CHAPTER VI

CHALLENGES IN THE EXISTING REGULATORY STRUCTURES

The evolution of the Indian Financial Sector, outlined in the previous chapters bears out the fact that the sectoral regulators play a major role in Indian financial system. However, such sectoral regulators often pose the problem of overlap of activities. There are areas which are outside the regulatory purview of all the sectoral regulators in India. The different types of Ponzi schemes that keep surfacing as also new innovations, require careful study while identifying the gaps in the regulations to avoid the oversight of any of these regulatory bodies. With the technological and financial innovations, laws are slow in keeping pace with these developments. At times, the law catches up with financial innovations only after a crisis or a scam has occurred. This chapter seeks to analyse various challenges that are prevalent in the current regulatory structures.

“A regulatory overlap” is said to occur when two or more regulators frame rule or regulation in respect of a subject and exercise, drawing upon the powers derived from the legislation under which they operate, supervision over the same concurrently. This normally happens in a silo or institutional regulatory model where each regulator has a defined area of regulatory activity under purview though the financial instrument or product sought to be brought under the purview is either not legally defined or there is lack of clarity of the nature of product. “Regulatory Overlap” is the biggest challenge that policymakers could have in a jurisdiction which has silos model.

The most recent instance of such a regulatory overlap was seen during the Etihad Airways- Jet Airways transaction. Upon the liberalization of the Indian Aviation industry in September, 2012, 49% foreign direct investment was allowed; Eithad Airways intended to buy a share of 24% in Jet Airways, a domestic carrier in India. This transaction was subject to regulatory approvals from a number of regulators in India including the Securities Exchange Board of
India, the Competition Commission of India and the Cabinet Committee on Economic Affairs. The compliance requirement of the Government of India (Foreign investment Promotion Board and Cabinet Committee on Economic Affairs) was granted on July and October 2013 as the transaction was in accordance with the FDI Policy of India. The jurisdicalional clash came up between the CCI and SEBI. Both the regulatory authorities in this present situation had bona-fide jurisdiction over different parts of the transaction and no one was binding over the other.

The Competition Commission of India approved of the Combination in accordance with the Competition Act 2002 taking into consideration that Etihad was in a business of transport services and other requisite approvals such as pricing, joint airport handling etc had been satisfied. The Competition Commission observed: 66

“It is observed that the Parties have entered into a composite combination comprising inter alia the IA, SHA and the CCA, with the common/ultimate objective of enhancing their airline business through joint initiatives. The effect of these agreements including the governance structure envisaged in the CCA establishes Etihad’s joint control over Jet, more particularly over the assets and operations of Jet.”

In light of the above observations, SEBI sent Jet Airways a notice stating that if the control of the combination was being transferred, it will have violated regulation 4 of the SEBI (Substantial Acquisition of Shares and Takeovers Regulations), 2011. The notice was criticized as it was contended that SEBI should not rely on observations of CCI due to it being a different regulatory body providing for decisions under its own legislation. SEBI eventually gave an order

66 Etihad Airways PJSC and Jet Airways, Combination Registration No. C-2013/05/122 (Competition Commission of India, 12/11/2013)
in favour of the transaction stating that control as stated in Competition Act 2002, was broader than the Takeover Code. The control as stipulated under the Takeover code had not been breached due to the specifics of the transaction:

- Etihad’s right to nominate only 2 out 12 directors;
- Promoters being able to nominate the chairman of the board of Jet, who shall have a casting vote;
- Etihad not having any quorum rights at the board or general meeting;
- Lack of any veto/ affirmative voting rights with Etihad;
- Any pre-emptive/ tag along rights with Etihad.

Furthermore, no violation or open offer was to be provided due to the transfer of shareholding being under 26% and no control being transferred. Thus, this conflict was resolved quickly and amicably but it led to raising of an alarming issue wherein due to overlapping jurisdictions of various regulatory bodies, a commercial transaction could have been stalled or even annulled as per the Apex Court.

It is very clear from the historical background set out in the earlier chapter, that in India, there are multifarious financial activities and consequently the entities operating them are regulated by different regulators with totally different objectives. On account of innovations of very sophisticated financial instruments and galloping advancements in the space of information technology, metamorphic changes are taking place in the financial and banking sectors in India. Almost all these institutions which were established with specific objectives have diversified over a period of time or intending to diversify into various business areas to keep themselves competitive. In the process, they all fall into regulatory overlap of various regulators. For instance, the banks which undertake business of mutual fund or insurance business through their subsidiaries are governed by RBI for banking activities, SEBI for mutual fund activities and IRDA for insurance activities, as regulation by silos.
At times, the multi-tier systems create problems on account of existence of a variety of legislations governing different functions and in the process it could create avoidable and unintended consequences. For instance, there is a provision in the Securities (Contracts) Regulations Act, 1956 which stipulates that the contracts in derivatives are valid only if they are dealt in Stock Exchanges. It gave rise to an interpretation that all other derivatives i.e. OTC derivatives are wager in nature and hence not valid. Though the intention of engrafting that provision in SCRA was to doubly ensure that the Exchange traded derivatives are not categorized as “wager”\(^1\). It created avoidable confusion in the market when banks tried to enter into OTC derivatives on the strength of circulars issued by RBI\(^2\). Then a clarificatory provision was introduced in Chapter III-D of the RBI Amendment Act, 2006, to clothe the OTC derivatives with legal sanctity with retrospective effect.\(^{68}\) This was also one of the main reasons for bringing about regulatory structure for OTC derivatives. This typifies

\(^{67}\) Sec 18A, Securities Contracts (Regulation) Act, 1956

18 A 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.]

\(^{68}\) Sec. 45V, Reserve Bank of India Act, 1934

45V. Transactions in derivatives.—(1) Notwithstanding anything contained in the Securities Contracts (Regulation) Act, 1956 (42 of 1956) or any other law for the time being in force, transactions in such derivatives, as may be specified by the Bank from time to time, shall be valid, if at least one of the parties to the transaction is the Bank, a scheduled bank, or such other agency falling under the regulatory purview of the Bank under the Act, the Banking Regulation Act, 1949 (10 of 1949), the Foreign Exchange Management Act, 1999 (42 of 1999), or any other Act or instrument having the force of law, as may be specified by the Bank from time to time.

(2) Transactions in such derivatives, as had been specified by the Bank from time to time, shall be deemed always to have been valid, as if the provisions of sub-section (1) were in force at all material times.
the extent to which a non-obstante clause in the special legislations under the jurisdiction of various regulators, at times obfuscates the issue and in the process leads to unintended consequences within the financial sector. At times lack of understanding of complex financial transactions even under clearly laid down framework of law also could pose problem, as it happened in the derivatives litigation of banks with clients.

The recent case of Rajshree Sugar Mills v. Axis Bank before the Madras High Court deals with an issue on exotic derivatives. Rajshree Sugar Mills had entered into a US Dollar- Swiss franc option structure with Axis Bank in June 2007. It later filed a suit before the Madras High court seeking a declaration from the court that such derivatives was void and unenforceable on the ground that there was no underlying exposure. It was contended that the contract was a pure wagering contract and that the company was lured into wagering on the movement of the dollar against the Swiss franc by misrepresentation by the Bank.

The court having discussed the essentials of a wagering contract under the law determined that the present contract could be compared to a contract of insurance where an assured sum becomes payable at the occurrence of a certain event.

The court thus upheld the contract much to the relief of the Bank and the Supreme Court also upheld the ruling of the High Court.

One important issue that comes for discussion here is that while designing the regulatory structure is the introduction of non-obstante provision in the substantive legislations governing the financial regulation. This becomes very common when two authorities operate in a specific financial field or similar instrument or product. When two or more enactments operating in the same field

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and each containing a non obstante clause stating that its provisions will have effect notwithstanding anything inconsistent therewith contained in any other law for the time being in force. The conflict in such cases is resolved on consideration of purpose and policy underlying the enactments and the language used in them”. Another test that is applied is that the later enactment normally prevails over the earlier one. This is especially so when earlier enactment is a State Act and the later enactment is a Central Act both referable to List III and operating in the same field.

The Supreme Court as well as various High Courts has taken the same view while deciding a number of cases involving the issue of “non-obstante clauses”. The test laid down by the Apex court in cases where two Central statutes conflict on a non obstante provision in each of the statute, is as follows:

(a) Leges posteriors priores conterarias abrogant (The later law abrogates the earlier contrary law). This principle is based on the reasonable premise that Parliament, with full knowledge of a previous law enacted by it, nevertheless intended to pass a subsequent and inconsistent law and hence intended that the subsequent law, being the later will of Parliament should prevail.

(b) The aforesaid principle is subject to the exception embodied in the maxim: generalia specialibus non derogant (a general provision does not derogate from a special one) i.e. that a special law will abrogate and prevail over a general law.

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73 G. Sridharamurti v. HPCL, 1995 SCC (6) 605.
74 Allahabad Bank v. Canara Bank AIR 2000 SC 15 5 at paras 38-40;
Hence even a previously existing special statute will prevail over a subsequent but general law.\textsuperscript{75}

(c) However where both Parliamentary statutes are special in nature, there is a third rule which has been resorted to for resolving a situation of inconsistency. The Supreme Court in these circumstances has resolved the inconsistency by reference to the principles and policy underlying the two enactments.\textsuperscript{76}

Another issue is the overlapping jurisdiction of various regulators. For instance, as pointed out earlier, both SEBI and RBI have been given concurrent jurisdiction under the Securities Contract Regulation Act, 1956 over the Government Securities. Though Government Securities are principally under the jurisdiction of RBI under the RBI Act, 1935 and Government Securities Act, 2006, still the definition of “Securities” in Securities Contract Regulation Act, 1956 includes “Government Securities.” However, Central Government under a Gazette notification demarcated the lines of activities under this Act between SEBI and RBI.

One more instance of overlapping activity, is that SEBI and RBI are having overlapping jurisdiction on “Currency Future”. While the entity which operates the currency future that is the Stock Exchange is licensed by SEBI under the Securities Contracts Regulation Act, 1956, the rules governing the “Currency Future” are regulated by RBI.

An important development touching on the subject of overlapping jurisdiction is worth mentioning. In April 10, 2010, SEBI came out with an order banning 14 insurance companies both private and public, from raising funds through unit linked schemes on the ground that these partake the character of Mutual fund schemes and as such it required the approval of SEBI without which the

\textsuperscript{75}Allahabad Bank v. Canara Bank AIR 2000 SC 1535.

\textsuperscript{76}Morgan Securities and Credits Pvt. Ltd. v. Modi Rubber Ltd. (2007) AIR SCW 350
Insurance companies cannot sell. A whole time member of SEBI passed an order under the Section 11, 11B and 12(1B) of the SEBI Act, passed a *suomoto* order against 14 insurance companies under the discretionary power of SEBI of investigation. They debarred all the stated 14 companies from “*any offer document, advertisement, brochure soliciting money from investors or raise money from investors by way of new and/or additional subscription for any product (including ULIPs) having an investment component in the nature of mutual funds, till they obtain the requisite certificate of registration from SEBI.*”

However, according to Insurance Regulatory and Development Authority, the ULIPS were part of Insurance business and has directed the 14 insurance companies banned by SEBI, notwithstanding the said order of SEBI to continue to carry out insurance business as usual including offering, marketing and servicing ULIPs in accordance with the Insurance Act 1938.

Therefore this resulted in a considerable confusion and highlighted the issue of regulatory overlap. Therefore, all 14 insurance companies were bound by the order of SEBI and even if it is considered illegal by IRDA can only be set aside by the appropriate appellate body being either the Securities Appellate tribunal (SAT) or the Supreme Court of India as per the SEBI Act. IRDA cannot nullify and negate the direction as given by SEBI as it is bound by its powers contained in its statute.

This means that all agreements made by insurance companies as part of their ULIP scheme was void as an agreement in violation of Section 23 of the Contract Act is void.

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This standoff between the regulators forced the Finance Ministry to intervene and it asked the two regulators to seek a legally binding opinion. Following this, SEBI has moved the Supreme Court on this issue.

However, since the matter came to a block, the Government came out with an ordinance called Securities and Insurance (Amendment and Validation) Ordinance 2010 settling the issue of the regulatory jurisdictional disputes. This ordinance had created a framework for a joint committee of the officials consisting of Union Finance Minister as Chairperson, Governor of RBI, Chairman, SEBI, Chairman, IRDA, Chairman, Insurance Regulatory Authority as ex-officio members of the said Joint Committee. This Committee will decide any dispute or difference that may arise amongst the regulators on the issue of overlap of regulation of any financial instruments.

Subsequently, there was an intense debate on the need for this ordinance as it was felt that the matter could have been solved amicably between the regulators without any Governmental interference. However, the Government appeared to have taken the line that since the matter could not be settled amicably amongst the regulators, the need for the ordinance was felt. The Government also went ahead giving legislative shape to the ordinance by bringing a bill to bring a new Chapter IIIE of the Reserve Bank of India Act, 1934 to give effect to the above through the Securities and Insurance Laws (Amendment and Validation) Bill, 2010. In his reply to the debate on the Bill in Lok Sabha on 3rd August 2010, which was passed by voice vote, the Honourable Finance Minister sought to clarify that with regard to protecting the interests of investors in the market, he reiterated that the government would take prompt and definitive steps to protect the interest of investors and was committed to doing all to dispel any uncertainty in the country’s financial market. He said the proposed law was necessary as the interest of investors had to be protected by all means.
It was considered necessary that in order to prevent clash among regulators over areas of jurisdiction, he said, adding the government could not remain a mute spectator to uncertainties of financial markets. He said even the Raghuraman Committee has said in its findings that “it is premature to have only one market regulator.”

One point that requires detailed study arising out of the problem of overlapping jurisdiction is the ultimate interests of the investors. Though both Regulators testify to their avowed objective of upholding the interests of investors, the result appears to be the reverse.

One more issue that comes to the fore in this context is that different structures of Penalty that are in place under various legislations. For instance, enacted Payment and Settlement Systems Act, 2007 has a structure of penalty with the right in favour of regulator to recover the penal amount from a third party, i.e. Garnishee like order. SEBI Act and the other Acts have different structure of penalty for its regulated entities and so is the case with IRDA. The Companies Act, 2013 along with its Rules stipulate a stringent framework of Penalties. While the sectoral regulators can have different penalty structures for the offences and violations, there should exist clearly laid down principles that govern such penalty structure which will guide the imposition of the Penalty based on the intensity of the offence committed, the sense of proportionality while imposing such fines, the intention of the offender, whether repetitive in nature. When sound principles governing imposition are clearly laid down, it will imbue the regulated entities with more confidence in the regulator and promote an atmosphere of fair play.

Similarly, while some regulators have properly established appellate authorities, others do not have. While in the case of SEBI there is a Securities Appellate Tribunal, there is no such structured Appellate Authority over some of the
Activities under the regulatory purview of RBI. There was an attempt; however some time back to create separate Appellate Tribunal for Insurance Regulator. Another area of concern is the treatment to collaterals collected by the service providers such as Clearing and Settlement Agencies operating under various regulatory jurisdictions. For instance, the collaterals collected by the service providers under RBI are given protection as against those under the capital market or commodities markets. For instance, under the Payment and Settlement Systems Act, 2007, entities that are licensed by RBI under the Act to operate the payment system are protected from the adverse effects of insolvency in respect of the collaterals collected by them from the participants who have become insolvent. While the Act specifically gives such protection to entities that are operating under it, the same was not made available to entities that operate outside such payment system such as clearing houses of stock exchanges. It creates avoidable gap and leads to inequitable treatment amongst the market participants. At present there is no common approach to the law of collaterals in the financial market. There is a lack of clear approach on treatment of the “collaterals which are taken as part of the financial transactions. The Financial laws that fall under the regulatory purview of different regulators give dissimilar treatment to the “collaterals” that are part of the transactions in the financial sector. The recovery of collaterals is governed by different statutes with different procedures. There exists lack of uniformity in treatment of collaterals.

However, in order to be compliant with Principles of Financial Markets Infrastructures notified by Bank for International Settlements, amendments to the Securities Contracts (Regulation) Act, 1956 and Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2012 were brought in to effect.

Lastly, one very important problem that remains unresolved is that lack of sufficient information on entities which are regulated by a multifarious agencies
in a centralized platform especially in case of a crisis. Lack of legislative support for sharing of information could create serious problems in the event of failure of an entity that operates in various financial markets. At present there is a High Level Group on Capital Market which has representatives from SEBI, RBI, and IRDA etc. This Group is an only informal arrangement which share information on various issues amongst the regulators. Interestingly, The Advisory Group on Securities Market Regulations, 2001 under the chairmanship of Mr. Deepak Parekh has recommended that a legal status be accorded to this High Level Group on Capital Market. The absence of legal framework for sharing of information amongst Regulatory agencies might give them an opportunity to cite the existing provisions of the Act(s) under which they are created from parting with the information.  

Thus it is to be concluded that with increase in technological advancements and resultant innovations which take place in the financial markets giving rise to newer financial activities, the challenges that they pose to the regulators will continue. Creation of similar financial products or where financial activities are placed under more than one regulator either on account of lack of clarity on the design of the activity, the problems of overlaps and resultant challenges therefrom would continue. Further regulation of different financial products under different regulators in India has given rise to peculiar legal challenges such as regulatory overlaps, appellate issues, dissimilar regulations amongst various segments etc. This requires careful consideration for appropriate resolution.

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