GAPS IN REGULATORY STRUCTURES

Last chapter analysed at greater length the legal challenges that are in existence due to its regulatory silos model. The current chapter in the context of the same regulatory silos model, will seek to analyse the regulatory gaps. There can be no regulatory structure which can be said to be an ideal or perfect model free of any problems. Those problems would crop up with the increasing growth of the financial markets. This chapter examines types of such regulatory gaps and its implications.

There are still many activities in the financial sector which are yet to be brought under the regulatory purview of the regulators. When there are multiple layers of regulatory set up, there always arises a gap or vacuum in the system in respect of certain financial activities which are without regulation or control or financial activities that "fall between two stools" thereby escaping any regulatory oversight. The areas of activities in the financial markets which operate beyond the purview of any regulatory framework are categorized as "Gaps in the Regulatory framework".

Shadow Banking as a regulatory gap:

The term "shadow bank" for the first time came about after Paul McCulley coined the expression to indicate US non bank financial institutions engaged in maturity transformations that is use of short-term deposits to finance long-term loan arrangements.

The Group 20 Leaders identified the shadow banking system as one of the main gaps in the regulatory architecture and accordingly suggested that the Financial Stability Board (FSB) in collaboration with other international standard setting
bodies, identify and recommend measures to enhance the oversight and regulation of the shadow banking systems.\textsuperscript{79}

The term "Shadow banking system" can broadly be described as "credit intermediation which denotes any kind of lending activity where the saver does not lend directly to the borrower but the same takes place through an intermediary resulting in liquidity transformation that is investing in illiquid assets while acquiring funding through more liquid liabilities and maturity transformation through use of short-term liabilities to investments in long-term assets ,involving entities and activities outside the regular banking system".

With the commencement of the Great Financial Crisis 2008, this term was used widely to indicate or identify the increased role of financial entities and activities which were not part of banking systems but which functioned or performed the functions of bank-like system.\textsuperscript{80} "These entities and activities provide credit by themselves or through a chain that transforms maturity or liquidity, and builds up leverage as in the regular banking system. They also rely on short-term funding from the markets, such as repos and asset-backed commercial paper (ABCP).\textsuperscript{81} Based on such features, some authorities or market participants prefer to use other terms such as "market based financial" instead of "shadow banking"

It is important to note that the use of the term "shadow banking" is not intended to cast a pejorative tone on this system of credit intermediation. However, the FSB has chosen the term 'shadow banking as this is most commonly employed and in particular, has been used in all earlier communications.\textsuperscript{82}


\textsuperscript{80} \textit{Id}

\textsuperscript{81} \textit{Id}

\textsuperscript{82} \textit{Id}
Using the "shadow banking", financial entities may avoid financial regulation which in turn could lead to build up of leverages and risks in the financial system and hence proper control and supervision of this area of financial activity is essential in the overall health of financial market.\textsuperscript{83}

The shadow banking, operates more or less similar to conventional banking by conducting various intermediation activities akin to banks, but is distinct from the formal banking sector in the following ways:\textsuperscript{84}

1. Shadow banks cannot create money whereas conventional banking system can create or act as depository institutions.

2. Shadow banks raise funds through market instruments such as commercial papers, CDs, debentures or other structured credit instruments whereas the banks mobilize or raise funds through deposits.

3. Whereas the money raised by the Shadow banks is not insured the deposits raised by commercial banks enjoy Government guaranteed with suitable caps.

4. Shadow banks cannot resort to the Central bank in times of crisis as a lender of last resort whereas the banks can resort to Central Banks in times of crisis.

5. Lastly, the Shadow banks are not tightly regulated and there exist opaqueness in their operations whereas the banks are all tightly regulated through well laid down regulatory structure.

\textsuperscript{83} Id

\textsuperscript{84} R. Gandhi, Deputy Governor RBI, \textit{Dangers posed by Shadow Banking Systems to the Global Financial System - The Indian Case}, address at ICRIER's International Conference (August 21, 2014).
Shadow banking has attracted the focused attention of the economies in general in the aftermath of the Financial Crisis 2008 though it was present all throughout in the financial market even earlier. The biggest challenge that is posed by the shadow banking systems is the lack of correct statistical data to analyze their operations unlike in the case of banks where there exists a good statistical coverage. Some of the major challenges posed to regulations by this Shadow banking are:

a. Financial Stability and Systemic risk concerns: Since these entities are not allowed Central Bank funding, they are open and highly vulnerable to financial shocks on account of such safety nets like guarantee through Deposit insurance schemes available to banks. On account of their inter linkages with other entities of the banking sector or other regulated financial sector, any shock or failure in the shadow banking can greatly impact the market as a whole. Due to lack of regulatory framework for all financial markets, financial entities used to do regulatory arbitrage and create shadow banking entities. In some cases the regulated banks themselves could create subsidiaries or associates to carry out shadow banking systems.

b. Regulatory arbitrage across geographical jurisdictions: Different types of legal or frameworks for regulation across jurisdictions could provide a very great scope for spinning such entities. For instance, high taxation in some jurisdictions leads to avoidance of the same by the entities by operating through tax havens which provide for less or no tax structures.

c. Distortion of Monetary Policy: Lack of correct data or opaqueness of such entities may not give correct picture of the monetary policy and it may at times distort the information content that goes to build such monetary policy. For example, the actual information available on credit aggregate may not include the shadow banks.
d. Leads to procyclicity operation: The shadow bank activities, if kept beyond regulatory purview, could induce pro-cyclicity in its operations. That means to say that their leverage would increase during boom times of the market (as they have less problem in raising resources during boom) and their asset prices shoot up whereas during downturn they have difficulty in raising funds, the asset value decreases and costs shoot up.\(^{85}\)

In almost most of the countries, post financial crisis, the shadow banking has been the focus of a detailed study. Hence, initiatives were set in motion by the G-20 countries to do the needful in this direction through Financial Stability board (FSB). The FSB, based on its deliberations have identified four broad categories of potential regulatory responses to address the possible risks inherent in such shadow banking system: (1) the regulation of banks interaction with shadow banking entities (indirect regulation); (ii) the regulation of shadow banking activities; (iii) the regulation of shadow banking activities; and (iv) macro prudential measures. In all, FSB, has evolved 11 broad principles for strengthening the shadow banking system Board 27th October 2011.\(^{86}\)

In India, the non bank finance companies such as NBFCs, Micro finance companies, Chit funds, Money lenders etc., fall under this category.

However, there exists a very extensive regulatory framework for the NBFC. They are all regulated by the Reserve Bank of India. The legislative initiative and regulating Micro finance companies as NBFC by RBI are some of the recent regulatory initiatives. However, the ground is yet to be fully covered in terms of extensive regulatory coverage in respect of chit funds and money lenders though there are state legislations governing the money lenders.

\(^{85}\)Id

**Dark Pools in stock markets:**

A 'Dark Pool" is defined by Financial Industry Regulatory authority of USA, to mean "as an alternate trading system that does not display quotations or subscribers' orders to any person or entity either internally within an ATS dark pool or externally beyond an ATS dark pool"

Dark Pool is a type of transaction wherein the trading volumes built by larger orders especially by big entities that are generally not available to the public. The liquidity of the bulk of dark pool is indicated by a bulk trades which are facilitated or enabled outside the stock exchange systems. This brings about opaqueness in the stock market transactions. These high frequency trading between the parties in which absolute anonymity is maintained about the parties, the price at which they are concluded.

In October 2009, "the Securities Exchange Commission noted that the practice of not sharing with the public the price quotations could lead to a situation of a two-tiered market in which the public does not have fair access to information about the best available prices and sizes for a stock that is available to some market participants. Moreover, the SEC also noted that dark pools do not, in all instances, report fully the post trade information which in the SEC's views, "detracts from the public's ability to assess the sources of liquidity in a stock and dark pool trading activity in general." \(^{87}\) Subsequently, SEC came out with a rule relating to Public action of Certain Aggregate Daily Trading Volume Data, March 5, 2010 vide SEC.Rel.No.34-61658 stipulating that each trade in a dark pool is required to be reported to the regulator and Financial regulatory Authority has

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also stipulated that any larger transaction, including dark pool, may voluntarily report trading data in the aggregate after the closure of the market.

In India, "dark pools' are not permitted on account of lack of transparency in such trades. In Indian stock markets not all securities have a very high degree of liquidity and if dark pools are permitted by the regulators, then all the big deals that take place in stock exchanges will gravitate to these dark pools. That will make the price discovery in the stock exchanges very difficult. The liquidity in dark pool refers to the trading volume created by institutional orders that are not available to the public.

The following are some of the activities which are required to be brought under the regulatory framework:

a. One area of regulatory gap exists in the field of Over the Counter market activities concerning bond market and forex market. While there exists a regulatory structure for screen based trading activities that take place in the stock exchanges for equity transactions, there is no such structure available for bond trading which take place in RBI owned Negotiated Dealing System or Negotiated Dealing System (order Matching) which provides an anonymous trading platform for Government Securities transactions. Divergent views emerge on the status of these platforms. One being that since it is a screen based transaction it should be treated as a “stock exchange” and governed under the Securities Contracts Regulation Act, 1956. The counter view appears to be that not all screen based transactions are necessarily “stock exchanges” and should be treated as “Alternate Trading Platforms or Systems” and regulated separately as they are done in countries such as Canada, Australia, UK etc., Similarly entities such as Reuters, Bloomberg which offer screen based services for the forex transactions should also be brought under the regulatory purview as they all fall outside the purview as part of Alternate Trade Systems.
b. Another important area for consideration of regulation is whether there is a need to regulate entity wise instead of product wise. For instance, one single bank offers various financial services through its subsidiaries some of them falling under SEBI, Insurance and the rest with RBI. This gives rise to regulatory arbitrage on account of the fact that the less regulated has a different treatment as against stringently regulated activity. This gap is required to be plugged.

c. Another area of gap exists in the case of the new genre of micro-finance companies. The micro finance companies borrow from the banking system and extend credit facility to the rural people especially women who are into village industries. Though the credit facility operates on no collateral basis, the rates of lending by some of these companies were found to be very high. This, coupled with forcible recovery mechanism adopted by these companies drove the borrowers to commit suicides in the State of Andhra Pradesh. This forced the Andhra Pradesh Committee to come out with a law regulating the recoveries by these companies which effectually stopped recovery of loan itself. Subsequently, the Reserve Bank constituted a Committee under Mr.Y.H.Malegam to go into the issues connected with the micro-finance companies. One of the key recommendations of the Malegam Committee is to cap the lending rate at 24%.

Now The Micro Finance Institutions (Development and Regulation) Bill, 2011 is pending before the Parliament.

This leads one to conclude that there is a compelling need to have a relook at the existing regulatory structures in India and the existing regulatory gaps to be bridged. Before embarking on this exercise, it should be thoroughly analyzed as to which type of regulatory model would be suitable to Indian conditions.

Changing Dynamics of the Regulatory Architecture for Financial Markets

Obviously, the line of thinking that could be taken is to integrate the roles into a single regulator. Before choosing the ideal model for Indian conditions, it is essential to examine different models and the international experience on the same.

Other regulatory gaps:

The recent payment and settlement crisis at National Spot Exchange Limited (NSEL) highlighted, inter alia, a gap in the regulations of the Commodity Spot Exchanges in India. Initiatives to launch commodity Spot Exchanges in India are of relatively recent origin. Setting up of such exchanges was facilitated in the mid-2000 in response to a felt need that a sustained and healthy development of futures market contingent upon the simultaneous development of the physical or spot market for commodities. In order to provide adequate liquidity on the trading platforms, Government of India permitted the electronic spot exchanges a facility of offsetting (cash settlement) the contracts on the day of entering into contracts, but it also mandated that if the contracts were not offset (cash settled) on the same day, they would have to compulsorily result in delivery of goods. The one-day forward contracts traded on spot exchanges were exempted from the provision of the FCRA, with stiff conditions including a ban on short selling and the launch of longer term contracts.\textsuperscript{89}

Detailed investigations into the various malpractices at NSEL have revealed the need for comprehensively addressing the problems in commodity spot markets in India. The FMC has been brought under the ambit of the Ministry of Finance, Government of India, to ensure better co-ordination among various financial sector regulators.\textsuperscript{90}


\textsuperscript{90} Id.
The fallout of the events in the NSEL on other exchanges / markets was limited. However, the episode revealed certain systemic concerns with regard to ownership and governance arrangements in exchanges and common ownership of exchanges and existing technology platforms. The episode has emphasized the need for ensuring that no single shareholder or a group of shareholders is permitted to dominate the functioning of the exchange or exercise management control.\textsuperscript{91}

One major regulatory gap yet to be filled up is lack of adequate legal framework for unorganized financial sector which cater to the major lending activities in semi-urban and rural areas is the money lending by the private money lenders. Since the banking sector has not yet reached out to the remote corners of the country, the financial needs of these pockets are catered to by the money lenders who control most of these markets. The advantage for these lenders are that they, unlike in the case of banks who lend only against specified collaterals and on the basis of specified norms, lend against any collaterals and are not bound by norms of lending. Further the rural people appear to be more comfortable with these money lenders on account of easy access to credit without any compelling need for completing legal formalities. Though there exists in most of the states a law to regulate money lending, they are mostly archaic and out of tune with the development in financial sectors. Connected with that is also prolific growth of unregulated chit funds in rural areas or collective investment schemes.

A Ponzi scheme is a fraudulent investment operation under which an individual or entity pays returns from fresh capital made by investors instead of from profits of the scheme. These schemes are the most tantalizingly deceptive means of luring innocent people to invest in such schemes with promise of higher returns. The perpetuation of the high returns requires an ever-increasing flow of money from new investors to sustain the scheme. The recent financial scam that shook

\textsuperscript{91} Id.
West Bengal was caused by the collapse of a Ponzi scheme by Saradha Group, a group of Indian companies that was believed to be running a wide variety of collective investment schemes, as chit funds in April 2013, causing an estimated loss of INR 200–300 billion to about 1.7 million depositors. In the aftermath of the scandal, the State Government set up an inquiry commission to investigate the scam and also set up a fund of INR 5 billion to ensure that low-income investors were rescued from financial bankruptcy. The Government of India through the Income Tax Department also launched a multi-agency investigation to investigate the Saradha scam, as well as other similar Ponzi schemes. This poses a very big gap in the financial sector in that these kinds of schemes in unregulated sectors pose challenges to the regulators and policy makers.

The existence of regulatory gaps lead to practice of regulatory arbitrage by the participants in the financial market. Lack of a proper regulatory structure or loopholes in the regulatory structure enables a market participant to take advantage of the same in its favour or capitalize on such loopholes to circumvent an unfavourable regulation. Such regulatory arbitrage practices could be resorted to by different methods such as by restructuring transactions, financial engineering and operating from a different geographical location, where there is lesser or no regulation of the same product. For instance, a financial entity is subjected to a very tougher tax regime, that financial entity may operate from a country where there is a lenient tax structure or tax haven. While it may be difficult to totally avoid regulatory arbitrage, the same however could be limited by closing the glaring loopholes in the regulatory structure, increase the costs of circumvention of the regulations, impose stiff penalty structure for the offenders etc.,

The classic example is the Sahara case in India, in respect of which Supreme Court came out with a landmark judgement. The Sahara and its group companies Sahara India Real Estate Corporation Limited (SIRECL) and Sahara Housing Investment Corporation Limited (SCHICL) floated an issue of Optionally
Fully Convertible Debentures (OFCDs) and collected subscriptions from investors to the tune of Rs.17, 656crores. This was done through Private Placement and avoiding compliance with SEBI regulations relating to public issue of securities. Sahara challenged the SEBI order of refund to the investors on the ground of non-compliance and violation of the SEBI rule, before Supreme Court. The Honourable Supreme Court as part of final judgement upholding the stance taken by SEBI, made interesting observations by way of ratio, which touch directly upon the issue of regulatory arbitrage that was taken advantage of by Sahara.

Some of those observations that have a bearing on regulatory gaps are as follows:

1. The Supreme Court held that though the OFCDs issued by Sahara group companies may be hybrid in nature, it did not cease to be the term"Security" within the meaning of Companies Act, SEBI Act and Securities Contracts Regulations Act, 1956(SCRA). Though "hybrid instrument was not specifically defined in SCRA, it was covered within the term of "marketable security". Secondly, since it was issued to millions of people, doubtless it is a marketable security.

2. Although the intention of the companies was to make the securities look like private placement, it ceases to be so when the same are issued to more than 50 through Information Memorandum and hence SEBI will have jurisdiction. The Court concluded that based on the transactions, the intentions and actions of the companies were to issue securities to the public in the garb of private placement.

The landmark judgement in this case not only upheld the regulatory jurisdiction of SEBI in the matter but also highlighted the case of an unlisted company taking advantage of the gaps in the laws i.e., the
Companies Act and SEBI Regulation. This judgement also put at rest the jurisdictional gap that existed between the Ministry of Corporate Affairs and SEBI. The judgement has also clarified the applicability of concurrent jurisdiction of both SEBI and the Ministry of Corporate Affairs in matters of public interest.

**Self Regulatory Organizations:**

A self-regulatory organization (SRO) is an organization that is invested with the authority to exercise a limited degree of regulatory authority over an industry or profession. Such an authority could be in addition to some of regulations by way of principle based regulation or for the purpose of filling vacuum of an absence of government oversight. The ability of an SRO to exercise regulatory authority does not necessarily derive from a grant of authority from the government.

In United States securities law, a self-regulatory organization is a defined term. The principal federal regulatory authority—the Securities and Exchange Commission (SEC)—was established by the Federal Securities Exchange Act of 1934. The SEC originally delegated authority to the National Association of Securities Association of Securities Dealers (NASD) and to the National Stock Exchanges to enforce certain industry standards and requirements related to securities trading and brokerage. On July 26, 2007 the SEC approved a merger of the enforcement arms of the NYSE and the NASD, to form a new SRO, the Financial Industry Regulatory Authority (FINRA). In addition, Congress created the Municipal Securities Rule Making Board (MSRB) as an SRO charged with adopting investor protection rules governing broker-dealers and banks that underwrite trade and sell tax-exempt bonds, 529 college savings plans and other types of municipal securities.
Owing to the prominence of the SROs in the securities industry, the term SRO is often used too narrowly to describe an organization authorized by statute or government agency to exercise control over a certain aspect of the industry.

The IOSCO principles for SROs state that ‘the regulatory regime should make appropriate use of self-regulatory organizations that exercise some direct oversight responsibility for their respective areas and to the extent appropriate to the size and complexity of the markets’. 92

Arguably, for India, since the securities industry is expansive, very active and complex, this imposes a significant burden on the regulators. So the regulators can benefit from the regulatory resources that the private sector can provide. However, the objective of delivering regulation efficiently should be a top priority in order to ensure that India’s markets remain competitive. 93

To regulate the SROs in India, SEBI has come out with Regulation for Self Regulatory Organizations (SRO), 2004. Similarly, RBI has granted the status of SROs to Micro-finance industry associations, Federation of Foreign dealers Association. While, unlike in the US model, in India there exists no legal framework in the statute itself for granting such SROs status, the regulators grant such status to Industry bodies/association from the statutory powers that they derive from their own statutes. This leaves a gap in the SRO models that straddle across the markets. A common set of principles and code should be applied across the markets instead of prescribing sectoral principles for such agencies by the respective regulators.


The above leads one to conclude, the grey areas in regulation or gaps in regulatory oversight would continue so long as there is a faster pace of development in the financial activities. It may not be possible for policy makers to foresee all scenarios of growth and provide for regulation of the same. It merits mention here that, howsoever perfectly a regulatory framework may be said to have been structured, there would always exist some degree of limitation or imperfection. The gaps in any regulatory model cannot be wished away. The only solution for the same appears to be “to learn the lesson and initiate corrective action on time”.