

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

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

KEY RECOMMENDATIONS OF FSLRC

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[97] *Id* at p. 13.

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

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

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

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

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

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

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

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

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

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

SUMMATION

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

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

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

Regulation should also aim at fixing the responsibility of individual players, including officials of banks, and all persons who had dealt with relation to a

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

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

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

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

CHAPTER VII

CONCLUSION AND SUGGESTIONS

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

[1]Joseph Stiglitz, *Free Fall - America, Markets and the Sinking World Economy*, Penguin Books, London, (2010).

[2] Rakesh Mohan, "*Emerging Contours of Financial Regulation*", RBI Monthly Bulletin, June, 2009, available in http://rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/ECFRBU0609.pdf, accessed on 01.06.2016 at 21.04 hrs at p. 8.

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

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

However, it would be unwise to believe that our regulatory system is superior to other systems or that enough has been done to prevent the derivative products from posing a grave threat to the financial stability in India. On the contrary, the need for vigilant regulation suitable to the investment culture of the country and maturity of the markets, and ensuring transparency and appropriateness of the derivative

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

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

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

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

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

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

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

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

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

The report further reads as follows:

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

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

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

RESEARCH FINDINGS:

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

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

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

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

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

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

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

12. In India, RBI mostly comes out with product specific regulations, whereas SEBI comes out with sector specific regulations. Both these regulators specify their regulatory directives through Master Circulars and Directives, which the bodies coming within their respective regulatory spheres are bound to comply. Failure to comply with regulatory requirements is met with administrative penalties. However, it is to be noted that OTC derivatives often fall outside the purview of regulatory directives. Many a times, they are disguised in the form of mutual obligations contract, and are netted-off, to bring them out of the balance sheet.
13. US, UK and China were taken as sample countries, and these countries have almost similar method for regulation of financial derivatives as India. The standard method adopted consistently in most of the common law jurisdictions is that there would be a statutory framework for macro

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

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

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

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

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

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

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

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

SUGGESTIONS FOR IMPROVEMENT OF REGULATORY FRAMEWORK:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

identified. It shall also be ensured that they cannot play in the financial markets, till a specified period, even if they change organisations, so that the phenomenon of "seller escaping the aftershocks" syndrome can be nipped in the bud. It would be ideal that there is a properly laid down "Account Discovery Disclosure Matrix". This simply means that each individual official who is dealing with financial instruments should make proper disclosures about their income and the income of their relatives/ related institutions periodically, and there should be clear guidelines as to who all will be considered as relatives/related institutions and what all income shall be revealed, and this would differ as the position of the individual official increases in the organisation. Officers with higher responsibility should make more disclosures. Similarly there should be appropriate provisions in the law to keep account trails of individual and corporate accounts, of organisations as well as individuals involved in financial derivatives in an easily accessible manner and subject the same to periodical auditing.

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

provisions should be laid down for dealing with financial frauds and acts violating market discipline.

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

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

proportionate to their stake holdings. The funds can qualify to be an investment and this could be used to pay off the stake holder in case of failure of the organisation. This is necessary to prevent the government by helping the big players and letting small players lose their investment. This would also give a more equitable ground in the financial market for players to take calculated risks similar to banks maintaining statutory liquidity ratio and cash reserve ratio permitting banking institutions to assume safe risks.

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

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

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

List of Published Works

The following works were published in research Journals:

1. Unit Linked Insurance Products and Regulatory Tangle: (2011) PL February S-12.
2. Regulation of Financial Derivatives: Some Policy Considerations: The IUP Law Review, Vol I, No.3, 2011, p. 27.

APPENDIX I

PUBLISHED ARTICLE I:

Unit Linked Insurance Products (ULIP) and Regulatory Tangle

(2011) PL February S-12

The recent dispute between Securities and Exchange Board of India (SEBI) and Insurance Regulatory Authority of India has taken new dimensions with the intervention of Finance Ministry cutting in to call a draw. The main point of dispute was whether the ULIPs are insurance products or "collective investment scheme" as defined in Section 2(ba)[1] read with Section 11 AA[2] of Securities and Exchange Board of India Act, 1992(SEBI Act). This has led to a regulatory row hitherto unknown in the centralized regulatory regime as prevalent in India.

The row brings out a need for discussion into the following issues:

(a) Nature of regulatory scheme in India
(b) Nature of regulation-entity centric or product centric
(c) Role of various regulatory agencies in regulation of Collective investment schemes
(d) Nature of ULIP products
(e) Definition of "contract of insurance" as exempt from the purview of collective investment schemes under Section 11 AA of SEBI Act.

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[1] [(ba) "collective investment scheme" means any scheme or arrangement which satisfies the conditions specified in Section 11AA;]

[2] S 11 AA of SEBI Act reads as follows:

(2) Any scheme or arrangement made or offered by any company under which-

(i) the contributions, or payments made by the investors, by whatever name called, are pooled and utilized solely for the purposes of the scheme or arrangement;

(ii) the contributions or payments are made to such scheme or arrangement by the investors with a view to receive profits, income, produce or property, whether movable or immovable from such scheme or arrangement;

(iii) the property, contribution or investment forming part of scheme or arrangement, whether identifiable or not, is managed on behalf of the investors;

(iv) the investors do not have day to day control over the management and operation of the scheme or arrangement.

(3) Notwithstanding anything contained in sub-section (2), any scheme or arrangement

(i) made or offered by a co-operative society registered under the cooperative societies Act,1912(2 of 1912) or a society being a society registered or deemed to be registered under any law relating to cooperative societies for the time being in force in any state;

(ii) under which deposits are accepted by non-banking financial companies as defined in clause (f) of section 45-I of the Reserve Bank of India Act, 1934(2 of 1934);

(iii) being a contract of insurance to which the Insurance Act,1938(4 of 1938), applies;

(iv) providing for any scheme, Pension Scheme or the Insurance Scheme framed under the Employees Provident Fund and Miscellaneous Provisions Act, 1952(19 of 1952);

(v) under which deposits are accepted under section 58A of the Companies Act, 1956(1 of 1956);

(vi) under which deposits are accepted by a company declared as a Nidhi or a mutual benefit society under section 620A of the Companies Act, 1956(1 of 1956);

(vii) falling within the meaning of Chit business as defined in clause (d) of section 2 of the Chit Fund Act, 1982(40 of 1982);

(viii) under which contributions made are in the nature of subscription to a mutual fund;

shall not be a collective investment scheme.]

Nature of Regulatory Regime in India:

Regulation in India is an oft discussed topic. However the exact nature of regulatory regime has seldom been examined. Indian Constitution provides for the frame work on which regulatory agencies work in the country. Part XI read with 7th Schedule of the Constitution provides the guidelines of legislative process. According to this Constitutional scheme, Parliament of India and State Legislatures shall have exclusive any matter which comes within List I and List III respectively and both the Parliament of India and State Legislatures have exclusive power to make laws regarding the matters enumerated in List II of the Constitution of India. Articles 249-255 provides guidelines in case of conflict between the legislative powers. These provisions have been responsible for non-overlapping of the regulatory powers in India. Further unlike many other countries, regulation through specialized agencies is a relatively new phenomenon in India. Till very recently regulation was mainly done through the various departments of the government itself. This is also one good reason why regulatory overlapping was not very frequent in India.

However even during the time regulation was handled by the various departments of government, there were disputes as to the jurisdiction and powers of various departments. In most of these cases resolution was possible without going for a legal battle since the matter involved the same branch of the government. However since the evolution of regulation through self-sustaining corporate bodies, the dispute resolution has become more difficult especially since jurisdiction means power and no regulatory body would be willing to forgo the power that comes along with the jurisdiction.

Very recently the Reghuram Rajan Committee on Financial Sector Reforms has proposed establishment of a Financial Stability and Development Council which the planning commission has said would solve most of the issues relating to regulatory competition. Deputy Chairman of Planning Commission Mr Montek Singh Ahluwalia has reportedly[3] favoured fast tracking the process of setting up FSDC which he thinks would solve issues where two or more regulators are involved.

Nature of regulation-entity centric or product centric:

As already stated the legislative scheme outlined by Article 246 of the Constitution of India states that the appropriate legislative body has power to regulate the "matters enumerated in" the relevant List of 7th Schedule. A reading of various entries in 7th schedule would make it clear that the entries cover both entities and areas. In the case of IRDA and SEBI, Entry 43 of List I of Schedule 7 of Constitution of India reads as follows:

> "Incorporation, regulation and winding up of trading corporations, including banking, insurance and financial corporations, but not including co-operative societies"

Entry 47 mentions insurance whereas Entry 48 mentions stock exchanges and futures market.

A perusal of the legislative scheme under which SEBI and IRDA works would make it clear that these bodies are established to regulate the "securities market" and "insurance business" and reinsurance business". The term "securities market" is not defined in SEBI Act, but Sub clause (2)(a) of Section 11AA of SEBI Act gives an indication that it means any marketplace dealing in securities similar to stock exchanges.[4] The other provisions of

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[3] http://www.dnaindia.com/money/report_montek-singh-for-putting-financial-stability-and-development-council-on-fast-track_1371508 as viewed on 16.04.2010 at 23.09 hrs.

[4] S 11(2)(a) of SEBI Act provide that the measures mentioned in S 11 (1) deals inter alia with (a) regulating the business in stock exchanges ***and any other securities markets***;

Section 11AA also gives an indication that SEBI Act deal with entities and not the business of securities, though SEBI can regulate the market through regulation of entities which play in the market. Similarly IRDA Act also provides for regulation of entities playing in the insurance market. While it is true that these regulatory bodies also gets the power to regulate specific products through the entities floating the products, the thrust of regulation is always on the activities of the bodies which are regulated by these bodies. Thus it is clear that the role of agencies like SEBI and IRDA are more generic in nature-viz, to control the market place rather than the specific products. Further the SEBI Act mentions certain specific type of entities[5] that are coming within the purview of regulatory regime of SEBI. Only those entities venturing into any of the activities mentioned in the SEBI Act could be regulated by SEBI. Similar is the case of IRDA. As such it should be seen that those entities carrying on a business or activity that comes within the purview and already regulated by one of such authority should not normally come within the regulatory regime of the other.

It is also pertinent to note that these entities like SEBI and IRDA are products of a liberalization regime which did away with license raj; and any attempt by these agencies to prohibit entities from dealing with any product solely on the ground that these entities are not registered with them.

Role of various regulatory agencies in regulation of Collective investment schemes:

Collective investment schemes as defined in S 2(ba) read with S 11AA of SEBI Act has the following features:

1. These are schemes or arrangements by a company other than schemes exempt under Section 11AA (3).
2. Under these schemes, the contributions, or payments made by the investors are pooled and utilized solely for the purposes of the scheme or arrangement;
3. Such contributions or payments are made by the investors with a view to receive profits, income, produce or property, whether movable or immovable from such scheme or arrangement;
4. The property, contribution or investment forming part of scheme or arrangement, whether identifiable or not, is managed on behalf of the investors;
5. The investors do not have day to day control over the management and operation of the scheme or arrangement.

As can be seen from this definition, this is a very wide definition, with the obvious intention to bring any collective investment scheme where investors do not have day to day control over management or operation of the scheme with the regulatory umbrella. However it has to noted that Section 11AA (3) excludes certain schemes from within the purview of collective investment schemes even though they are having the very same basic characteristics identified under S 11AA (2). The question is why? To answer this question we need to examine the exempted items, which are:

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[5] S 11(2)(b) of SEBI Act: reads (b) registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with securities markets in any manner;

13[(ba) registering and regulating the working of the depositories, [participants,] custodians of securities, foreign institutional investors, credit rating agencies and such other intermediaries as the Board may, by notification, specify in this behalf;]

(c) registering and regulating the working of [venture capital funds and collective investment schemes],including mutual funds;

Exempted Schemes/arrangements	Regulatory agency
Any scheme or arrangement offered by a cooperative society registered under the Cooperative Societies Act,1912(2 of 1912) or a society being a society registered or deemed to be registered under any law relating to cooperative societies for the time being in force in any state;	Regulatory body formed under the Cooperative Societies Act including Registrar of Cooperative Society
Any scheme or arrangement under which deposits are accepted by non-banking financial companies as defined in clause (f) of section 45-I of the Reserve Bank of India Act, 1934(2 of 1934);	Reserve Bank of India
A contract of Insurance to which insurance Act, 1938 applies	Insurance Regulatory & Development Authority of India
Any Pension, insurance or other scheme under Employees Provident Fund and Miscellaneous Provisions Act 1952	Employees Provident Fund Organisation
Scheme of acceptance of deposits under S 58A of Companies Act, 1956	Registrar of Companies
Scheme of deposits by a company declared as Nidhi or Mutual benefit society under S 620A of Companies Act, 1956	Registrar of Companies
Chit business as defined under S 2 of Chit Funds Act, 1982	Officer appointed by respective State Government
Contributions in the nature of subscription to a Mutual fund	SEBI

It is pertinent to note that each of these exempted schemes are governed by a special statute, different from SEBI Act and the mode of regulation of these schemes are provided under the relevant statute, and is regulated by another regulator(except mutual funds). An argument that can be advanced is that since Mutual funds, which are also exempted from the definition of collective investment schemes are regulated by SEBI itself, it would not be correct to look at the exempted products in this manner. However it is pertinent to note that in S 12(1B) of the Act which provides of registration of entities carrying on collective investment scheme mentions "collective investment schemes including mutual funds"[6], thereby making it clear that the definition of collective investment schemes in Section 11AA(2) was intended to exempt all those schemes and arrangement otherwise regulated. It is also pertinent to note that the definition of collective investment schemes and the provisions related to registration of persons carrying on such scheme were brought in through SEBI (Amendment) Act, 2002, S. 7(w.e.f. 29-10-2002) and on that date SEBI had in place a separate set of regulations for mutual funds called Securities and Exchange Board of India (Mutual Funds) Regulations, 1996. If we see the exclusion of Mutual

[6] S 12(1B): No person shall sponsor or cause to be sponsored or carry on or cause to be carried on any venture capital funds or collective investment schemes including mutual funds, unless he obtains a certificate of registration from the Board in accordance with the regulations:

Funds from the definition of collective investment schemes, the legislative intention in exempting schemes or arrangements already regulated by various bodies from further regulation by SEBI would become crystal clear. This deduction would be further strengthened by the argument that the statutes we are discussing, viz SEBI Act and IRDA Act are products of liberalization which is a philosophy antithetic to over-regulation, including regulation by multiple bodies.

Viewing the scheme of the SEBI Act from this angle, it would be clear that a contract of insurance, which is regulated by Insurance Act and IRDA, would not come within the purview of SEBI regulations.

Nature of ULIP products:

One of the main issues that were raised by the order of Ld. Prasanth Sharan, Whole Time Member, SEBI dated April 9, 2010 was regarding the nature of ULIP products. To quote from the impugned order:

> "I conclude that ULIPs offered by the said entities are a combination of investment and insurance and, therefore, the investment components are in the nature of mutual funds which can only be offered / launched after obtaining registration from SEBI under Section 12(1B) of the SEBI Act."[7]

To understand this further, we need to first look into the definition of the term 'mutual fund'. SEBI (Mutual Fund) Regulations, 1996 define Mutual fund as follows:

> "mutual fund" means a fund established in the form of a trust to raise monies through the sale of units to the public or a section of the public under one or more schemes for investing in securities including money market instruments or gold or gold related instruments or real estate assets;[8]

The Mutal Funds Act of British Virgin Island gives a better definition as follows:

> "an entity which collects and pools investor funds for the purpose of collective investment and which issues shares that entitle the holder to receive on demand, or within a specified period after demand, an amount computed by reference to the value of a proportionate interest in the whole or in a part of the net assets of the entity."

The essential features of mutual funds as per the SEBI definition are:

(a) A fund has to be established in the form of a trust
(b) The purpose of the trust is to raise money
(c) Money is raised through sale of units to public or a section of public under one or more schemes of investing in securities.

It is pertinent to note the following regarding this definition:

a. The definition precedes the definition of collective investment scheme in time.
b. Except the requirement that mutual funds are to be established in the form of a trust, the other two conditions are similar to definition of collective investment scheme under S 11AA of SEBI Act.
c. The definition is silent as to what the holder is entitled to.

It is in this light the definition of Mutual funds under Mutual Funds Act of British Virgin Island turns out to be better than the Indian definition. In the definition of Mutual funds under Mutual Funds Act, the holder of units of mutual fund is entitled to receive on demand, or within a specified period after demand an amount computed by reference to

[7] See Para 24 of the Order dated April 9, 2010, available in SEBI Website.
[8] Regulation 2(q) of Securities and Exchange Board of India (Mutual Funds) Regulations, 1996

the value of proportionate interest in the whole or in part of the net assets of the entity. This appears to be a proper definition for Mutual funds.
Now let us examine the nature of ULIP products:

a. The Unit Linked Insurance Product has two components- insurance and investment
b. The customers are given option to choose from various funds maintained by the company as per IRDA guidelines for the purpose of investment.
c. The customer gets the option to move from one fund to another fund, and enhance, balance or secure the returns at specified points of time.
d. The insurance part of the product should always be active for the product to give any returns. Some of the insurance companies permit partial withdrawal of funds before maturity, in which case the funds required for insurance is parked with the insurance company. However it does not appear that any insurance company is giving a scheme where the insurance part can be totally withdrawn by the customer, keeping his funds with the insurance company only for the investment purposes.
e. Going to the rationale of the order of SEBI dated April 9,2010, some of the grounds taken by SEBI for coming to conclusion that ULIPs are similar to Mutual Funds and the correct position regarding each of them are given in the table below:

<table>
<tr><td>Arguments by SEBI</td><td>Correct Position/Counter Argument</td></tr>
<tr><td>The attributes of the investment component of ULIPs launched by these entities are akin to the characteristics of mutual funds which issue units to the investors and provide exit at net asset value of the underlying portfolio.</td><td>The definition of Collective investment scheme under S 11AA of SEBI Act recognises that there could be collective investment schemes outside SEBI regulation, including insurance product and company deposits</td></tr>
<tr><td>The investment component of ULIPs is subject to investment risks associated with securities markets which are entirely borne by the investors.</td><td rowspan="2">True but it needs to be also kept in mind that the guidelines issued by competing regulator IRDA are sufficient to hedge the investment risks</td></tr>
<tr><td>There are two components of ULIPs - an insurance component where the risk on the life insurance portion vests with the insurer and the investment component where the risk lies with the investor. This establishes conclusively that ULIPs are a combination product and the investment component need to be registered with and regulated by SEBI.</td></tr>
<tr><td>Further, it has been said that ULIPs have a mandatory insurance cover which forms a vital and inseparable part of every ULIP. In this regard I note from one of the products offered by one of the entities that for a sum</td><td>Here instead of going into the issue whether insurance component is the vital and inseparable element, the Ld. Member has instead gone into the issue whether the ULIP is predominant, and after coming to the</td></tr>
</table>

	assured of Rs. 15,00,000/- an annual premium of Rs. 1,50,000/- is collected for 10 years. The premium allocated for insurance out of this is Rs. 7500/- in the first year and Rs. 3000/- in subsequent years. (The annual premium for a term plan for 10 years for an identical sum assured for an identical life assured by the same company is Rs. 3,342/-) Here, the insurance component is 2% of the premium paid. The products offered by other entities also follow a broadly similar pattern. Thus, the argument that insurance is both predominant and inseparable in a ULIP fails.	conclusion that the insurance is not a predominant element, on the basis of the conclusion that the value of insurance component in case of some products is much less compared to investment component. It must be borne in mind that the issue is not whether which component is predominant, but whether the components are inseparable, since if the components are inseparable, the insurance companies would go out of the purview of SEBI regulation by virtue of Section 11AA(3)(iii) of SEBI Act.

Hence it can be concluded that it is unreasonable to hold ULIPs as mutual fund products simply because the requirements under SEBI guidelines are fulfilled, since the definition of mutual funds in SEBI guidelines have not be updated since the introduction of S 11AA in 2002 and further the legislative intention is clear in the language of S 12(1B), which says that "No person shall sponsor or cause to be sponsored or carry on or cause to be carried on any venture capital funds or ***collective investment schemes including mutual funds***[9], unless he obtains a certificate of registration from the Board in accordance with the regulations". Since mutual funds are also in the exempted category in S 11AA (3) of SEBI Act, the purposive inclusive of mutual funds alone within the registration requirement under S 12(1B) of the said Act clearly shows the intention of legislature to exempt all other collective investment schemes, which may have some of the features of mutual funds, but are regulated by a different regulator. Now in the light of the above discussion, it can be understood that the most critical test is whether the ULIP is an insurance product.

Definition of "contract of insurance"

Neither the SEBI Act nor IRDA Act defines what is meant by a contract of insurance, though indications under both these statutes are that the contract of insurance is defined in Insurance Act, 1938. However a perusal of Insurance Act, 1938 would reveal that the term 'Contract of insurance' though used in the Insurance Act, 1938 is not defined there in. However the Insurance Act defines different types of life insurance business and also frequently refers to "contract of insurance". Hence we need to look into cases laws for a proper definition of contract of insurance.

In *Prudential Ins Co* v *Inland Revenue Commrs*[10], the Kings Bench as defined a contract of insurance as "a contract where by one party (insurer) promises in return for a money consideration (premium), to pay to the other party (insured) money or money's worth on the happening of an uncertain event more or less adverse to the interest of the insured."

[9] Emphasis supplied.

[10] (1904)2KB658:73LJKB 734:91 LT 520:20 TLR 621

In *Gould* v *Curtis*[11] the Kings Bench held that in case of life insurance policies, it is not necessary to have a character more or less adverse to the interest of the insured in the case of life insurance since life insurance has an investment aspect as well, such as one providing for the uncertainty of life.

From the above decisions it is apparent that insurance, especially life insurance has an integrated investment aspect as well. Even the traditional life insurance products, has the investment aspect and the pay out on maturity happens by liquidating the value of the collective investment, through a complex actuarial calculation, and if the logic adopted by SEBI in its order dated April 9, 2010 is applied, all life insurance products would come within the purview of S 11AA(2) and this was clearly not the legislative intention as can be seen from exemption given to contracts of insurance under S 11AA(3)(iii) of SEBI Act.

The question now posed is whether ULIPs specifically have the features of contract of insurance as defined in Prudential Ins. Co. and Gould. In fact this issue was examined in *Fuji Finance Inc. v. Aetna Life Insurance Co Ltd*[12] where the Court of Appeal in UK held 'capital investment bonds' (having features identical to ULIPs), to be contracts of insurance. The arguments raised against such reckoning by the court below was that a policy is not a contract of insurance unless quantum of the payment made unless triggered by death or a contingency on life (and not same as what insured would get on surrender of the policy), similar to the argument raised by SEBI in its order dated April 9, 2010. The court of appeal rejected this argument and held that since the policy came to an end on the death of the insured and the right to surrender was related to the continuance of life for it could not be exercised after the death of the insured, there was an uncertainty involved. While it accepted that a contract offering merely a surrender value would not have been an insurance policy, it held that there should be no reason why a contract that offers both death benefits and surrender benefits should not be considered as a contract of insurance. There seems to be no reason why this logic as applied to capital investment bonds are not equally applicable to ULIPs in India and hence ULIPs are contracts of insurance exempt from the regulatory purview of SEBI under S 11AA(3)(iii) of SEBI Act.

Final Analysis:

In the light of the above discussions, the following conclusions can be drawn:

a. Regulatory regime in India, post liberalization can bring in a scenario of regulatory competition which was hitherto unknown, and there is requirement of a dispute resolution mechanism between regulators to avoid such conflicts. Such mechanism should also ensure that before any orders which may affect the matters within the jurisdiction of another regulator, the matter has to be referred to the affected regulator and the dispute resolution mechanism and on post resolution of the dispute and/or approval of the order through the dispute resolution mechanism, such orders should be made public. This is required both for good governance, to avoid regulatory conflicts and to ensure smooth functioning and healthy growth of the financial sector.

b. Collective investment scheme is a generic term and the essential requirements to constitute any scheme or arrangement as provided in S 11AA (2) of the SEBI Act would also cover the entities exempted under s 11AA (3) of the said Act. The purpose of the exemption there fore is to avoid regulatory conflicts and an understanding of the exemption in this sense is missing from the SEBI order dated April 9, 2010.

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[11] 1913)3 KB84,95

[12][1997] Ch 173, [1996] 4 All ER 608.

c. It is undisputed that ULIPs are combined insurance and investment products. But it should also be understood that both the insurance and investment parts are currently regulated by IRDA, and hence further regulation by SEBI is both unnecessary and contrary to the spirit of S 11AA(3) of SEBI Act. Further such regulation is also not in sync with the purposes of liberalization which gave birth to agencies like SEBI and IRDA.
d. ULIPs which offer a combination of insurance and investment are contracts of insurance drawing the logic of *Fuji Finance Inc. v. Aetna Life Insurance Co Ltd* and hence are exempt from the regulatory purview of SEBI.

In the light of the discussion above, it is proper to conclude that regulatory competition at least in the case of ULIPs was perfectly unavoidable had SEBI took into account all aspects of law and regulation. However, it should not go unseen that existence of multiple regulatory bodies will create such scenes in future, since regulation means control and control means power. Hence it is pertinent to create an appropriate dispute resolution mechanism, which would pre-empt regulatory issues and resolve them before those issues go ugly. The most appropriate mechanism should be a higher body, with legal experts in board, which would judiciously decide on issues of regulatory competition taking all the parties into confidence and which has powers to withhold the orders before they are issued. It would be only appropriate that such issues are resolved before it goes public since the impact of such regulatory issues would be much higher on individual investor than any of the regulators can imagine.

APPENDIX II

PUBLISHED ARTICLE II:

Regulation of Financial Derivatives: Some Policy Considerations:

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Regulation of Financial Derivatives: Some Policy Considerations

John Varghese*

Financial Derivatives which form a major driving force in the international monetary sphere are being used by banks and financial Institutions to mitigate risks arising from the volatility of the underlying asset. They form the back bone of international economy. Derivatives Regulation in the US and India is essentially a hybrid of "institutional" and "functional" regulation. Though Regulatory Institutions have come up with disclosure norms to ensure greater transparency in the trading of derivatives, derivative regulation is more focussed on self-regulation. This paper tries to examine the various models of regulation of financial derivatives from a purposive perspective.

Introduction

Financial Derivatives have established themselves as a major driving force in the international monetary sphere in the recent past. While derivatives were originally used as an effective monetary instrument to multiply the wealth through ripple effect, of late these instruments are also used by banks and financial institutions to mitigate risk arising from the volatility of the underlying asset. This apart, derivatives along with the new generation monetary instruments such as Investment securities in bearer form have already become the back bone of International Economy.

Regulation of Financial Derivatives has a chequered history. There were periods in history when the trading in these instruments was banned. However like any prohibition, the prohibition of openly trading in financial derivatives only led to evolution of a clandestine market for these instruments, and innovative players in these markets created new types of instruments to bypass regulatory restraints.

Derivatives regulation in the United States as well as in India is essentially a hybrid of "institutional" and "functional" regulation. Some organisations that trade in derivatives are regulated by institutions like FSA, Securities and Exchange Commission, RBI, SEBI etc., and these institutions have come up with disclosure norms to ensure greater transparency in the trading of derivatives. On the other hand, the functional regulatory regime controls the instruments are "financial instruments" with a slew of measures to ensure transparency and accountability. On the whole it can be seen that the derivative regulation is more focused on self-regulation with an underlying assumption that the trade houses that utilises derivatives does so prudently and with self-regulation.

History of Derivatives Markets and Regulatory Efforts

Ever since money was invented, humans have devised ingenious ways to increase its worth. Financial sector have been dominating the political scenario of many civilizations and countries of the world since very early days in varying degrees. Financial derivatives have been in existence from very early days of development of financial sector. The history of derivative trading began almost simultaneously with history of trading. This is evident in many early civilizations as Rome, Mesopotamia and India[1]. Even in India, forward contracts were engaged for the purpose of trade right from Indus valley civilization[2].

In the medieval period, the European merchants made extensive use of financial derivatives for trade. An important legal development in the history of financial derivatives was the Royal Decree in Antwerp that made contracts for future delivery transferable to third parties. At about the same time, Merchants discovered that there is no need to settle forward contracts by delivering the underlying asset, as it is sufficient if the losing party compensates the winning party for the difference between the delivery price and the spot price at the time of settlement. Contracts for differences were written on bills of exchange, government bonds and commodities. Although it is likely that similar deals had been done in Bruges and with monti shares[3] in Italy, contracts for differences were used on a large scale for the first time in Antwerp. The commodities exchanges whose history starts with the beginning of options and futures trading in Amsterdam Stock Exchange in 1611, gave further impetus to the growth of financial derivatives.

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[1]Aristotle, *Politics*, (trans. Benjamin Jowett), vol. 2, in The Great Books of the Western World , (ed. Robert Maynard Hutchins) University of Chicago Press, Chicago (1952), book 1, p. 453, as quoted in Siems, T. F. (1997) *10 Myths about Financial Derivatives,* Cato Policy Analysis no. 283, http://www.cato.org/pubs/pas/pa-283.html accessed on 10-05-2010. Siems quotes Aristotle's story about Greek philosopher Thales indulged in perhaps the world's first futures contract. Thales was profited by forecasting that the next olive harvest would be an exceptionally good one. As a poor philosopher, he did not have many financial resources at hand. But he used what he had to place a deposit on the local olive presses. As nobody knew for certain whether the harvest would be good or bad, Thales secured the rights to the presses at a relatively low rate. When the harvest proved to be bountiful, and so demand for the presses became high, Thales charged a high price for their use and reaped a considerable profit. This is similar to what we call 'options' in the modern financial jargon, though the option exercised by Thales was more of a betting than making a shrewd financial calculation, since no one was sure whether the crops could survive the harvest when the prediction was made!

[2]See Zohary, Daniel and Maria Hopf, "*Domestication of Plants in the Old World: The Origin and Spread of Cultivated Plants in West Asia, Europe, and the Nile Valley*, 3rd ed., Oxford: Oxford University Press (2000), pp.140-141, who maintains that the sesame plant was cultivated in the Indus Valley between 2250 and 1750 BC. A tablet, which is from 1809 BC, shows that a Mesopotamian merchant borrowed silver, promising to repay it with sesame seeds "according to the going rate" after six months. He may have used the silver to finance a trading mission to the Indus Valley to obtain sesame seeds. This contract combines a silver loan with a forward sale of sesame seeds.

[3]'*Monte shares*' literally meant "mountain (of indebtedness) of shares which were sold as bonds. Such shares were sold according to fluctuating market price, and could be bequeathed to heirs or vacated upon death of the holder, in which case they bore higher rates of interest. Interest payments were pledged to the tax revenue from the city of Rome. This was a main source of income for papacy during the renaissance period. See Charles L. Stinger, *The Renaissance of Rome*, Indiana University Press, USA, p. 128.

By the end of 19th Century, there were well established Commodities Exchanges in different part of the world and India was a leader in commodities trading. During early 20th Century, there were a number of well-established commodity markets in India, trading in futures and other similar derivatives[4]. They were regulated by social control of close-knit groups and whenever such control failed; there would be a crisis[5].Some analysts were of the view that by the beginning of 1900's India had one of the world's largest future's industry[6]with well-established commodities exchanges.

The history of regulation of financial derivatives is also not recent. The first attempt to regulate the financial markets can be seen from the early 16th century. Thus in Antwerp, contracts for differences were outlawed shortly after forward contracts had been made transferable, around 1541[7]. Later on, a ban on short selling was imposed in 1610. But it is unlikely that this restriction was effective because a forward contract did not show how it will be settled. Even if the contract requires the delivery of the underlying asset, the parties to the contract can informally agree on a cash payment at the delivery date. In Amsterdam in 1621, 1630 and 1636, three edicts were issued with the intention to undermine contracts for differences by making them unenforceable in the courts[8]. In 1734, the British Parliament passed the *Sir John Barnard's Act*, which declared contracts for the future delivery of securities to be "null and void". Fines amounted to £500 for "refusals" and "putts" and £100 for short-selling operations. The *Act* applied only to derivatives on securities because, as debated in Parliament, it was feared that commodity markets would move back to Amsterdam if contracts for the future delivery of commodities were outlawed in London. Hence for a long time, the trade in derivatives was based on reputation of traders rather than on the basis of legal backing. In France too the *Commercial Code* of 1807 outlawed the trading in securities otherwise than in authorized exchanges. A Police Order of January 24, 1823 again restricted the trading in securities

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[4]The history of futures trading in commodities in India dates back to the later part of 19th century when the first commodity exchange, viz. the Bombay Cotton Trade Association Ltd was set up for organizing futures trading. The early 20th century saw the mushrooming of a number of commodity Exchanges. The principal commodity markets functioning in pre-independence era were the cotton markets of Bombay, Karachi, Ahmedabad and Indore, the wheat markets of Bombay, Hapur, Karachi, Lyallpur, Amritsar, Okara and Calcutta; the groundnut markets of Madras and Bombay; the linseed markets of Bombay and Calcutta; Jute and Hessian markets of Calcutta; Bullion markets of Bombay, Calcutta, Delhi and Amritsar and sugar markets of Bombay, Calcutta, Kanpur and Muzaffarnagar. There were no uniform guidelines or regulations. These were essentially outcomes of needs of particular trade communities and were based on mutual trust and faith.

[5]Report of the Expert Committee to study "The Impact of Futures Trading on Agricultural Commodity Prices}", Ministry of Consumer Affairs, Food & Public Distribution, Government of India (2008) (Abhijit Sen Committee), p. 2.

[6] Asani Sarkar, "*Indian Derivatives Market*", as available in the website http://www.newyorkfed.org/research/economists/sarkar/derivatives_in_india.pdf (Last accessed on 10-05-2010) at p. 3

[7]Swan, Edward J, *Building the Global Market. A 4000 Year History of Derivatives*, Kluwer Law International, The Hague (2000), p.144.

[8]See Wolfgang Hafner*et al*. (Ed.), *VinzenzBronzin's Option Pricing Models - Exposition and Appraisal*, Springer, Switzerland, 2009 at p. 443. See also, Joseph de La Vega, *Confusion de Confusiones, Am*sterdam, 1688, translated by Hermann Kellenbenz H, 1957, reprinted by Baker Library, Harvard Business School, 1998.

and commodities to authorized dealers at stock exchanges. However Jureg[9]notes that this did not prevent trading in such commodities or derivative trading, but only took them out of the premises of stock exchange, based on reputation, with no recourse to court in case of breach of contract. In the 1820s, derivative trading with government bonds flourished in Paris. Contracts such as contracts for future delivery (négotiations à terme), forward contracts (marchésfermes) and options (marchés à primes, marchéslibres), a call option called an “achat à prime” and a put option called “vente à prime” and repurchase agreements, which were called “reports” were greatly traded in Paris. By 1857 however, contracts of future delivery were made legal if the delivery date did not exceed 2 months (1 month for railway shares). In Germany contracts for future delivery were called “Zeitgeschäfte”,which were subdivided into Contracts for future delivery were subdivided into forward contracts (fest abgeschlosseneGeschäfte, festeGeschäfte, Fixgeschäfte) and options (Prämiengeschäfte, Dontgeschäfte).

In 1885, derivative contracts became legally enforceable in France, although it was still possible to raise the objection against gambling under some circumstances. In Germany the regulatory framework was similar to that in France for most of the nineteenth century, i.e. derivatives were traded in a legal limbo. In Prussia contracts for future delivery were outlawed for Spanish government bonds in 1836, for all foreign securities in 1840, and for securities of railways in 1844. After the unification of Germany in 1871, it was up to the courts to decide whether a contract for future delivery was legitimate or whether it was motivated by illegal gambling. The courts took into consideration the contract’s terms, the profession and wealth of each party and anything else that might shed light on the contract’s purpose, which all gave rise to considerable legal uncertainties. In 1896, Germany passed a law (Börsengesetz) that severely restricted derivative dealings. It became illegal to conclude contracts for the future delivery of wheat and milling products, and for shares of mines and factories. The government also could regulate and prohibit contracts for all other goods and financial assets. These severe restrictions disrupted commodity markets and financial markets in Germany, diverting trade in commodities and securities to foreign exchanges[10]. The German law of 1896 also determined that contracts for future delivery were enforceable only if both parties had registered as dealers. However instead of facilitating any meaningful regulation, this clause took out derivatives trade largely into the unregulated zone, since many traders opted not to register themselves and instead opted to carry on trade in derivatives on reputation basis.

In India too trade in financial derivatives have been carried on for long on a reputation basis. Indian Contract Act, 1872, contained provisions modelled on Gaming Act, 1845(UK) which prohibited agreements by way of wager[11]. For long this provisions were thought to be prohibiting derivative transactions, though the courts have, on many occasions clearly decided to the contrary[12]. Soon after independence, Forward Contracts

[9]Weber, Ernst Juerg, “A *Short History of Derivative Security Markets”* (June 2008), Available at SSRN: http://ssrn.com/abstract=1141689, p. 27.
[10]*Id*, at p. 39.
[11] Section 30 Indian Contract Act, 1872 provides that agreements by way of wager are void; and no suit shall be brought for recovering anything alleged to be won on any wager, or entrusted to any person to abide by the result of any game or other uncertain event on which any wager is made.
[12] See Bhagwandas Parasram v. Burjorji Ruttonji Bomanji, AIR 1917 PC 101, Ismail Lebbe Marikar Ebrahim Lebbe Marikar v. Bartleet and Company, AIR 1942 P. C 19, Rajshree Sugars

(Regulation) Act, 1952 and Securities Contract (Regulation) Act, 1956 were enacted in quick succession in India, and the objectives of these Acts, interestingly, were to prevent undesirable transactions in securities by regulating the business of dealing therein, "by prohibiting options and by providing for certain other matters connected therewith"[13]. There were specific provisions in these statutes, which prohibit the trading in certain financial derivative products. However the trading in such financial derivatives continued in the grey market throughout this period.

It was only in the wake of liberalisation of Indian Economy which started from 1991, the financial derivatives got some respectability. Currently there are three regulators in the regulatory space governing financial derivatives in India: The Reserve Bank of India (RBI), Forwards Market Commission (FMC), Securities and Exchange Board of India (SEBI). There is also a level of self-regulation among the market players. However, each of these regulators play in a different turf, for example, Reserve Bank of India is concerned with only the activity of banks and Non-Banking Financial Companies (NBFCs) in dealing with derivative instruments; whereas other companies dealing in derivatives are being controlled by SEBI. To understand the scope of regulation by these entities it is necessary to understand the basic theory of regulation.

Definition of Regulation:

Robert Baldwin[14] tries to analyse the meaning of the word "regulation" as follows:

> "At its simplest 'regulation' refers to the promulgation of an authoritative set of rules, accompanied by some mechanism, typically a public agency, for monitoring and promoting compliance with these rules. Rule-making and monitoring/enforcing mechanisms need not be located in a single institution. A second broader conception of regulation takes in all the efforts of state agencies to steer the economy. Such an approach has the merit that a variety of tools are considered as possible alternatives to possible command and control type regulation, so that where rule making seems to be inappropriate as a means for achieving policy objectives, other tools may be used. A third definition, broader still considers all mechanisms of social control-including unintentional and non-state processes- to be forms of regulation. Thus such a definition extends also to mechanisms which are not products of state activity, or part of any institutional arrangement, such as development of social norms and the effects of markets in modifying behaviour."

Thus regulation has three different connotations, in an ascending order of broadness:

a. . Regulation means administrative rule making power, which restricts administrative discretion and provides a framework for administrative action, such as any regulation by RBI for regulation of activities in derivatives market.

b. Regulation means all efforts taken by state agencies to steer the economy, including the efforts by state agencies to enforce compliance through agreements, guidelines which do not have any binding force but which sets best practices which cannot then be ignored by the market players.

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and Chemicals Limited v. AXIS Bank Limited, 2008 Bus L R 908, 2009(1) CTC 227, (2008)8 MLJ 261.

[13]See the Object clause of Act 42 of 1956.

[14] Robert Baldwin, Colin Scott, Christopher Hood (Ed), *A Reader on Regulation*", Oxford University Press (1998) at pp 3-4.

c. Regulation means all mechanisms of social control including self-regulation.

In this paper, the word regulation is being used in the broadest sense of the word.

Regulatory Approaches:

There are three distinct approaches to regulation as follows:

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

In India, though in practice the interest group approach and the regulatory capture approach drives regulatory activities to a great extent, the public interest approach is the only publically taken approach to regulation. Generally, regulatory framework of securities market has been divided into prudential regulation and conduct of business regulation. This division is arguably flawed in two respects: It inadequately reflects philosophical justification for regulation, and it focuses on type of rule imposed rather than the type of risk which is to be addressed[15].

Regulatory Styles:

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

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

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

Advisory Regulation: This system, which was largely followed in countries like Japan, where while regulatory authorities exercise wide discretion in issuing guidance,

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

compliance is largely voluntary[16]. The Old boy network, with retired government officials commonly transferring to the management of businesses ensured low relational distance in regulation[17].

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

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

1. **Command and Control theory:** Classical model of regulation with the regulator making and enforcing the rules. In India, control of RBI is broadly falling within the category. RBI issues regulations, which generally the regulated entities have no option but to follow.
2. **Partial Industry Intervention theory:** The regulated businesses will have some obligations in their licenses which the agencies would enforce. A key aspect of such regulation is that though all players are obliged to have licenses, only those with a dominant market are exposed to all the regulatory requirements. SEBI in India generally operates in this mode.
3. **Franchising:** Firms wanting to carry the regulated activity bid for the right to do so. The franchise would be issued to the most favoured bidder, who will have to carry out regulated activity for a fixed period of years. The franchisee agreement would contain certain clauses as to quality and mode of carrying out the activity, which the regulator would then seek to enforce. Though such a model is largely not applicable in financial sector in India, telecom regulation in India is the best example for such a model of regulation.
4. **Regulation by Contract:** In this model, the government enters into contract with the regulated entities, and clauses of contract contain the terms of regulation. A good example of this type of regulation can be seen in Stock Exchanges entering into listing agreements with companies, and regulating the companies through these listing agreements. While the primary objective of entering into listing agreement is obviously not regulation, regulation takes place incidentally to the main purposes which help in achieving regulatory standard across all firms contracting with the regulatory body, without ever issuing a mandatory rule[18].
5. There is no accepted definition for the term self-regulation. In this scheme of regulatory regime, the representative organisations, for example a trade organisation, develops a system of rules which it will then monitor and enforce against, in some cases, its members and in rarer cases larger community[19]. These representative bodies function independently of government encouragement, and mostly the major objective behind self-regulation is to prevent government from coming up with mandatory regulation. In India, Foreign Exchange Dealers

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[16] . Herald Baum, "Introduction: Emulating Japan?" In H. Baum (Ed), *Japan: Economic Success and Legal* System Berlin: Walter de Gruyter, (1997) pp.12-13.

[17] *Ulrikr Schaede, "The 'Old Boy' Network and Government Business Relationship in Japan" in In H. Baum (Ed), supra n. 18. at p. 343.*

[18] *Supra n.* 15, at p. 26.

[19] *Id*, at p 27

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

Objectives of Derivative Regulation:

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

a) Ensuring that the underlying instruments are transactionally, informationally and functionally efficient.

b) Regulation should not hinder or have negative impact on financial innovation.

c) Steps should be taken to avoid regulatory arbitrage.

Financial Standard Foundation (FSF), after analysing the reports of International Organization of Securities Commissions (IOSCO) and Committee on Financial Sector Assessment (CFSA) and various other international bodies has set certain guidelines for regulation of securities market which are internationally accepted [20] and has been continuously monitoring the performance of various countries in meeting these objectives. The regulatory guidelines set by FSF are as follows:

1. The principles of the regulator should be clear and objectively stated.
2. The regulator should be operationally independent and accountable in the exercise of its functions and powers.
3. The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
4. The regulator should adopt clear and consistent regulatory processes.
5. The staff of regulator should observe the highest professional standards, including appropriate standards of confidentiality.
6. The regulatory regime should make appropriate use of Self-Regulatory Organisations (SRO's) that exercise some direct oversight responsibility for their respective areas of competence to the extent appropriate size and complexity of markets.
7. SRO's should be subject to the oversight of regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.
8. The regulator should have comprehensive inspection, investigation and surveillance powers.
9. The regulators should have comprehensive enforcement powers.

[20] Based on data available on http://www.estandardsforum.org/india/standards/objectives-and-principles-ofsecurities-regulation accessed on 29-1-2011

10. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance programme.
11. The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.
12. The regulators should establish information sharing mechanisms that set out when and how they will share both public and non -public information with their domestic and foreign counterparts.
13. The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.
14. There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions.
15. Holders of securities in a company should be treated in a fair and equitable manner.
16. Accounting and auditing standards should be of a high and internationally acceptable quality.
17. The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.
18. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.
19. Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.
20. Regulation should provide for minimum entry standards for market intermediaries.
21. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.
22. Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.
23. There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.
24. The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.
25. There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.
26. Regulation should promote transparency of trading.
27. Regulation should be designed to detect and deter manipulation and other unfair trading practices.

28. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.
29. Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.

Derivatives Regulation in India:

In India derivatives trading is regulated by a mixture of command control, franchising, contractual and self-regulatory mechanism. As already mentioned, the Securities Contract (Regulation) Act 1956 (SCRA), the Forward Contracts (Regulation) Act, 1952, Depositories Act, 1996 and certain provisions of Companies Act, 1956 provide the statutory backbone for derivatives regulation. However it is worth noting that apart from creating a regulator and entrusting the duty of regulating derivatives with the regulator, these statutes do not deal with regulation of derivatives in great respect. While Section 17 of SCRA entrust the regulatory responsibility of certain types of derivatives to SEBI, Sections 20, 21 and 21A of Reserve Bank of India Act, 1934 empowers RBI as the regulator in respect of certain government securities market and also regulate the major players in the derivatives banks-the financial institutions. SEBI has created certain Self-Regulatory Organisations (SRO's) which are non-governmental bodies with the responsibility to regulate their own members through a set of rules of conduct for fair, ethical and efficient practices. SEBI also exercises its regulatory oversight through Stock Exchanges. Stock Exchanges are bodies created by cooperation among market players and the SEBI generally maintains tight regulatory oversight over these market places. These bodies like the National Stock Exchange, Bombay Stock Exchange (BSE), Multi Commodities Stock Exchange (MCX) etc., act as franchisees to SEBI to enforce regulation of players in derivatives market through a process of listing contracts, rules and guidelines. Commodities market is regulated by yet another regulator, Forwards Market Commission (FMC) which, unlike SEBI and RBI is not a statutory body but a department of Ministry of Consumer Affairs. FMC exercises considerable powers under Forwards Contract(Regulation) Act, 1952 regarding futures and options trading in commodities,(which is a variant of derivatives) and exercises its control both through command and control mechanism as well as through franchising regulatory duties to commodities exchanges like MCX etc. There are also a host of self-regulatory organisations, at national {Foreign Exchange Dealers Association of India (FEDAI)} and at international level I.S.D.A. which set industry standards for derivatives trading and ensure compliance through a peer pressure mechanism.

Regulatory objectives in India:

As early as in 1997, SEBI and PWC along with USAID had tried to outline the broad features of regulatory framework for derivatives market. As per the PWC report[21] the following were the considerations that should be kept in mind while evolving an appropriate framework for exchange traded derivatives:

> "…the regulatory framework must provide the necessary protections but not restrict market development. Such a framework should be based on:
>
> - The demand for such a market,

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[21]Available on http://pdf.usaid.gov/pdf_docs/PNACC022.pdf (Last accessed on 29-01-2011) at p 5-6

- Potential market participants and how they believe they would use the market,
- The existing financial and legal infrastructure and its integration into the regulatory structure, and
- The existing market environment and culture.

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

a) consistent with minimum best practice derivatives market standards, and
b) designed to ensure a market that is open and competitive (free from manipulation and other forms of trade practice abuse).

The self-regulator has the front line responsibility to assure financial integrity, to protect the customer and to ensure open and competitive markets that treat outside capital and all participants fairly and equitably. In addition to performing at least a periodic auditing of all SRO programs and activities, the oversight regulator steps into investigate alleged market

manipulation or other wrongdoing and takes appropriate enforcement action when the SRO does not adequately fulfil its responsibility[22] The report further points out the following minimum regulatory goals that are internationally accepted:

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

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

i. **Investor Protection:** This includes rules relating to ensuring fairness and transparency in market dealings, guidelines for safeguarding client's money, ensuring competent and honest service and market integrity.
ii. **Quality of Markets:** aims at enhancing important market qualities, such as cost efficiency, price-continuity, and price-discovery.
iii. **Innovation:** Should not stifle innovation which is the source of all economic progress.

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

> "The derivatives exchange/segment should have a separate governing council and representation of trading/clearing members shall be limited to maximum of 40% of the total members of the Governing Council. The exchange shall regulate the sales

[22] *Id,* at p. 6.

practices of its members and will obtain prior approval of SEBI before start of trading in any derivatives contract[23]."

However RBI which regulates empowered to regulate the interest rate derivatives, foreign currency derivatives and credit derivatives which are basically traded by financial institutions like banks and Non-Banking Finance Companies have an entirely different set of regulatory goals. In its Guidelines on Derivatives Trading[24], RBI has outlined the following as the regulatory goal:

a) To ensure suitability and appropriateness of the derivative products being offered to customers.
b) Providing adequate information to the investors about the products.
c) Ensuring proper documentation of the derivatives product.
d) Identification of risk.
e) Risk measurement and setting proper risk coverage limits.
f) Ensuring independent risk control mechanism.
g) Segregating operational management control of the organisations dealing with derivatives.
h) Audit requirements.

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

Out of the regulatory objectives identified by FSF, except the requirement of internal control of market intermediaries all other regulatory requirements are either in progress for compliance or fully complied with in India. The latest available report of CFSA dated March 2009[25] concluded that India has fully implemented 20 IOSCO principles, broadly implemented 8 and partly implemented the remaining 2 principles. The gaps in compliance, as observed by the report, included those in the areas of supervisory autonomy, transparency and disclosure, regulation and inspection of market intermediaries, and oversight of the secondary markets. According to the report, there is a clear division of regulatory jurisdiction over Indian financial markets between the Securities and Exchange Board of India, the equities market regulator, and the RBI, which also oversees the government securities market. On the basis of this FSF has concluded that India has complied with only 58.33 % of the IOSCO guidelines, with a rank of 14 in Financial Standards Index, in which Netherlands ranks first with 73.33 % compliance.[26] UK ranks 5 and USA ranks 7 in this index, as on March 2009, with 68.33% and 65% compliance respectively.

Lessons from 2008 Market Crash:

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[23] See the copy of the circular is available in http://www.sebi.gov.in/Index.jsp?Content Disp=Search (Last accessed on 28-01-2011).

[24] DBOD. No. BP. BC. 86/21.04.157/2006-07 dated April 20, 2007 and the annexed guidelines available on http://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=3432 (Last accessed on 29-1-2011).

[25] For details see http://www.estandardsforum.org/india/standards/objectives-and-principles-of-securities-regulation (Last accessed on 29-1-2011)

[26] See the Financial Standards Index ranking available in http://www.estandardsforum.org/browse/ranking accessed on 29-1-2011.

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

Rakesh Mohan, Deputy Governor to Reserve Bank of India, in a speech entitled "Emerging

Contours of Financial Regulation: Challenges and Dynamics"[27] after considering the most

influential[28] committee reports that came up regarding financial regulation and integration comes to a conclusion that all these reports acknowledged the regulation and supervision in advanced economies were clearly too lax in the recent times, and there needs to be re-thinking leading to much strengthened and perhaps intrusive regulation and supervision in financial sector. Dr Mohan further goes on to observe:

> "With financial deregulation in key jurisdiction like the United States and the UK, along with most other countries, financial institutions also grew in complexity. Financial conglomerates began to include all financial functions under one roof: banking, insurance, asset management, proprietary trading, investment banking, broking, and the like. The consequence has been inadequate appreciation and assessment of the emerging risks, both within institutions and system wide.[29]"

This systemic risk in conjunction with the unprecedented explosive growth of securitised credit intermediation and associated derivatives was based on an erroneous assumption that such products constituted a mechanism which took off the risk off the balance sheets of banks, placing it with a diversified set of investors resulted in the collapse of the global economy in 2008. The opaqueness of these derivative products, which was the result of their valuation becoming increasingly dependent on model valuation and credit ratings, rather than observable and transparent market valuation, made shadow banking system and other rot in the system unobservable. As a result of all these factors, rather than reducing systemic risk, the system of complex securitisation and associated derivatives only served to increase systemic risk. Moreover, it became increasingly difficult to trace where the risk ultimately lay[30].

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

1. Deregulation of derivatives trading leading to lack of oversight over the practices of originator firms.

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[27] Available in http://rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/ECFRBU0609.pdf accessed on 1/2/2011.

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

[29] *Id* at p. 6.

[30] *Id*, at p. 7.

2. Watering down of the concept of risk during 1990's leading to further laxity in regulatory approach. As Lynn Turner, former chief accountant of Securities Exchange Commission (SEC) observes, what resulted in the effective collapse of major financial institutions such as AIG and Enron was the introduction of credit derivatives that the congress and administrations ensured would never be subject to regulation[31]. He points out that the regulatory system in place for years leading up to the crisis was not out dated but was systematically dismantled by the administration.
3. Increased complexity of the derivatives product made them beyond the understanding of regulator and common investors giving leeway to the originator to stash high risk financial products and market them as no risk products to unknowing investors.
4. Uncontrolled operation of Statistical Rating Organisations which continued to rate bad derivative products as good deepened the impact.
5. Repeal of Glass-Steagall Act, 1933 which was designed to segregate banking and securities business with Gramm-Leach-Bliley Act, 1999 which effectively removed the segregation between investment and commercial banking led to creation of a vicious circle of bankers who were more interested in satisfying their greed than in ensuring consumer protection.

Dr Shyamalan Goliath, former Deputy Governor of RBI, in a paper entitled "Financial Crisis- Some Regulatory Issues and Recent Developments"[32] records that one of the important lessons that India learned from the financial crisis is that financial sector development per se cannot be an objective in itself. It needs to be pursued in the broader context of financial stability and has to necessarily correspond to the level of maturity of the financial system and the needs of the real economy. Reforming financial markets involves improving access to simple, transparent, and easy-to-understand products. Increasing complexity does not facilitate the market mechanism. The purpose of financial instruments is to transfer risk to those that understand these risks, not to hide or camouflage them. Regulatory comfort and assessment should therefore be a critical determinant in pursuing financial reforms. In regard to derivatives, India has both OTC and exchange traded instruments for currency and interest rates. OTC markets in India are well regulated, unlike many other jurisdictions, to address issues of leverage and customer appropriateness and suitability. Only OTC contracts where one party to the transaction is a RBI regulated entity is considered legally valid. Suitable reporting and post trade clearing and settlement mechanisms are being further strengthened. In fact the realization that OTC derivatives require more regulation is deepening even in USA where the Obama Administration's Reform Plan announced in June 2009 called for all OTC derivatives to be traded to recognised clearing houses to eliminate lack of transparency and threat of widespread defaults. According to the plan, clearinghouses and exchanges would provide

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

[32] Inaugural address at the FIMMDA-PDAI Annual Conference, January 4, 2010, Mumbai available in http://rbidocs.rbi.org.in/rdocs/Speeches/PDFs/SMRM040109.pdf accessed on 31/12/2011.

a needed guarantee to derivatives transactions by requiring dealers and corporations to post collateral on the deals and meet daily margin requirements[33].

Suggestions for improvement of regulatory framework:

Joseph Stiglitz, in his latest book, "Free Fall - America, Markets and the Sinking World Economy[34]" has pointed out the need for a stricter regulatory regime for derivatives, in other words, re-regulation and more government involvement in the economy. As Dr. Rakesh Mohan, Deputy Governor, Reserve Bank of India, in his paper prepared for the Financial Stability Review (June 2009 issue) of Bank of France[35], observed that unproductive financial innovation have to be discouraged in the new regulatory regime post crisis. Moreover, the debate on financial innovation and regulation has to be considered in terms of potential and systematic relevance of such innovations besides the capabilities for bringing them effectively under the regulatory umbrella. There are also suggestions to have a central counter party (CCP) for OTC derivatives especially for Credit Default Swaps (CDS) applicable to all jurisdictions, which will help to ensure greater transparency and better reporting. In addition Dr Mohan suggests that public authorities should also encourage the financial industry to standardise contracts and to use a data repository for the remaining non-standardised contracts and promote fair and open access to central counterparty services. Dr Mohan also suggests that through the expanded Financial Stability Forum, now renamed as Financial Stability Board, the International Monetary Fund and the international standard setters, international standards, including those for macro-prudential regulation, the scope of regulation, capital adequacy and liquidity buffers, should be coordinated to ensure a common and coherent international framework, which national financial authorities should apply in their countries consistent with national circumstances.

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

However, it would be foolish to believe that our regulatory system is superior to other systems or that enough has been done to prevent the derivative products from operating as weapons of mass destruction in India. On the contrary, the need for vigilant regulation suitable to the investment culture of the country and maturity of the markets, and ensuring transparency and appropriateness of the derivative products to ensure customer safety

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[33] See Roya Wolverson, "The Road to Financial Regulatory Reform", July 22, 2010 Council on Foreign Relations, available on http://www.cfr.org/publication /21266 /road_to_financial_ regulatory_reform.html accessed on 31/12/2011.

[34] Joseph Stiglitz, *Free Fall- America, Markets and the Sinking World Economy* , Penguin Books, London (2010)

[35] Supra n. 29 at p. 8.

have been brought to the forefront by the experiences of countries that followed laissez faire policy in regulation of derivatives. It is also imperative that there should be some international standard setting process for both product design as well as approach towards risk of all forms so far as derivative products are concerned, since in the current globalised economy, strict regulatory regime in some countries and lax standards in others would lead only to regulatory arbitrage. In a globalised economy, regulatory arbitrage is much more dangerous since corporations have global presence and loss in some jurisdictions would have fatal effects in organisational efficacy in other jurisdictions, leading to a higher risk to investors from even tightly regulated countries. Hence there is a need for creation of a network amongst regulators in various countries, as well as the different regulators in the same jurisdiction, to ensure better regulatory cooperation, common regulatory standards and denial of regulatory arbitrage opportunities to unscrupulous players in the market, An international regulatory framework arrangement, much like the BASEL guidelines for banks, should be brought in place for derivative instruments and trading in derivatives market. Such a framework should lay down standards of risk taking in derivative instruments and guidelines to derivative product design and tighter control over structure of underlying securities, which will then help to have a uniform standard across the world for such instruments. There should also be a proper control mechanism to identify sufficiently early, mitigate and to cover up the various types of risks involved in similar type of instruments. Such an approach would enable to retain the derivatives products as good risk hedging tools for all investors, rather than an instrument to satisfy the greed of a few investment bankers.

In fact it should be kept in mind that financial products per se are not bad; it is the greed behind them that make them bad. In order to keep away greed from derivatives products, regulatory vigil should focus on the transparency of the products as well as the system, which will then make these products what they profess to be- money multipliers-not just for a few, but for all prudent investors.