Report
of the
Working Group on Securities, FSLRC

1 Broad approach

The approach paper (FSLRC, 2012) of the Financial Sector Legislative Reform Commission (FSLRC) argues persuasively for a non-sectoral approach to law making: "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." Moreover, the FSLRC proposes to remove tight connections between a particular regulatory agency (for example, Securities and Exchange Board of India (SEBI)) and the functions that it performs (for example, securities regulation) so that any law could be made the mandate of a different agency, in future, by a simple amendment.

The Working Group (WG) therefore confined its deliberations to the special issues that arise in the field of securities that may not be fully covered by the general framework of the Commission. For example, the Commission proposes a unified consumer protection law and a unified Financial Redressal Agency. The WG's focus in the field of consumer protection must therefore be on the unique consumer protection issues that need to be addressed in the domain of securities. The WG's approach in other aspects of financial regulation (for example, micro prudential regulation and resolution) has been guided by similar considerations – identify what is unique about securities and try and address these unique issues.

The WG's perspective on this issue of "uniqueness" of securities markets is that a well functioning securities market is a public good. There are positive externalities (for example, price discovery and resource allocation) which justify regulatory intervention directed at the functioning of the market itself that go beyond the needs of the particular parties involved in a specific trade. This view has implications for several aspects of securities regulation.

- In the field of consumer protection, the WG's report is predicated on "Market Integrity" as the primary objective of securities regulation. There is a need for a legal framework for preventing insider trading, fraudulent practices and other forms of market abuse in a broad range of financial markets.
- Similarly, the public good nature of the market makes it imperative to address issues of legal certainty of contracts in financial markets. What might be regarded as an issue for the legal ingenuity of the contracting parties in pure bilateral contracts becomes a key regulatory concern (perhaps even a systemic risk concern) when we turn to the standardized contracts in a securities market.
- A similar issue arises in the field of disclosure – rather than focus on information flows between the contracting parties, securities regulation must concern itself with information flows to the market as a whole. The legal framework for registration and publication of offer documents in the case of a public issue flow out of this concern.

In this regard, this WG makes the following recommendation:

1. *The legal framework for securities must recognize the public good nature of financial markets and establish the principles of market integrity and transparency as key regulatory objectives*

2 Definition of security

Any discussion of securities markets must begin with the definition of securities. The WG finds that globally it is common to use a very broad definition of securities for certain purposes like market integrity[1].

For example, Section 2(a)(1) of the Securities Act (1934) in the United States uses a definition of securities which covers not only the common types of securities like stocks and bonds, but also includes an omnibus clause covering investment contracts[2]. A large body of case law has emerged in the United States of America (USA) elaborating on the meaning of this term: the essential characteristics required for an investment contract to become a security are the following: (1) an investment; (2) in a common enterprise; (3) with a reasonable expectation of profits; (4) to be derived from the entrepreneurial or managerial efforts of others. Investments which are of a unique nature and are not designed to be traded publicly or offered to a number of potential investors are excluded. This is a principles based definition that can expand to cover new instruments that arise through the process of financial innovation. All such securities are covered by the general anti-fraud provisions of Section 10(b) of the Securities Act (1934).

In the European Union (EU) (including the United Kingdom (UK)), the Market Abuse Directive (2003/6/EC) covers a broad range of financial instruments (which is significantly broader than just transferable securities. Apart from a wide range of securities and derivatives, the definition covers "any other instrument admitted to trading on a regulated market". For example, in the UK, the principal stock exchanges (like LSE), the important commodity markets (like LME) and the major derivative exchanges (like Liffe) are all regulated markets and any instrument traded on these exchanges is covered by the market abuse provisions of Section 118 of the FSMA (2000). Moreover, the market abuse provision covers "related investments" so that an OTC derivative on an instrument that is traded in a regulated market is covered by the market abuse provisions.

The WG also notes that in India, there have been several instances of financial products that have been designed to fall between the cracks in the definition of securities in Indian law.

[1] Such a broad definition could however lead to excessively onerous requirements when it comes to registration and issue of prospectuses. A broad definition is workable only if a broad exemption from the registration requirements is provided for small issues to a limited number of people.

[2] The full definition reads as follows: "The term 'security' means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

Much ingenuity has been expended on designing debt instruments that escape regulation as deposits and also avoid regulation as securities.

Keeping these in mind, the WG proposes a broad principles based definition of securities. Such a definition should not be too closely tied to entities that are in existence today because such a definition can quickly become obsolete. For example, in the USA, the term "investment contract" (Securities Act, 1934) is entity neutral. Similarly, the definition of transferable securities in Article 4(1)(18) of MiFID Directive (2004) tries to be entity neutral:

- shares in companies and other *securities equivalent to shares in companies, partnerships or other entities*[3], and depositary receipts in respect of shares;
- bonds or other forms of securitised debt, including depositary receipts in respect of such securities;
- any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures;

In this regard, this WG makes the following recommendation:

2. *The definition of securities should be entity neutral and should be broad enough to cover new instruments that emerge from the process of financial innovation. It must include a wide range of unlisted tradable instruments for the purpose of market abuse regulations, but must have broad exemptions for the purpose of registration requirements as explained in Recommendations 6 and 8.*

2.1 Public Offer and Registration Requirements

As already stated the WG recommends a broad definition of securities that is entity neutral. The definition covers securities issued by companies, trusts, LLCs and other entities. The restriction on public issues must also be similarly broad and entity neutral.

Any issuer seeking to make a public offer must file a prospectus and also agree to continuing disclosures. The regulator should thus have statutory jurisdiction over issuers of securities in respect of these matters. At present, many of the continuing disclosure obligations are imposed through the listing agreement which is merely a private contract between the issuer and the stock exchange. This is discussed further in Section 3 later in this report (Recommendations 11 and 12).

Most countries provide an exemption from the prospectus requirements for small issues. In India, Section 67 of the Companies Act (1956) exempts offers to less than 50 persons.

However, the WG recommends several changes to the registration/prospectus requirements:

[3]Emphasis added

3. *The registration requirement must be entity neutral and should not therefore be restricted to companies.*
4. *There is a need to prevent redistribution of shares by the original recipient of shares. Otherwise, indirectly an offer may be made to a large number of persons.*
5. *There is need for an aggregation requirement whereby offers of the same class of securities by the same issuer over a period of say twelve months are aggregated. Concomitantly, the number of 50 may need to be increased to 100 or 150.*
6. *It is necessary to exempt offers to qualified institutional investors who do not need as much protection as retail investors.*
7. *There is a need to impose a registration requirement when the total number of holders of the securities exceeds a threshold (say 500 or 1000) even though only a small number of investors were approached in any given year..*
8. *It is desirable to have a "crowd funding exemption" for issues that are small in the aggregate even if they tap a large number of investors.*

In the early 1990s, India moved from a regime of merit regulation to one of disclosure based regulation. This change has not however been enshrined in statute. This WG therefore makes the following recommendation:

9. *The statute must explicitly state that the purpose of the registration requirements is to ensure adequate disclosure and that the registration requirement is not to be used as a form of merit based regulation of public offers.*

2.2 Derivatives and Commodities

Market abuse is an important consideration for derivatives including OTC derivatives. After the global financial crisis, it is no longer possible to argue that OTC derivatives do not need to be regulated from a market abuse point of view.

It is however necessary to distinguish between derivatives on commodities and long term commercial contracts. A long term agreement for purchase of natural gas by a power plant is actually a forward contract in natural gas. It might not be appropriate to regulate this commercial transaction as a financial derivative. On the other hand, an exchange traded natural gas futures or a natural gas swap contract in the OTC market should be subject to regulation as financial derivatives.

The EU definition of financial instrument (Section C of Annex 1 of the MiFID Directive (2004)) takes an interesting approach. It covers the following kinds of options, futures, swaps, forward rate agreements and any other derivative contracts:

- Derivatives relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures. These are included regardless of whether they are cash settled or physically settled and regardless of whether they are exchange traded.
- Derivatives relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties.
- Derivatives relating to commodities that can be physically settled provided that 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 it is not for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls.

The effect of this kind of definition is to exclude commodity contracts only if they are physically settled, are traded outside a regulated market and are either for commercial purposes or do not have characteristics like clearing and margining that are associated with financial derivatives.

In this regard, this WG makes the following recommendation:

10. *Commodity derivatives should be regulated in the same way as financial derivatives while taking care to exclude genuine commercial transactions in commodities.*

3 Obligations of Listed Entities

Currently, listed companies are subject to disclosure and governance obligations under the Companies Act (1956) and also under the listing agreement with the stock exchange. The listing agreement is essentially a contract between the stock exchange and the company and lacks statutory force. Moreover, in a situation where the stock exchanges are increasingly for profit entities, a purely contractual obligation to a stock exchange is not an adequate foundation for imposing disclosure and governance obligations.

The USA is a very interesting model of how the obligations of listed entities has been completely separated from company law because company law is a state subject while the important securities laws are federal laws. The contents of the registration statement (prospectus) is laid down in Schedule A of the Securities Act (1934). Section 13 of Securities Exchange Act (1934) requires all issuers of registered securities to file annual and quarterly reports as well as other information required to keep prospectus up to date. Neither of these obligations are restricted to companies because the registration requirement is not limited to companies.

In this regard, this WG makes the following recommendation:

11. *The obligations to make adequate disclosures (prospectus, annual and quarterly reports and material event disclosures) must be laid down in statute and made applicable to all listed entities regardless of their legal form. The details regarding the content and format of these disclosures can be left to delegated legislation.*

Similarly, the entire corporate governance requirements under Clause 49 of the Listing Agreement in India lack statutory force. There is a need to provide a statutory basis for this that does not rely only on a contract between the stock exchange and the listed entity.

In this regard, this WG makes the following recommendation:

12. *There must be a statutory provision allowing the regulator(s) to impose corporate governance obligations on listed entities in relation to (a) minimum proportion of independent directors in the Board of Directors (or similar governance organ) and its key committees (b) financial literacy requirements of members of key committees of the board.*

It may be noted that governance codes that are based on the "Comply or Explain" philosophy can be based on the statutory provisions regarding disclosure requirements (Recommendation 11) and do not require any additional statutory basis.

Section 11 of the SEBI Act (1992) empowers SEBI to regulate takeover of companies and SEBI has accordingly framed the Takeover Regulations (2011). The statute does not however lay down the objectives of these regulations let alone their scope and extent. This is an excessive delegation of legislative powers to the regulator and it is desirable for the statute to delineate the scope of the takeover law.

13. *The scope and objectives of takeover regulations must be laid down in statute. In particular:*
    - *The regulations should cover all acquisitions of 25% of the voting rights as well as creeping acquisitions by controlling shareholders.*
    - *Minority shareholders must be treated fairly by giving them an opportunity to sell at the higher of the highest price paid by the acquirers and the undisturbed market price by means of an open offer.*
    - *While the long term goal is therefore a regime of 100% open offers, taking into account the development of takeover financing and other relevant factors, the regulator may specify a lower size of the open offer. The regulator(s) would be required to publish a report every five years justifying the size of the open offer.*
    - *The Board of the target company should be restricted from alienating material assets, incurring material borrowings, issuing new shares, buying back shares except with the approval of the shareholders by special resolution during the pendency of an open offer.*
    - *The regulator should impose appropriate disclosure requirements on the acquirer to allow the shareholders of the target company to make an informed decision.*

4 Legal certainty for derivatives

Derivative contracts need legal certainty so that participants do not have to worry that the contracts are declared unenforceable on the ground that they are wagering contracts. Globally, three different approaches have been tried to deal with this problem:

1. A distinction does exist between wagering and hedging; and derivative contracts may be enforceable because they are used for hedging and not for wagering. The difficulty is that the distinctions between hedging, speculation and wagering are not clear cut, and in the absence of a bright line test, participants would face legal uncertainty.
2. All wagering contracts can be made enforceable solving the problem completely. For example, the Gambling Act (2005) in the UK[4] states that "The fact that a contract relates to gambling shall not prevent its enforcement." This is perhaps too sweeping a change for India and in any case, it goes far beyond financial regulation.
3. Certain kinds of derivatives are exempted from the wagering laws. Usually, the exemption is granted to (a) exchange traded derivatives and (b) contracts between

[4]Prior to 2005, Section 412 of the FSMA (2000) exempted a wide range of derivative contracts from the unenforceability of wagering contracts.

> sophisticated counter parties in the OTC market. India has followed this route, but the range of eligible counter parties is very narrow (only entities regulated by the RBI). By contrast, the definition of "eligible contract participant" under the Commodity Futures Modernization Act (2000) in the USA includes most financial institutions , pension funds and other investment funds, as well as companies and individuals with minimum level of assets (the level of assets being lower in case the derivative is used for hedging of risks).

In this regard, this WG makes the following recommendation:

14. *Legal certainty of enforceability of derivative transactions must be ensured for (a) exchange traded derivatives and (b) OTC derivative transaction between sophisticated counter parties without reference to whether and by whom they are regulated.*

5 Financial Market Infrastructures

The governance and regulation of Financial Market Infrastructures (FMI) pose special challenges because of the conflicting objectives of safety and efficiency, and the difficulties of using competition to improve performance. The CPSS-IOSCO[5] "Principles for financial market infrastructures" (April 2012) bring out the key issues involved:

> Principle 2: Governance An FMI should have governance arrangements that are clear and transparent, promote the safety and efficiency of the FMI, and support the stability of the broader financial system, other relevant public interest considerations, and the objectives of relevant stakeholders.

Many of the FMIs in India are organized as for-profit entities in the private sector, and the CPSS-IOSCO point out that "An FMI that is, or is part of, a for-profit entity may need to place particular emphasis on managing any conflicts between income generation and safety."

While much of the financial sector relies on competition to deliver innovation and low costs, there are difficulties in applying this idea to FMIs. Again, the CPSS-IOSCO point out:

> In addition, factors such as economies of scale, barriers to entry, or even legal mandates, may limit competition and confer market power on an FMI, which could lead to lower levels of service, higher prices, or under-investment in risk-management systems. Caution is needed, however, as excessive competition between FMIs may lead to a competitive lowering of risk standards.

In this regard, this WG makes the following recommendation:

[5]Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions

15. *The regulator(s) should be mandated by law to balance the conflicting objectives of safety and efficiency in relation to for-profit FMIs. Moreover, the regulator(s) must be required to publish a report every five years on how it achieved this balance highlighting the emerging competitive landscape and technological developments.*

6 Securities settlement and payment systems

In a securities trade, settling in central bank money refers to a situation when the central bank settlement facility allows settlement of the cash leg of the trade in the books of the central bank. The balances of these cash settlement accounts therefore represent an account holders claim on the central bank.

Globally, there has been a trend to allow Central Counter Parties (CCP) to settle in central bank money. The core principles for any systemically important payment systems envisages that the assets used for settlement should be a claim on the central bank (BIS, 2001). Central banks of many jurisdictions such as Japan and the United States have a clear collective policy on mandating the use of central bank money for settling when it involves systemically important institutions (BIS, 2003).

In India, the legal framework on payment systems is governed by the Payment Act (2007). There is no inter-linkage between payments systems and CCP in India as the Payment Act (2007) excludes stock exchanges and their clearing houses from its jurisdiction. This leaves out some of the biggest clearing houses in the country, which are systemically important, from the ambit of Payment Act (2007). Clearing houses of stock exchanges in India such as National Stock Exchange of India Limited (NSE) and Bombay Stock Exchange (BSE), clear and settle trades independently in commercial bank money.

The failure of a commercial bank or a liquidity crisis faced by a commercial bank, which the clearing houses use for settlement can lead to systemic failure. The ability to settle in central bank money and the access of clearing houses to the discount window would allow them to address immediate liquidity concerns in the event of crisis.

In this regard, this WG makes the following recommendation:

16. *Every clearing house should be able to settle in central bank money. There should be mandatory settlement in central bank money for systemically important clearing houses, which should be stipulated in primary legislation.*

The Payment Act (2007) specifically excludes stock exchanges and clearing corporations from its ambit. The WG makes the following recommendation:

17. *Clearing corporations of stock exchanges should be brought within the scope of the Payment Act (2007) to ensure finality of netting and settlement and to allow the clearing corporations to appropriate the collateral of insolvent members towards their settlement and other obligations.*

7 Definition of insider trading and market abuse

At present, the definitions of insider trading and market abuse are contained in subordinate legislation. The WG is of the view that this constitutes excessive delegation of legislative powers. The WG therefore recommends that insider trading be defined in the statute itself.

In the USA, insider trading is part of the general prohibition of "manipulative and deceptive devices" under rule 10b-5. Under the misappropriation theory, insider trading covers the "purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information".

In the EU the Market Abuse Directive (Article 2) prohibits trading on the basis of inside information by any person who possesses that information:

(a) by virtue of his membership of the administrative, management or supervisory bodies of the issuer; or

(b) by virtue of his holding in the capital of the issuer; or

(c) by virtue of his having access to the information through the exercise of his employment, profession or duties; or

(d) by virtue of his criminal activities.

In this regard, this WG makes the following recommendation:

18. *The definition of insider trading should be incorporated into the statute and should cover only cases where the trading was in breach of a fiduciary duty or other relationship of trust and confidence.*

19. *The definition of other forms of market abuse like fraud, misrepresentation and the use of deceptive devices must also be part of the statute.*

8 Market intermediaries

In contrast, to countries such as UK which follow an activity based regulation, SEBI currently follows an entity based approach in defining intermediaries. Sections 11 and 12 of the SEBI

Act (1992), lists out entities whose business SEBI has power to regulate. Intermediaries Regulation (2008) also provides a list of entities that fall under the definition of intermediaries.

For example, Section 11 of SEBI Act (1992) enumerates the following intermediaries:

- Stock exchanges and any other securities markets
- Stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with securities markets in any manner
- Depositories, participants, custodians of securities
- Foreign institutional investors
- Credit rating agencies[6]
- Venture capital funds
- Collective investment schemes including mutual funds;

By contrast, in the UK, FSMA (Regulated Activities) Order (2001) uses a principles based definition that covers the following *activities*:

- Holding out to the public as being in the business of dealing in securities as principal
- Dealing in securities as agent
- Arranging deals in investments
- Managing investments
- Safeguarding and administering investments
- Mutual funds
- Advising on investments

Each of these activities has certain exclusions. For example, giving advice in newspapers and similar media is excluded from the activity of advising on investments.

In this regard, the WG makes the following recommendations:

20. *In order to bring consistency in the scope of activities conducted by "market intermediaries", an activity based approach should be followed to define market intermediaries in primary securities legislation.*

21. *A broad set of activities which are intended to be regulated by the securities regulator, whether or not such activities are primary or ancillary functions of the concerned entity must be specified.*

[6] The clause enumerating this and the previous two sets of intermediaries is followed by the phrase: "Such other intermediaries as the Board may, by notification, specify in this behalf"

The fundamental obligations of securities market intermediaries must also be written into statute. For example, Schedule III of Intermediaries Regulation (2008) enumerates several obligations like: high standard of service, due diligence, disclosure of fees, prompt disbursal of payments, timely and adequate disclosures, confidentiality of client information, avoidance and management of conflicts of interest, sound corporate governance and compliance. These obligations should be written into primary statute in a principles based manner.

22. *In order to ensure that the securities market regulator adequately enforces the provisions in relation to code of conduct of market intermediaries, the principal legislation in relation to securities market should lay down the broad principles of code of conduct of market intermediaries, specifically covering high standard of service, due diligence, disclosure of fees, prompt disbursal of payments, timely and adequate disclosures, confidentiality of client information, avoidance and management of conflicts of interest, sound corporate governance and compliance.*

9 Mutual Funds

In India, Mutual Fund Regulations (1996), mandate that mutual funds must be organised as a trust. As opposed to this in various jurisdictions funds may be incorporated in any legal structure they choose. For example, in the EU, UCITS Directive (1985) allows mutual funds to be constituted in accordance with contract law (as common funds managed by management companies), trust law (as unit trusts), or statute (as investment companies).

In this regard, this WG makes the following recommendations:

23. *Regulation regarding governance structure of funds should be neutral to the legal structure adopted by the fund. Regulations should not specifically prescribe the legal structure of the fund.*

24. *To facilitate more flexible and modern legal forms of organization, suitable amendments may be required in taxation and other laws.*

Indian law related to mutual funds is contained almost entirely in delegated legislation as the primary statute (SEBI Act, 1992) merely provides that regulation of mutual funds is one of the functions of the regulator. It is desirable to provide greater guidance in statute about the governance of mutual funds and their investment restrictions. In this regard, this WG makes the following recommendations:

25. *The primary statute must contain broad provisions on the governance of mutual funds including: the basic principle of unit holder approval for major decisions (or exit opportunity in lieu of such approval); requirements regarding offer documents and periodic disclosures; requirements regarding custodian and auditors. Details regarding these can be left to delegated legislation.*

26. *The primary statute must also lay down the broad principles of investment restrictions including matters like diversification requirements, borrowing restrictions, and liquidity of underlying investments. Details regarding these can be left to delegated legislation.*

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