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Impact of FSLRC on Indian Market and Securities Regulations: Legal implications

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Abstract

The Financial Sector Legislative Reforms Commission (FSLRC) was commissioned with the task of consolidating the legislative, administrative, and executive aspects of the financial sector. The paper makes an attempt to analyze various issues related to securities, derivatives, financial market infrastructure, insider trading and market abuse as well as consumer protection. The paper also analyses the recommendations of the FSLRC vis-à-vis various legislations such as the Securities Contracts (Regulation) Act, 1956 (SC(R)A), the Depositories Act, along with the SEBI Act, 1992 and Regulations such as SEBI Insider Trading Regulations.

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1. Introduction

Laws must be animated by an economic purpose and the market failures that they seek to address. Once this is done, the ideas apply consistently across all sectors of finance.

–The Working Group on Securities, FSLRC

The genesis of the Indian Financial Code (IFC) stands on the platform of India’s exponential development and growth rate despite its archaic and scattered financial laws. This unconsolidated nature of the Indian financial structure has created many loopholes that have resulted in numerous frauds, Ponzi schemes, and insider trading issues. The lacunae in the Indian financial structure and related issues have made the protection of investors and the redressal of consumer grievances in the capital market difficult.

It is an established fact that the various aspects of financial market—securities, insurance, derivatives, and so on—overlap at times; such a situation confuses the consumer as to which authority to approach for redressal, resulting in repetitive petitions before various regulators. Moreover, it was felt that the present financial legislations were incapable of addressing contemporary financial issues. These were some concerns that lingered around the Indian financial market, making it speculative and precarious for investors, both domestic as well as foreign.

With the objective of dispensing with archaic financial laws and modernising the sector, the Finance Minister announced the formation of the Financial Sector Legislative Reforms Commission (FSLRC) during the 2011–2012 budget speech. In its report, the FSLRC *inter alia* dealt with a “single window” financial structure under a super regulator and widened the scope of the term “security”. The IFC aims to create harmony among various financial legislations and bring synthesis among them. However, the purpose of the FSLRC is to dissolve the watertight compartments among the various regulators and to usher in uniformity so that the grey areas in financial laws are deftly dealt with. The FSLRC was established by the Ministry of Finance, Government of India on March 24, 2011. The Commission was chaired by B. N. Srikrishna, a former Judge of the Supreme Court; the board of members comprised experts from the fields of finance, economics, public administration, law, and so on. The Approach paper was released by the Commission in October 2012. The two volumes of the Report of the Commission were presented to the Government of India on March 22, 2013.

The primary concern of the FSLRC and the different Working Groups with respect to the securities market was “uniqueness”—uniqueness that would define the securities market as well as its functioning, channelized towards public good. There are positive externalities that justify regulatory intervention

directed at the functioning of the securities market itself that go beyond the needs of the particular parties involved in a specific trade.

The FSLRC and the subsequent Indian Financial Code (IFC) aimed at gaining investor confidence and providing adequate protection to the consumers of the investment market. The third objective was to reduce speculation in the market and, thereby, make it stable. The fourth objective was to allow certain micro-prudential regulations to reduce systematic risk in the market. The FSLRC Report was a joint effort of the various experts who were constituted into distinct Working Groups:

1. Working Group on Banking
2. Working Group on Insurance, Pension, and Small Savings
3. Working Group on Payments
4. Working Group on Public Debt Management
5. Working Group on Securities

The Terms of Reference (TOR) of the FSLRC included the following aspects:

1. Review the structure and functioning of the legislative and regulatory systems governing the finance sector. It primarily aimed to review the potency of the existing laws and the functioning of the regulators and their respective departments. The review was focussed on the individual and collective functioning of the regulators and was intended to monitor the effectiveness and efficiency of the same.
2. Create transparency in the use and applicability of law by prefixing the legislative intent with each piece of financial legislation.
3. With exceptions for emergency measures, review the necessity for mandatory feedback for subordinate legislations.
4. Review the ambit for the invocation of emergency powers, especially in situations where regulatory action would be required on ex parte basis.
5. Assess the interaction between the Foreign Exchange Management Act (FEMA) and the foreign direct investment (FDI) policy (regarding exchange control) vis-à-vis other regulators.
6. Examine the vigilance of the regulators and ensure their autonomy.
7. Assess the relevance of the legislations on the basis of judicial pronouncements and changes in the financial sector policy post-liberalisation.
8. Inspect issues pertaining to data protection and the privacy of financial sector consumers.
9. Evaluate the symbiotic relation among financial legislations and the implication of information technology on them.
10. Analyse the recommendations of the expert committees and regulators.

11. Evaluate the functioning of the inter-state financial services and the role of the state governments.
12. Assess any other pertinent and relevant issues.

This paper is based on the hypothesis that the laws governing the financial sector in India are archaic and scattered, making both investment as well as investor protection fragile. Another assumption is that comparing the IFC and the recommendations of the FSLRC with the financial rules and regulations of developed countries would be a beneficial exercise—it would result in a healthy comparison with the processes followed in other jurisdictions.

The paper deals with the following objectives:

- Analyse the concepts and aspects pertaining to securities, the derivatives market, hedge funds, and clearing corporations, as evaluated in terms of the FSLRC Report.
- Understand the scope of the various legislations and the amendments made to them under the auspices of the FSLRC.
- Analyse the recommendations of the FSLRC vis-à-vis various legislations such as the Securities Contracts (Regulation) Act, 1956 (SC(R)A), the Depositories Act, along with the SEBI Act, 1992 and regulations such as the SEBI Insider Trading Regulations.
- Assess the efficacy of these recommendations with regard to the financial market and the effect of the recommendations on market behaviour.
- Understand the treatment meted out towards insider trading and fraud under the IFC and the FSLRC recommendations.
- To recommend further possible changes that would make investment issues in India less cumbersome and more investor friendly.

2. FSLRC Recommendations with Respect to Securities

The term “security” is defined under Section 2(h) of the SC(R)A to include shares, scrips, stocks, bonds, debentures, debenture stock, and other marketable securities of similar nature in an incorporated company or a body corporate; derivatives; units or any other instrument issued by any collective investment scheme to the investors in such schemes; security receipts as defined in Section 2(zg) of the Securitization and Reconstruction of Financial Assets and Enforcement of Securities (SARFAESI) Act, 2002; government securities; and other such instruments as may be declared by the Central Government to be included as securities. The intention of the legislature was to incorporate rights and interests in securities within the ambit of the term in the SC(R)A. This inference can be drawn from the case of *Brooke Bond India v. UB*

& *Others*,¹ where it was held that the SC(R)A regulates the shares of the listed companies and that unlisted shares are not governed by the provision of the Act. However, the current stand of the Supreme Court (*Bhagwati Developers Pvt. Ltd. v. Peerless General Finance*)² is that the SC(R)A applies to unlisted public companies as well, since it is not the listing but the free transferability that determines the marketability of a security.

Moreover, Section 2(h)(i) of the SC(R)A uses the term “marketable” while defining the term “securities”. The term “marketable securities” is defined under Section 2(16A) of the Indian Stamp Act, 1899 to mean the securities of “listed” companies. Thus, the definition of “securities” under the SC(R)A needs to include the terms “listed” as well as “marketable”.

The definition under the SC(R)A became problematic. There were several instances of financial products that had been designed to fall between the cracks in the definition of securities as per Indian law.³ Therefore, a broad principle-based definition of securities would have been a *sine qua non*. Since financial service is a dynamic system, if “securities” were to be defined around specific “entities”, the superannuation of those entities would render the securities obsolete. The Working Group on Securities⁴ recommended that the term “securities” must not be restricted to companies alone; the definition of “securities” would need to be broadened to include the securities of incorporated or unincorporated bodies.⁵

The Working Group on Securities, therefore, recommended that the definition of securities should be entity-neutral and must also be broad enough to incorporate new instruments that emerge as a product of financial innovation. Globally, it is acknowledged that providing a wide connotation to the term “security” is required primarily for purposes of market integrity. In India, so far, the term security is defined under the SC(R)A in an inclusive manner, providing a list of instruments that can be called “securities”.

However, the definition of securities in the SC(R)A does not include any unit linked to insurance policies.⁶ The term “government security” has been defined to mean a security created or issued by the

¹ 1992(2) Bom C.R 429.

² SC 2013 Reportable.

³ As seen in the case of *Sahara India Real Estate Corporation Limited & Ors Vs. Securities Exchange Board Of India & Anr.*, 2012 SC reportable.

⁴ The Working Group on Securities was established by the FSLRC under the Chairmanship of Jayanth Varma and was required to submit the draft report on July 2012.

⁵ Recommendation 2 and 3 of the Working Group on Securities Recommendations.

⁶ Sec 2(h), Securities Contracts (Regulation) Act, 1956.

Central Government or a State Government for the purpose of raising public loans in the form specified in Section 2(c) of the Public Debt Act, 1944.⁷

Though the broad ambit of the definition may sound interesting at first, it may lead to excessive onerous requirements with respect to registration and the issue of prospectuses. The Report of the Working Group on Securities observed that such a broad definition would work only if the registration requirements were made entity-neutral and extended to a specified number of people. The Working Group recommended that while filing a prospectus for making a public offer, an issuer must also agree to continuing disclosures and that the regulators must have statutory jurisdiction over such matters.

The definition of securities in the Indian Financial Code (IFC) keeps the term flexible and broad, yet non-exhaustive in nature. The IFC defines a “security” as a transferable financial instrument that is non-negotiable in nature, which would include the instruments under the SC(R)A definition along with certain new instruments that were previously not included, such as:

- Depository receipts
- Transferable warehouse receipts
- Instruments traded in exchanges
- Investment contract that is neither a deposit nor an insurance contract, and so on

Terms such as “derivatives”, “government securities”, and “warehouse receipts” are also defined in the IFC.

With the inception of the Securities and Exchange Board of India (SEBI), India entered the era of disclosure-based regulation rather than merit-based regulation. However, the disclosure requirements are not well-defined in the statutes. Therefore, the Working Group on Securities recommended that the existing statute must provide the registration requirements in order to ensure adequate disclosure and that the registration requirements should not to be used as a form of merit-based regulation of public offers. A broad, entity-neutral definition of “securities” is provided under the IFC, creating restrictions on public issues that are equally broad and entity-neutral. Any issuer seeking to make a public offer must file a prospectus and also agree to continuing disclosures. Previously, the continuing disclosure obligations were imposed through the Companies Act, 1956, read with the Listing Agreement, which is merely a private contract between the issuer and the stock exchange, and hence, is not statutorily binding in nature. Even under the present Act of 2013, the position remains the same. Thus, the Working Group recommended the following:

⁷ Sec 2(b), Securities Contracts (Regulation) Act, 1956.

- Maintain the registration requirements entity-neutral; they should not be restricted to companies.
- Prevent redistribution of shares by the original recipient of the shares; otherwise, the issue shall indirectly be made to a larger group of people.
- Implement an aggregation requirement, streaming the period to 12 months.⁸
- Exempt the offers to qualified institutional investors, who do not need as much protection as a retail investor.
- Impose registration requirements when the total number of the security holders exceeds a threshold.
- Request exemption for “crowd funding”.

The fact that an attempt has been made to incorporate the concept of “crowd funding” in the Code makes the Code progressive and unique at the same time.

The U.S. provides an interesting model for disclosure and governance obligations. The U.S. model is entity-neutral, since the companies laws in the U.S. are specific to each state while the securities laws are federal laws. The contents of registration are provided in Schedule A of the Securities Act, 1934. The U.S. Securities and Exchange Commission (SEC) requires that all issuers of registered securities need to file annual and quarterly reports as well as any other information that is required to keep prospectus updated. These obligations are not restricted to companies since these registration obligations are not entity-bound.

As per Recommendation 11 of the Working Group on Securities, the obligations to make disclosures (prospectus, annual and quarterly reports, and material event disclosures) must be laid down in a statute and made applicable to all listed entities. The Working Group recommended that the regulators be granted the power to enforce corporate governance obligations with respect to the independent directors and the key committees in a board, and to enforce financial literacy requirements of the members in the key committees in the board.

The litmus test of “securities” is their free transferability. According to the FSLRC, a consolidated definition follows from a consolidated approach towards the trading of securities (including in exchanges, broking houses, clearing corporations, and payment systems). One of the issues regarding trading was with respect to the issuance of securities, especially where the issuer changes owing to a takeover and the people not agreeing to the change are able to sell the securities at a “fair price”. The SEBI Takeover Regulations, 2011 empowers the SEBI to regulate the takeover of companies; however, the statute does

⁸ The Working Group on Securities recommended that the aggregation requirement for offers of the same class of securities by a single issuer should be aggregated over a period of 12 months.

not lay down the objective, scope, and extent of these Regulations. This is an excessive delegation of legislative powers to the regulator; hence, the delineation of these powers is imperative. Clause 213 of the IFC speaks of selling securities at a “fair price” in the event of an actual or potential change in the control of the issue. It also specifies the regulations that the regulator is required to make in order to:

- Determine the criteria of change in control;
- Ensure all the owners of listed securities have adequate information to make informal decisions;
- Determine and prevent any action that would forbid the determination of a fair price.

The regulator is also granted the power to specify the conditions under which specific transactions may be exempted from compliance for carrying out transactions under Part VII and also to exempt transactions from compliance with the regulations under Part VII.

3. Derivatives, Commodities, and Futures

In India, “derivatives” are defined under the SC(R)A to include:

- A security derived from a debt instrument, share, loan (secured or unsecured), risk instrument, contract for differences, or any other form of security.
- A contract that derives its worth from the prices or the index of prices of the underlying securities.⁹

Derivatives and commodities are part of the secondary market and over-the-counter¹⁰ (OTC) instruments are one-on-one negotiated contracts. Most of the trades in government securities are in the OTC market; moreover, all the spot trades where securities are traded for immediate delivery and payment take place in the OTC market. The Enron fiasco (October 2001) and the global financial crisis (2008) highlighted the significance of regulation in OTC derivatives, the lack of which results in market abuse.

In India, derivative trading takes place on either a separate and independent derivative exchange or a separate segment of an existing stock exchange. The derivative exchange/segment functions as a self-regulatory organisation (SRO) and the SEBI acts as the oversight regulator. The clearing and settlement of the trades on these derivative exchanges/segments needs to be done through a Clearing Corporation that is independent in governance and membership from the derivative exchange/segment. The governance problems of infrastructure institutions are handled using a three-way separation of shareholders, managers, and trading members; netting by novation happens at the clearing corporations.

⁹ Sec 2(ac) inserted by the Securities Laws (Amendment) Act, 1999.

¹⁰ Black’s Law Dictionary (2nd edn.) defines an over-the-counter market (in the U.S. context) as the largest securities market in the U.S. where trading takes place between dealers over the phone, rather than via an exchange. These transactions are regulated by the National Association of Securities Dealers.

The Working Group on Securities was concerned about the market abuse of derivatives (including OTC derivatives). As discussed earlier, the global financial crisis emphasised the need for the regulation of OTC derivatives. What is necessary is a clear distinction between commodities derivatives and derivative contracts.

3.1 Derivatives

The term “derivative” includes equity derivatives, currency derivatives, and commodity derivatives. Derivatives undoubtedly face an image problem owing to market abuse and concerns that have arisen in other jurisdictions. However, in a mature market, the growth of derivatives has been nothing short of remarkable. According to the Chicago Mercantile Exchange (CME), the S&P mini futures contract marked its tenth anniversary in 2007,¹¹ suggesting the longevity of the mini futures contracts in the market, which in turn reflects investor confidence in the same. Hence, the derivatives market, despite its image, does create an attractive option for the investors. Bearing this issue in mind and in order to remove the speculations surrounding derivative contracts, the IFC provides an introduction to the derivatives market to reflect its stability and provides further support to the already existing derivatives regulations and rules in order to attract more investors to the market.

3.2 Commodity Contracts

In India, commodity contracts are regulated by the Forwards Markets Commission (FMC) and the Forward Contracts (Regulation) Act, 1952.

The European Union’s definition of the term “financial instrument” covers the following options, futures, swaps forwards that create agreements, and any other derivative contracts:

- Derivatives relating to securities, currencies, interest rates or yields, or other derivative instruments, financial indices, or measures.
- Derivatives relating to commodities that must be settled in cash or in cash at the option of one of the parties.
- Derivatives relating to commodities that can be physically settled, provided they are traded on a regulated market; derivatives relating to commodities that can be physically settled and are not traded on a regulated market if they are not intended for commercial purposes, which have the characteristics of other derivative financial instruments with regard to whether, inter alia, they are

¹¹ Source: PR Newswire. (2009). *CME Group, NASDAQ OMX Celebrate 10th Anniversary of E-mini NASDAQ-100 Contract*. <http://www.finanznachrichten.de/nachrichten-2009-06/14232462-cme-group-nasdaq-omx-celebrate-10th-anniversary-of-e-mini-nasdaq-100-contract-008.htm>.

cleared and settled through recognised clearing corporations or are subject to regulated margin calls.¹²

This definition excludes commodity contracts only if they are physically settled and are traded outside a regulated market and either are intended for commercial purposes or do not have characteristics such as clearing and margining that are associated with financial derivatives. The Working Group recommended that commodity contracts should be regulated in the same manner that financial derivatives are regulated, while taking care to exclude genuine commercial transactions in commodities. Moreover, a derivatives contract needs certainty so that the participants do not speculate with regard to its unenforceability as a wagering contract.¹³ This issue is diligently dealt with through different approaches. First, a distinction does exist between wagering and hedging, and derivatives contracts may be enforceable since they are used more for hedging than for wagering. Secondly, all wagering contracts can be made enforceable, thereby solving the problem. Thirdly, certain types of derivatives are exempted from the wagering law. Usually, the exemption is granted to exchange-traded derivatives as well as contracts between parties in the OTC market.

The Commodity Futures Modernization Act, 2000 of the U.S. defines an “eligible contract participant” to include most financial institutions, pension funds, and other investment funds, as well as companies and individuals with minimum levels of assets.¹⁴ India has followed the last route; however, the range of eligible counterparties is very narrow.¹⁵ These ideas are reflected in Clause 182 “Enforceability of Derivatives” of the IFC. The clause states that the derivative contracts made between “sophisticated counterparties”¹⁶ are not void as per Section 30 of the Indian Contract Act.

If commodities futures had been governed by the SEBI and the Ministry of Finance, the fiasco pertaining to this segment of the market could have been averted. The concerns of the FSLRC with respect to derivatives were regarding the constraints for developing a national common market for commodities; regarding the linkage between commodity derivatives market and other financial sector markets; and finally, whether they could function independently in an integrated and globalised financial framework.

The proposed Unified Financial Authority would take over the task of organised financial trading from the Reserve Bank of India (RBI) with regard to the bond-currency-derivatives nexus and from the FMC

¹² Section C of Annex 1 of the MiFID Directive (2004).

¹³ Black’s Law Dictionary defines a “wagering contract” as a contract by which two or more parties agree that a certain sum of money or other things shall be paid or delivered to one of them on the happening of an uncertain event or upon the ascertainment of a fact which is in dispute between them.

¹⁴ The minimum level of assets is lower if the deviation is used for the hedging of risks.

¹⁵ These are limited to the entities regulated by the RBI.

¹⁶ A “sophisticated counterparty” is any person other than a retail consumer under this Code.

with regard to commodity futures, thereby unifying all organised financial trading including equities, government securities, currencies, commodity futures, corporate bonds, and so on.

4. Financial Market Infrastructure

Financial market infrastructure (FMI) is especially challenging since it involves the conflicting objectives of safety and efficiency, coupled with the difficulty of using competition for improving performance.

The joint report of the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commission (CPSS-IOSCO) identified the key issues in FMI as:

- Transparent governance arrangements
- Promotion of safety and efficiency of FMI
- Stability of the broader financial system
- Relevant public interest considerations
- Objectives of relevant stakeholders¹⁷

In India, financial economic governance is responsible for the development of market infrastructure, processes, and redistribution. These objectives are achieved through principles of public administration and law.

The development of financial economic policy in India has two basic elements: the development of the market infrastructure and processes, and secondly, the redistribution and financial inclusion initiatives. The framework proposed by way of the Code reflects that the first objective rests with the regulators while the latter objective rests with the government.

In India, FMIs are usually profit-based organisations in the private sector, and therefore, they do not fall within the purview of the CPSS-IOSCO definition.¹⁸ While the CPSS-IOSCO report further states that factors such as the economies of scale and barriers to entry or even legal mandates may limit competition and confer market powers on an FMI (which may lead to lower levels of services and higher prices or underinvestment in risk management systems), caution is required as excessive competition among the FMIs may lead to competitive lowering of the standards of risk. Since the financial sector in India relies on the competition to deliver innovation and low costs, it becomes especially difficult to instil the spirit of the CPSS-IOSCO report.

¹⁷ Principle 2, *Principles for Financial Market Infrastructures*, April 2012. (Source: www.bis.org/publ/cpss101a.pdf)

¹⁸ An FMI that is a for-profit entity or that is part of one would need to place particular emphasis on managing any conflicts between income generation and safety.

Accordingly, Chapter 39 of the Code deals with “infrastructure institutions”. Infrastructure institutions are defined to mean and include exchanges, depositories, trade repositories, central counterparties, and settlement systems (including the settlement system in a payment system).

All infrastructure institutions shall be treated as financial services providers and would be allowed to make bye-laws with the main objectives of minimising market abuse and fostering transparency. Transparency is achieved by the publication of information. Further, a provision has also been made for the governance and monitoring mechanism. As far as the regulators are concerned, they will have the power to give directions to the infrastructure institutions and they would also be required to publish a report every five years regarding the conduct of the functions and the powers as well as the manner in which balance is achieved by the institutions.

The rationale behind providing such a vast range of protective and empowering provisions to infrastructure institutions is to ensure that the transactions made by them are final. The FSLRC was of the view that additional privileges should be granted to certain regulated institutions that were primarily not private parties. These privileges include acting as a depository, finality of settlement, and clearing.

Since securities are intangible properties, the only proof is the contract, which creates the challenge of establishing ownership. To avoid such problems, the Commission recommended that the depositories could store securities (including government securities) in electronic format, which may be utilised to ascertain the title to the securities. The depositories would be allowed to make records of hypothecation or pledge. The depositories could communicate on the trading platforms and make changes in the records accordingly.

Multiple trades could lead to multiple obligations for the parties and the members. In an organised financial system, these are netted to result in a consolidated obligation of each member to the central counterparty (CCP). The settlement that is made in this manner must be final in nature; that is, the legal certainty of transactions in organised financial trading is achieved only by making the netted obligations bankruptcy-remote to the members of the organised financial system.

In the netting and settling system, if any individual transaction is undone, it would affect all other dependent transactions, thereby creating uncertainty for everybody. Problems would also emerge in exchanges when the trade is executed at one point of time but the exchange on security and money takes place at another point of time. The failure of a transaction may have a domino effect on all the other transactions. Therefore, the settlement by infrastructure institutions is final and cannot be undone.

The Commission recommended that infrastructure institutions must be given certain additional privileges that would ensure the finality of transactions. This would be achieved through the classification of

institutions since such privileges cannot be extended to private parties; these privileges are extended only to the regulated institutions. Thus, the recommendations give a detailed account of the treatment of settlements and transactions.

5. Insider Trading and Market Abuse

Integrity and fairness are imperative for the trading of securities that can be distorted otherwise by way of either market manipulation or through insider trading. Presently, the definition and the limits/scope of insider trading and market abuse are contained in subordinate legislation that constitutes excessive delegation of legislative powers. Hence, it was recommended that the terms be defined in the statute only.

The IFC divides “market abuse” into market abuse and criminal market abuse. Criminal market abuse includes:

- Abuse of information, i.e., failure to disclose information or provision of deceptive information; usage of gained information from sources for the purpose of trading; circulation of false information with the objective of changing the price of the securities and then trading those securities for profit.
- Insider trading, i.e., trading based on non-public information that is availed through some special relationships and is considered an unfair advantage in such markets.
- Securities market abuse, i.e., when a person—with the intention of making financial gains—artificially affects price, liquidity, demand, supply, or trading of securities, or gives deceptive or false impressions of the same.

The Code also provides the regulator with powers to make regulations that specify what conduct amounts to market abuse. The regulator may require individuals transacting in securities either to refrain from taking specified actions or to report transactions in securities.

The Code further provides different regulations guiding different securities or different classes of persons. Moreover, exemptions are provided for specific securities or classes of individuals. Clause 220 provides for punishment for both market abuse as well as criminal market abuse. The Commission has restricted the functioning of infrastructure institutions in three distinct ways:

1. Issue and abide by the bye-laws
2. Follow the objectives of the bye-laws clarified within the Code
3. Seek approval from the regulator for formation and modification of the bye-laws

On the one hand, the Commission accepted the unique feature of “good character” of some of the infrastructure institutions and the significance of the transparency enhancing measures, especially while

dealing with the market abuse issues. On the other hand, the Commission extended protection to these institutions from normal legal principles in areas such as evidence, property, bankruptcy, and so on.

Due to the increased powers and liabilities, the Commission also levied on the infrastructure institutions the additional costs of setting up new infrastructure institutions, which would increase the cost of using such institutions. To curb any form of malpractice and abuse, the Code requires a review to be conducted by the Unified Financial Agency (UFA) every five years that examines the balance obtained among the regulatory objectives and the effect on competitiveness in the market.

Insider trading is seen as an increased form of threat to the finance sector at large and is considered to be responsible for the decreased faith of investors, which in turn affects investor confidence. Given the need for increasing transparency and following incidents of insider trading, the SEBI realised the need for creating an atmosphere of trust in the market. Hence, in order to address the problem of insider trading, the SEBI set up a High Level Commission of 16 members under the chairmanship of Honourable Justice N.K. Sodhi and representatives from across sectors (such as legal, corporate, stock exchanges, and investment banking sectors) in April 2013. The Commission submitted its report on December 7, 2013. The Report increased the scope of the regulation to cover public servants in possession of price-sensitive information; the recommendations were comprehensive in nature and overhauled the existing regulation on insider trading. Moreover, it addressed grey areas such as open offers under the Takeover Regulations.

6. Consumer Protection, Micro-Prudential Regulation, and Resolution

Investor confidence in the market is built not just through fairness of the market but also by ensuring that a sound consumer protection mechanism is in place. The three pillars of the FSLRC, i.e., micro-prudential regulation, consumer protection, and resolution are tightly interconnected and work towards the goal of consumer protection. Micro-prudential regulations aim to reduce (but not remove) the probability of the failure of financial firms. Resolution is the resort that comes to the forefront when financial firms fail.

The traditional approach of *caveat emptor*¹⁹ is slowly (in some instances) giving way to the concept of *caveat venditor*.²⁰ Therefore, the burden of consumer protection has now shifted to the financial firms. This idea is captured in the consumer protection clauses of the Code.

Regarding consumer protection in the securities market, the FSLRC aims at:

¹⁹ A commercial principle that without a warranty, the buyer takes the risk of quality upon himself/herself.

²⁰ A maxim or rule casting the responsibility for defects or deficiencies upon the seller of goods.

- Creating “market integrity”, in order to prevent vices such as insider trading, fraudulent practices, and other market abuse issues in a financial market. Issues that at first seem to be aspects of bilateral contract turn out to be key to regulatory concerns in the longer run.
- Creating legal certainty for contracts in financial markets, i.e., standardisation of contracts in the securities market.
- Disseminating information to the market as a whole rather than to just the parties that are privy to such information, for the purpose of public good; i.e., formulating the legal framework for the registration and publication of offer document.

The Code first sketches certain basic rights for all financial consumers. It defines an “unsophisticated consumer” and specifies an additional set of protections such as the right to receive advice, protection from conflicts of interests of the advisors; access to the financial redress agency (FRA) for grievance redressal. Certain basic protections include:

- Professional diligence from the financial service providers
- Protection against unfair contract terms, unfair conduct, personal information
- Fair disclosures

The regulator is empowered so as to implement these protections. The principles guiding the usage of powers are also provided. The Commission envisions a single unified financial redress agency (FRA). This would be a valuable measurement system, since the database of the FRA would be a map that shows the pattern of consumer issues and problems. Hence, by way of systematic compilation of data, better and sounder regulations can be made. The Commission also envisaged a detailed mechanism for better cooperation between financial regulators and the competition, in order to create harmony between the two.

7. Recommendations and Analysis

The FSLRC and the subsequent IFC primarily aimed to consolidate the finance sector under one giant umbrella, which would include all aspects of the finance sector (securities, insurance, banking, and so on). However, in doing so, a monstrous giant has been created; if it fails or is incapacitated by some issue, the financial sector would relapse into a major crisis. This paper, however, analyses only the aspects related to the securities and derivatives markets in India with respect to the FSLRC.

The first thing that attracts attention in the Report and the subsequent Code is the formation of a Unified Financial Regulator. However, the fact that all the regulators have been put under one single head does

not reduce the existing turf war; secondly, this creates problems pertaining to the clash of egos among the regulators.

The term “securities” itself draws questions pertaining to the ambit and the scope of the term. While the term does incorporate the progressive nature of the ever-changing dynamics involved in securities, the term reflects a mere consolidation of the definitions that were already available in the SC(R)A and the Depositories Act. It is clear that the term lacks novelty and hence is subjected to an amalgamation of the various statutes that relate to the securities market. Most simplistically, a security represents an ownership position in a stock, a creditor relationship with a governmental body or a corporation, or else the rights to ownership represented by an option. It is a fungible, negotiable instrument that represents a financial value. Delimiting the definition of the term by way of certain specific instruments not only increases legal jargons but also increases the number of loopholes through which the issuers may participate in various securities market abuses. It should be understood that “securities” as a term implies not just the legal but also the business implications, which if not properly adhered to would frustrate the essence of the market as well as the investors’ confidence.

Moreover, the term “derivatives” has also been loosely dealt with in the IFC, indicating that the FSLRC was probably not too eager to create a consolidated market that is “abuse-proof”. Clearing corporations and their independence and transparency are not well defined. If these flaws can be eliminated, it is quite possible that the resulting Code would be far more glitch-proof.

The crucial question that remains to be answered is whether the Indian Financial Code, which was drafted based on the recommendations of the FSLRC, will be able to benefit the financial sector at large.

Broadly, the FSLRC requires the examination of every Act, Rule, Regulation, or Guideline, and the streamlining of the same to avoid duplication and ideally to bring about greater certainty among market participants so that they may precisely know the set of laws governing them. For instance, the wealth management industry needs some practical set of regulations. In the portfolio management/advisory space, any advisor or portfolio/wealth manager managing money/securities above INR 5 lakh technically comes under the purview of SEBI (Portfolio Managers) Regulations, 1993; however, the markets do not often follow the norms, which is not surprising considering there are thousands of advisors rendering advice—the SEBI does not have the bandwidth to regulate them and it may not be required to do so as well. The draft SEBI Investment Advisers Regulations issued in 2007 met a roadblock and did not see the light of day. However, the SEBI Investment Advisers Regulation, 2013 (which came into effect from April 2013) has been applauded from all quarters of the sector. Moreover, there is no clarity with regard to venture capital activity, i.e., whether an entity has to necessarily seek registration with the SEBI or whether registration is optional under the SEBI VCF Regulations.

8. Conclusion

The FSLRC and the resultant IFC have been successful as far as changing the definition of the term “securities” is concerned and in moulding it as per the requirements of the modern financial dynamics. Incorporating factors such as “crowd funding” has made the Code not only modern but also efficient over time. The IFC also deftly dealt with derivatives and related issues, namely, futures and clearing corporations. The IFC has given proper structure to the forwards market, making it more consolidated and refined. The archaic infrastructure issues that were haunting the finance sector for long have also been resolved, by incorporating the modern spirit of the CPSS-IOSCO report while maintaining the traditional attitude of the Indian finance sector, thereby protecting the interests of the investors and traders. Further, the IFC has also dealt with the issues of fraud, insider trading, and market abuse; investor protection is meant not only to avoid issues of market abuse but also to safeguard those who are affected by such practices.

With the dawn of the new world economy, India has witnessed a many reforms in its economic structure. The fact that India is often dubbed as an upcoming super power (along with China) has made it imperative to bring in certain changes in its economic and financial structure. The constant innovation and novelty offered by the finance sector cannot be denied and innovations in the finance legislations have become inevitable. What would be interesting to note in the future would be the manner in which the Code treats previous regulating authorities and the manner and the mode in which it would guide and treat the financial sector.

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