LITERATURE REVIEW

Why financial regulation?
‘The crisis was a wakeup call for theorists and policy makers’ (Camilla Anderson, 2011)
‘Developing the financial sector accelerates economic growth and enhance income inequality’ (Sarwat Jahan et al., 2011)
‘In designing new policies for the financial sector, old fashioned ideas are important’ (William Poole, 2010)
‘Financial Tech Solutions assessed for IOSCO principles for derivatives trading’ (India Infoline News Service/08:33, October 14, 2010)
‘United States proposes most radical reform of financial regulation since the new deal’ (Randall Dood, 2009)
‘What needs to be done to strengthen the financial regulation?’ (Andrew Crockett, 2009)
‘Asia is moving to a new leadership role in world economy’ (Anoop Singh, 2008)
‘Better incentives for all market players hold the key to greater financial stability’ (Laura Kodres, 2008)

Why IOSCO principles as a benchmark?
International Organisation of Securities Commissions (IOSCO) was established in 1983, as an international co-operative body of securities market regulators, initially by eleven securities regulatory agencies from North and South America. Currently there are more than 100 securities regulatory agencies who are members of IOSCO, covering more than 90 per cent of the world’s securities markets. In India, the Securities Exchange Board of India (SEBI) is a member of IOSCO.

The objectives of securities market regulation are:
(i) Protection of investors that is recognising the growing incidence of retail participation in the capital market, particularly equity markets;
(ii) Ensuring that markets are fair, efficient and transparent; and
(iii) Minimisation of systemic risk.

In 1998 IOSCO adopted a comprehensive set of Objectives and Principles of Securities Regulation (IOSCO Principles), which are recognised as the international regulatory benchmarks for all securities markets. The Principles were updated as of May 2003 to cross-reference additional IOSCO reports and resolutions to each principle. The IOSCO Principles comprise 30 principles that need to be in place for a regulatory and supervisory system to be effective. The principles relate to the following:
Principles 1 to 5: Principles relating to regulator
Principle 1: Responsibilities of regulator
Principle 2: Operational independence and accountability
Principle 3: Power, resources and capacity to perform functions
Principle 4: Regulatory processes of regulator
Principle 5: Professional standards of staff of regulator

Principles 6 to 7: Principles relating to self regulation
Principle 6: Regulatory regime
Principle 7: Regulator’s oversight over SROs and standards adopted by SROs

Principles 8 to 10: Principles relating to enforcement
Principle 8: Inspection, investigation and surveillance powers
Principle 9: Enforcement powers
Principle 10: Use of inspection, investigation, surveillance and enforcement powers

Principles 11 to 13: Principles relating to co-operation
Principle 11: Authority to share information with domestic and foreign counterparts
Principle 12: Information sharing mechanisms
Principle 13: Assistance provided to foreign regulators

Principles 14 to 16: Principles relating to issuers
Principle 14: Disclosure of financial results
Principle 15: Treatment of holders of securities
Principle 16: Accounting and auditing standards

Principle 17 to 20: Principles relating to collective investment schemes
Principle 17: Standards for eligibility and regulation
Principle 18: Rules governing legal form and structure
Principle 19: Disclosure requirements
Principle 20: Asset valuation and pricing and redemption of units

Principles 21 to 24: Principles relating to market intermediaries
Principle 21: Minimum entry standards
Principle 22: Capital and prudential requirements
Principle 23: Internal organisation and operational conduct
Principle 24: Procedure for dealing with failure of market intermediary

Principles 25 to 29: Principles relating to secondary markets
Principle 25: Trading systems
Principle 26: Regulatory supervision
Principle 27: Transparency of trading
Principle 28: Detection of manipulation and unfair trading practices
Principle 29: Management of large exposures, default risk and market disruption

Principle 30: Principle relating to clearing and settlement of securities

Principles 1 – 5: Principles relating to regulator

1. Principles-based regulation v/s. Rules-based regulation
There are two forms of regulation prevalent across countries: rules-based regulation and principles-based regulation. Countries following the principles based regulation are UK, Ireland and Australia, while countries like USA and continental Europe follow the rules-based regulation.

At present financial regulation in India is fragmented and rule based. It is over-prescriptive and restrictive of managerial discretion. (HPEC Report: Mumbai- An International Financial Centre, 2007)

2. Regulatory Independence in India
The need for regulatory and supervisory independence has been in sharp focus in recent times.

a. Financial Stability and Development Council
With a view to strengthening and institutionalizing the mechanism for maintaining financial stability and development, the government set up an apex body-the FSDC. The notification constituting the FSDC was issued in December 2010 and its meeting was held on 31 December 2010. (http://indiabudget.nic.in/)
It will also focus on financial inclusion. Financial inclusion can be defined as the delivery of credit and other financial services at an affordable cost to the vast sections of the disadvantaged and low income groups. (Sameer Kochhar, 2009)

b. The securities and Exchange Board of India (SEBI)
SEBI was in fact set up by the Indian Government in 1988 and the SEBI Act was passed in 1992. SEBI is headquartered in Mumbai and has regional offices in metros.
SEBI has been entrusted with the responsibility of dealing with various matters relating to the capital market. (Prasanna Chandra, 2008)

c. The Reserve Bank of India (RBI)
The RBI was set up in 1934, with the stated objective of monetary stability and operations on currency and credit system in India. The Reserve Bank is known as banker’s bank in India. (Justin Paul et al., 2007). The RBI’s regulatory involvement; in the Indian Capital Market has
so far been limited to three areas: a. Debt Management through Primary Dealers; b. Foreign Exchange Control and c. Liquidity support to market participants.

d. Insurance Regulatory Development Authority of India (IRDA)
The IRDA is an autonomous body formed by an Act of Parliament; the IRDA Act of 1999. IRDA is an independent agency; which reports to the Parliament on its activities; through Ministry of Finance.

e. The Pension Fund Regulatory and Development Authority.
The PFRDA is a more recent entrant; with the announcement of the new pension scheme; which is a defined contribution scheme; as against the previous defined benefit scheme. The draft PFRDA bill 2005, sets a framework for the development and regulation of pension funds in India with a view to promoting old age income security for all individuals. (India Managing Globalisation and Growth, 2009)

Regulatory Structure of the Indian Financial System:
A financial structure is a vertical arrangement of a well-integrated chain of financial markets and institutions that provide financial intermediation. Two prominent polar designs can be identified among variety that exists. At one extreme is the bank dominated system, such as in Germany, where a few large banks play a dominant role and the stock market is not important. At the other extreme is the market dominated system where the financial markets play an important role, while the banking industry is much less concentrated. The GOI has put insubstantial efforts to reform the financial market (Bharati V. Pathak, 2008)

The detailed Indian structure is given in the following chart: (CFSA Report on India’s Financial Sector Assessment)
Principles relating to self regulatory organizations (SROs) in India are:

a. Stock Exchanges/Bourse

According to the International Council of Securities Associations, SROs are non-governmental organizations who are a part of the regulatory system.

Self Regulatory Organisations (SROs) in India are:

- Stock Exchanges/Bourse.
Stock exchanges provide an organized market place for the investors to buy and sell securities freely. The market perfectly competitive conditions where a large number of buyers and sellers participate. (Guruswawy, 2009)

b. Association of Mutual Funds in India (AMFI).

AMFI was incorporated in 1995 with the objective of representing the mutual fund industry collectively. It has to noted that AMFI, though technically not an SRO, does perform certain self regulatory functions. (AMFI Work Book, 2006)

c. Primary Dealers Association of India

A system of primary dealers (PDs) was introduced in India in 1996; to further strengthen the Government Securities market infrastructure and to make it more liquid and broad based. PDAI was formed as an autonomous SRO; by the PDs (Bharati V. pathak, 2008)

d. Fixed Income Money Market and Derivative Association of India.(FIMMDAI)

Banks and Primary Dealers together formed another autonomous SRO; FIMMDAI in 1997. The FIMMDAI has now taken over the responsibility of publishing the yield curve in debt market. Earlier they have prepared the guidelines for standard documentation and procedure to followed for participants in commercial paper (CP) and certificate of deposit (CD) mark (ibid, 2008)

e. Foreign Exchange Dealers Association of India (FEDAI).

A self regulatory body, FEDAI was set up in 1958 as an association of banks dealing in foreign exchange in India, typically called Authorised Dealers (Ads). Its major activities include framing the rules governing the conduct of foreign exchange business among banks vis-à-vis the public, and liaising with RBI for reforms and development of the forex market (Dun&Bradstreet-Foreign Exchange Markets. 2007)

f. Financial Planning Standard Board of India (FPSBI)

FPSPI is an affiliate of FPSB USA. FPSBI is a professional membership and certification organization, It governs and awards the Certified Financial Planner (CFP) certification in India. Candidates wanting to practice financial planning by using the CFP mark need to fulfill certain requirements regarding registration and licencing. Financial
Planning is also known as personal banking/private banking/wealth management/personal financial planning

**Principles 8 to 10: Principles relating to inspection and enforcement**

**a. Inspection** The inspection process of intermediaries has been further reviewed with a view to expedite the inspection process as well as to improve the quality of follow up action resulting in enhanced level of compliance amongst the intermediaries. The findings of the inspections are communicated to the intermediaries and thoroughly discussed with them wherever necessary, to ascertain their views and action is initiated commensurate with the seriousness of the violation committed by the intermediary.

**b. Investigation** Timely completion of investigation cases and effective, proportionate and dissuasive action in case of violations of established securities laws is important for protection of investor’s interest, ensuring fair, transparent and orderly functioning of the market. It is also vital for improving the confidence in the integrity of the securities market importance of effective and credible use of investigation has also been underscored by IOSCO in its “Principles for the Enforcement of Securities Regulation”.

**c. Enforcement**

Effective enforcement in the form of effective follow ups and disciplinary actions makes a regulatory system effective. There are five enforcement mechanisms that SEBI uses in case of any violation(s) pertaining to the laws regulating the securities market.

**d. Surveillance**

An effective surveillance mechanism is one of the prime requirements for well functioning securities market. The primary responsibility of safe-guarding the integrity of the market and ensuring that the market is performing in accordance with the stipulated norms and practice, has been entrusted to stock exchanges, which act as first-level regulators. The exchanges, as part of their surveillance mechanism, keep a watch on securities and analyze their trading pattern and appropriate actions are initiated by them in case of any discrepancies. Any suspicious incident or price movement is reported to SEBI for further examination. Even with these powers, SEBI does not have the judicial authority to enforce its decisions and penalties, which can be appealed to the court of law and before the Securities Appellate Tribunal(SAT) of the Government of India. (Raghunathan, et al., 2007)

**Principles 11 to 13: Principles relating to Domestic and International co-operation**
A. Co-operation between Domestic Regulators

A system of unified regulator is not entirely suited to the present state of country’s overall financial system and its markets. For the present it would be best not to go beyond giving common guidelines.

B. Co-operation between Global Regulators

1. International Organisation for Securities commission (IOSCO).

IOSCO was established in 1983; as an international co-operative body of securities market regulators. Initially by 11 securities market regulators from North and South America; currently there are more than 100 securities market regulators; who are members of IOSCO; covering more than 90% of the World’s securities market. Securities and Exchange board of India (SEBI) is a member of IOSCO.(http://www.iosco.org/)

2. Basel Committee on Banking Supervision (BCBS)

BCBS commonly known as Basel committee; is a committee of banking supervisory authorities that was established by the Central Bank Governors of the group -10 countries in 1975.It usually meets at the Bank for International Settlements(BIS) in Basel; where its permanent secretariat is located.(http://www.bis.org/)

They have published Basel Accord 1 & 2; known as the Basel Core Principles on Banking Supervision(BCPs).The BCPs; have now become the de facto standard for benchmarking sound prudential regulation and supervision of banks.

3. International Association of Insurance Supervisors (IAIS)

IAIS has developed the Insurance Core Principles (ICPs); as the key Global Standards for prudential regulation and supervision for the insurance sector across jurisdictions. India has adopted ICPs for the insurance sector as benchmark.(http://www.iaisweb.org/)

4. Organisation for Economic Co-operation and Development (OECD)

The original OECD Principles on Corporate Governance were issued in 1999.Subsequent corporate scandals in a number of countries; led the revision of standards in 2004.Indai has adopted OECD standards.(http://www.oecd.org/)
5. **International Accounting Standard Board (IASB)**

The International Accounting Standard committee IASC) was established in 1973; for harmonizing global accounting policies and practices by developing International Accounting Standards (IASs). IASC had issued 41 IASs; till-2001. In April 2001, the International Accounting Standard Committee was reconstituted as International Accounting Standard Board and took over the responsibility of setting accounting standards from IASC. The standards issued by the IASB are known as the International Financial Reporting Standards (IFRSs). ([http://www.iasb.org/](http://www.iasb.org/))

As and when IASs are completely revised by IASB; they are issued as the IFRSs. India will adopt the IFRSs in the next few years.

6. **International Auditing and Assurance Standards Board (IAASB)**

IACP constituted in October 1977; was renamed as the IAASB in 2002. The standards issued by the IAASB were known as International Standards on Auditing (ISAs). In January 2008; IAASB categorized its ISAs under four groups, which are collectively known as ‘Engagement Standards’.

7. **Financial Action Task Force (FATF)**

The FATF is an inter-governmental body, responsible for setting global standards on anti-money laundering (AML) and combating the financing terrorism (CFT). India became observer at the FATF in the year 2006. Since then India has been working towards full-fledged membership of the FATF. As part of its membership, a joint FATF/Asia Pacific Group evaluation team visited India in November-December 2009 for on-site assessment of India’s compliance with the 40+9 Recommendations of the FATF. The FATF plenary adopted the mutual evaluation report on India on 24 June 2010 and on 25 June 2010 admitted India as 34th country member of the FATF. This will help India build capacity to fight terrorism and trace terrorist money and to successfully investigate and prosecute offences related to money laundering and terrorist financing. ([Economic Survey 2010-11, GOI](https://economysurvey.nic.in))
8. **International Monetary Fund and World Bank.** In June 1944, the representatives of 44 Allied powers met at Brettonwoods, New Hamshire, USA to give concrete shape to their ideas. The agreement reached at this meeting provided for establishing two institutions; known as ‘Brettonwoods Twins’. The Institutions set up were IMF and IBRD (World Bank). The FSAP is a joint initiative of the IMF and World Bank. ([http://www.world bank.com](http://www.worldbank.com))

9. **Financial Stability Board.**

The Financial Stability Forum (FSF) was established by the G7 finance ministers and central bank governors, in 1999, to promote international financial stability through enhanced information exchange and international co-operation in financial market supervision and surveillance. It decided in its plenary meeting in London on 11-12 March 2009, to broaden its membership and invite as new members the G20 countries that were not initially in the FSF. The FSF was re-launched as the Financial Stability Board in April 2009, with an expanded membership and broadened mandate to promote financial stability.

The current FSB comprises national financial authorities (central banks, supervisory authorities, and finance ministries) from the G20 countries as well as international financial institutions, international regulatory and supervisory groupings, committees of central bank experts, and the European Central Bank. ([http://indiabudget.nic.in/](http://indiabudget.nic.in/)).

**Principles 14 to 16: Principles relating to issuers/Corporate Governance Standards**

What constitutes corporate governance, has been a subject of intense debate throughout the world with no concise, universally agreed upon, defined parameters. However, the concept has evolved in different ways over the last two decades depending upon the prevailing economic system. As per some of the well-accepted definitions, corporate governance refers to the following:

- System by which business corporations are directed and controlled.
- The structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.
- Relationship among various participants in determining the direction and performance of corporations.
- Balance between economic and social goals and between individual and communal goals.
• Efficient use of resources and accountability for die stewardship of those resources.
• Enhancement of the long-term shareholder value while at the same time protecting the interests of other stakeholders.

It may be recalled that in April 2004, a Corporate Governance Country Assessment for India was carried out as part of the joint World Bank/IMF program of Reports on the Observance of Standards and Codes (ROSC). To provide a comparative perspective, principle-wise assessment as per this Report, wherever applicable, has been placed alongside the current assessment. In the said World Bank Report, the observance of principles was assessed on the scale which ranged from ‘Observed’ to ‘Not Observed’. However, as per the latest OECD evaluation methodology (2004), the assessment of revised principles has been done on the scale ranging from ‘Fully Implemented’ to ‘Not Implemented’. The Ministry of Corporate Affairs also constituted an Expert Committee on Company Law under the chairmanship of Dr. J J. Irani which released its Report in May 2005. Further, while doing the assessment on the basis of OECD principles on corporate governance, guidance provided under the commentary of ‘Evaluation Methodology’ published by the OECD has been followed.

The Ministry of corporate affairs (MCA) is the main regulator for compliance under Companies Act by all companies and for prescribing rules and regulations for all capital market transactions to be made by listed companies. (Pratab, 2008)

**Principles 17 to 20: Principles relating to collective investment schemes/mutual funds**

A Mutual Fund represents a vehicle for collective investment. When you participate in the scheme you become a part owner of the investments held under the scheme. (Prasanna Chandra, 2006)

The structure that is required to be followed by mutual funds in India is laid down under SEBI (Mutual Fund) Regulations, 1996. In the following paragraphs, we take a look at the structure of each of them:

a. The Fund Sponsor: Every project needs a promoter, who has overall responsibility for the project. The promoter of a mutual fund is referred to as a sponsor. As per the regulations a sponsor means’ any person who, acting alone or in combination with another body corporate, establishes a mutual fund’ (Sunder Sankaran, 2007)
The sponsor will form a Trust and appoint a Board of Trustees. As per the existing SEBI regulations, for a person to qualify as a sponsor, he must contribute at least 40% of the net worth of the AMC and possess a sound financial track record over five years prior to registration.

b. Mutual Funds as Trusts: A mutual fund in India is constituted in the form of a Public Trust created under the Indian Trusts Act, 1882. The Fund Sponsor acts as the Settler of the Trust, contributing to its initial capital, and appoints a Trustee to hold the assets of the Trust for the benefit of the unit-holders, who are the beneficiaries of the Trust. The fund then invites investors to contribute their money in the common pool, by subscribing to “units” issued by various schemes established by the trust, units being the evidence of their beneficial interest in the fund.

c. Trustees: The Trust - the mutual fund - may be managed by a Board of Trustees ie a body of individuals, or a Trust Company or a corporate body. Most of the funds in India are managed by Boards of Trustees. While the Board of Trustees is governed by the provisions of the Indian Trusts Act, where the Trustee is a corporate body, it would also be required to comply with the provisions of the Companies Act, 1956.

d. Asset Management Company.

The sponsors, or the trustees, if so authorized by the Trust Deed, appoint the AMC. The AMC so appointed is required to be approved by SEBI. Once approved, the AMC functions under the supervision of its own Board of Directors, and also under the direction of the Trustees and SEBI.

The Average Assets Under Management in 2010 was Rs.761626 Crores. (Survey of Indian Industry-The Hindu)

In addition to the above there are parties who provide support services to the mutual fund like custodians, registrar and transfer agents etc.

21-24: Principles relating to market Intermediaries

a. The Process of Registration / Renewal of Intermediaries
b. The process for granting No Objection Certificates (NOCs) to Intermediaries for setting up subsidiaries abroad
c. Recognition of Stock Exchanges
d. Registration of Foreign institutional Investors and Custodians of Securities
e. Registration of Collective Investment Schemes (CIS)
f. R Registration of Venture Capital Funds

**Principles 25 - 29: Principles relating to secondary market**

Secondary market witnessed volatility amidst adverse developments in global financial markets. Following were the major policy initiatives taken by SEBI relating to the secondary market:


b. Foreign Institutional Investors (FII) Permitted to Offer Domestic Government Securities as Collateral for Margins

c. Account Maintenance Charges (AMC) Collected Upfront on Annual Half Yearly Basis on Demat Accounts by Depository Participants

d. Call Auction in Pre-open Session

e. Mandatory Requirement of PAN

f. Securities Trading Using Wireless Technology

g. Smart Order Routing and

h. Securities Lending and Borrowing Mechanism (SLB)

**Principle 30: Principles relating to clearing and settlement of securities.**

‘What can early warning systems be expected to deliver?’ (Atish R Ghosh et al., 2009)

The objective is to assess the adherence to the extant standards and codes in payment and settlement systems prescribed by the Committee on Payment and Settlement Systems (CPSS) for the Systemically Important Payment Systems (SIPS) and CPSS-International Organisation of Securities Commission IOSCO) Recommendations for the Securities Settlement Systems (SSS) and Central Counterparties (CCPs). Taking into account the systemic importance of the CCP and its role in the SSS, the CPSS-IOSCO brought out in November 2004, Recommendations for CCPs which strives to set out comprehensive standards for risk management of CCPs.