CHAPTER – I
INTRODUCTION

The trend over the last decade is the tendency to bring in tighter regulation over the activities of the financial sector. World over, the increasing need for tighter regulatory framework is felt especially in the light of meltdown\(^1\) in financial markets, the total collapse of the once ubiquitous and sophisticated investment banks in the United States and the resultant series of financial crises that had a contagion effect throughout the financial markets across the borders. The root cause of the meltdown itself was trading in newer and innovative derivative transactions especially in Collateralized Debt Obligations related to mortgages and Credit Default Swaps by the banks in USA and Europe. Derivative contracts encompass a wide variety of financial transactions such as futures contracts, interest rate swaps, options contracts, foreign exchange contracts (currencies) etc. The exponential growth in derivative products occurred after 1999 when the Glass-Steagall Act was repealed. As a result, banks were allowed to operate as brokerage houses and take positions in derivative transactions. The Glass-Steagall Act, 1933, ensured separation of brokerage houses and banks in order to restrict banks from taking risky transactions which was the root cause of the crash that led to the Depression. The collapse of a very powerful and sophisticated investment banking system in USA and Europe exposed, in that process, a woefully inadequate regulatory framework over most of the financial markets viz. investment banks, derivatives markets which kept on inventing ever...\(^1\) The term meltdown in financial market is applied broadly to a variety of situations in which some financial assets suddenly lose a large part of their nominal value. In the 19th and early 20th centuries, many financial crises were associated with banking panics, and many recessions coincided with these panics. The recent meltdown is commonly believed to have begun in July 2007 with the credit crunch, when a loss of confidence by US investors in the value of sub-prime mortgages caused a liquidity crisis. This, in turn, resulted in the US Federal Bank injecting a large amount of capital into financial markets. By September 2008, the crisis had worsened as stock markets around the globe crashed and became highly volatile.
innovative and complex products that became not only inscrutable to the users but also to the regulatory agencies. The crisis occurred after an extended period named as “The Great Moderation: a period characterized by high global growth, huge financial sector expansion and low product price inflation, but accompanied by steep growth in monetary aggregates and asset prices, along with volatility in exchange rates.”

The monetary policy was narrow in its approach focusing more on inflation and less on financial regulation. “The price that the world has paid for the practice of such narrowly focused monetary policy, inadequate macro-economic policy coordination and neglect of financial regulation and supervision has been huge”

The more complex and sophisticated the financial products have become, the need for tighter control over them through a strong regulatory framework has become a *sine qua non* for an orderly and smooth functioning of the financial sector.

Though the Indian economy escaped this financial mayhem on account of a tighter regulatory framework over its financial sector especially the banking sector, still there is a need for review of the existing regulatory framework as it stands today. It is stated that, Indian financial sector has been undergoing metamorphic changes on account of major economic reforms since early nineties. A slew of bold reforms have opened up the financial sector of the country from the shackles of control and governmental interferences into globalization of the economy, privatization and liberalization.

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3 *Id.*
Consequently, there has arisen a complex structure of regulatory framework extending over a wide range of financial markets and products over a period of time. This has resulted in creation of multiple layers of regulatory structure in the financial sector. This takes one to the debate of determining an ideal Regulatory structure for the country viz Single Structure or maintenance of the status quo. Scientific investigation into the debate is a must in today’s context, which in fact the study intends to undertake.

In the light of the above, the research work attempts to do the following:

a. **Understanding and analyzing the existing regulatory environment for the financial sector.**

A clear understanding of the existing Indian regulatory environment in its myriad forms would reveal a structure of various regulatory bodies that oversees the vast canopy of financial sector. Each regulatory entity has a very comprehensive set of rules and regulations fully supported by a very sound legal framework as also judicial pronouncements. Today, expansion of the activities of financial sector has ranged from banking in the immediate post-Independence era to the securities markets namely equity and debt in eighties and nineties of the last century to sophisticated instruments such as derivatives in the first decade of the twenty first century. Even while a series of scams rocked the financial markets in the last decade of last century and in the first decade of 21st century, the process of innovation of sophisticated financial instruments in the market economy continued unabated. This has also brought about the need for creation of corresponding regulatory structures to regulate them.
b. Understanding the challenges and grey areas of financial sector along with the suggested regulatory changes.

The scams that took place towards the end of last century were believed to be, on account of lack of sufficient and strong regulatory mechanism in the financial markets. For example, the Harshad Mehta scam that rocked initial 1990s exposed a series of regulatory gaps. The scams that happened in the initial period of the current century, inter alia, exhibited inadequate implementation of some of the regulations. Notwithstanding a good regulatory framework for the financial markets, it appears that the process of implementation is some cases was not guided by proper due diligence. This highlights the need to have a strong and effective implementation of regulatory oversight functions over the markets. The Indian financial system started with the growth of a vibrant equity cult in capital market, then slowly expanding its vast canvass to debt and markets subsequently enriching its landscape with derivative markets, thus extending in the process, the regulatory contours governing these markets over a period of time. This has not only brought about a sea change in the laws governing the financial markets but has also increased the complexities that have come to stay in regulatory frameworks in the form of overlaps resulting in avoidable confusion in the markets. The Financial markets have today a well laid out regulatory

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4 A probe by the Securities and Exchange Board of India (SEBI) revealed that shares reserved for retail investors in several Initial Public offerings were cornered by a few operators by opening multiple demat accounts. On allotment of shares, they were sold on the listing day at a premium and making substantial gains. SEBI then charged NSDL with failure to prevent the opening of multiple demat accounts and not carrying out proper due diligence and imposed a penalty. Subsequently, SEBI constituted a Committee comprising of its two non whole-time directors, to examine three orders passed against NSDL by SEBI. This Committee found that NSDL was at fault for the alleged irregularities to IPO Scam during 2003-2006 and also held SEBI had failed to carry out is regulatory role adequately and recommended it to make a Code of Conduct for depositories.
structure consisting of strong regulators to ensure a robust oversight and supervision over various financial activities such as Reserve Bank of India, the Central Bank of the country, to oversee the banking sector and monetary authority, Securities and Exchange Board of India to oversee the capital and derivative markets, Pension Fund Regulatory and Development Authority to supervise Pension Funds, Insurance Regulatory and Development Authority to oversee the insurance sector etc. On account of the multiplicity of regulators in the country, there exist regulatory overlaps and grey areas leading to some areas of financial activities remaining unregulated.

c. Suggestions for Reforms- Suitable regulatory solutions to overcome the challenges.

The present structure of regulatory framework in the financial sector in India operates on Institutional Regulation or silos model. To address the grey areas that exist in the regulatory space, different solutions were suggested over a period of time. Whether a unified or multiple model of regulation would be appropriate for the country taking into account its, geo-political, economic, heterogeneous and social nature or whether such a regulatory model would disturb the existing equilibrium or promote smooth functioning of the financial systems without any glitches or whether regulatory solutions for addressing the problems that affect the financial markets could best be addressed by maintaining the status quo by laying down certain common parameters which would act as "guidance post" for the existing regulatory structures are questions that remain to be answered.

Therefore this study not only analyses the existing challenges in the finance sector regulation but also intends to find a workable solution to such challenges as may be necessary taking into account the jurisdiction specific requirements.
In this regard the research methodology adopted by the researcher is detailed herein below:

a. RESEARCH PROBLEM

The regulation of financial sector in India has moved away from strict to stricter over a period of time; which is converse to the overall trend of regulation in the light of liberalization, globalization and privatization. In the process, a complex and multiple structure of regulatory architecture has evolved over a period of time spanning a wide area of financial activities. This has given rise to the debate on the ideal structure that may be suitable for the Indian financial sector. Do we need to establish a ‘single regulator’ or do we work with the multiple regulators as we are doing at present? This is the question that this thesis attempts to investigate and answer.

b. AIMS AND OBJECTIVES

This research has been undertaken with the following aims:

(1) To analyze the existing regulatory environment for the Financial Sector.
(2) To analyze the challenges or grey areas of financial sector.
(3) To suggest suitable regulatory solutions to overcome the present day challenges

c. SCOPE

The present research covers an analysis of the sector based regulatory architecture as it exists today in India as also a detailed analysis of the multiple and unified models of regulatory structures existing in other countries. The research attempts to study the evolution of the existing regulatory structures in India, the regulatory gaps and challenges that are
present in such a structure, what could be an ideal regulatory structure for India and a working solution for the regulatory architecture for the financial sector, given the limitations, that could function seamlessly and at the same time safeguard the interests of ultimate customers and provide against the systemic risks.

d. LIMITATIONS

As this area of research has not been much dealt with by or has not been the focus of research in India, materials are not easily available except by way of Committee Reports that were constituted by the Government or Regulators for the purpose of creation of roadmaps or structural review of the regulatory framework in India. Accordingly, the available data, financial facts and figures have been gathered from only such sources as also from extensive research work that has been done by experts in western and Asian countries.

RESEARCH QUESTIONS:
In the light of above the present work attempts to answer the following research questions-

i. Whether India requires a unified regulator or should it maintain status quo, that means to say, to continue with the existing framework of multiple regulators for financial sector considering its geo-political, economic, heterogeneous and social conditions?

ii. Whether an overhaul in the present regulatory structure would disturb the existing equilibrium or promote smooth functioning of the financial systems without any glitches?

iii. Whether regulatory solutions for addressing the problems that affect the financial markets could best be addressed by maintaining the status quo by
laying down certain common parameters that would act as "guidance post" for the existing regulatory structures?

e. **RESEARCH METHODOLOGY**

“DESCRIPTIVE” *Method of Research* has been relied upon for conducting the research given the availability of resources and time. The researcher has relied mainly upon secondary sources, including books available in Library, Databases, Journals, Articles, expert Committee Reports, Newspapers and speeches.

The researcher in addition to these sources has also relied upon various reports on the Indian Financial sector such as the Narsimham Committee Report I and II, the Percy Mistry Committee Report, Raghuraman Rajan Committee on Financial Reforms and the recently published the Financial Sector Legislative Reforms Committee Report.

A detailed list of the books and articles, speeches of experts referred has been mentioned in the References Chapter and specific references to the authoritative sources have been cited throughout the thesis.

f. **MODE OF CITATION**

NLS Guide to Uniform Legal Citation is the uniform citation style used throughout the research.