Article

Key Recommendations of the Report of Financial Sector Legislative Reforms Commission

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Article

The Financial Sector Legislative Reforms Commission was set up by the Ministry of Finance in March, 2011 with the objective of reviewing and recasting the legislative and the institutional structure of the financial sector in India to make it attune to the contemporary requirements of the sector.

Several of the extant acts, rules and regulations applicable to the sector are primitive and are subject to amendments from time to time looking at the growing financial sector in size and sophistication. These amendments have also resulted in inconsistencies in legislative frameworks which are withholding the seamless functioning of the financial markets in India.

The Commission in the Report[1] dealt with issues such as defining the purpose of financial legal framework and identifying the broad structure of the regulators, their functions and powers. The nine elements would enable construction of the financial law and would enable building a sound foundation for the financial system. The nine elements are:

1. **Consumer Protection** – The Commission suggests that the burden of consumer protection should be placed upon financial firms. The draft code framed by the Commission shall establish basic rights for all financial consumers and shall set forth additional protection for unsophisticated customers. The Commission also proposes setting up of a Financial Redressal Agency (FRA) which would serve the aggrieved customers.

2. **Micro-prudential regulations** – In order to provide consumer protection, micro-prudential regulations need to be put in place to ensure that the probability of failure is reduced.

3. **Resolution** -- Setting up a resolution corporation would watch all financial firms which have made intense promises to households, and intervene when the net worth of the firm is near zero. It would force the closure or sale of the financial firm, and protect small consumers either by transferring them to a solvent firm or by paying them.

4. **Capital Controls** – The Commission did not have any view on the current restrictions applicable on cross-border activities however, Commission

[1] Report of the Financial Sector Legislative Reforms Commission, Volume I: Analysis and Recommendations, March, 2013 http://finmin.nic.in/fslrc/fslrc_report_vol1.pdf

wanted to place the capital control formulation and implementation on the correct footing and stated that RBI to form regulations on capital account transactions and Ministry of Finance to formulate rules.

5. **Systemic Risks** – Post the global financial crisis, monitoring the health of the financial system and mitigating any such risks of the entire financial system collapsing has been core focus area of all regulators. The Commission identifies 5 elements to systemic risk which shall be dealt by the Financial Stability and Development Council (FSDC) along with the Ministry of Finance. The 5 elements in systemic risks are:
   a. Construction and analysis of system wide database
   b. Identifying systematically important financial institutions, which shall be subject to heightened micro-prudential regulations
   c. Construction and application of system wide tools for dealing with systemic risks
   d. Inter-regulatory co-ordination
   e. Crisis management

6. **Financial Inclusion and Market Development** -- This agenda has two elements, one, development of market infrastructure and processes and two, redistribution of the financial inclusion initiatives. The Commission proposes that the first objective will be managed by the regulators and the second by government.

7. **Monetary Policy** – The Commission felt that the objectives, powers and accountability mechanism needed to be set for monetary policy.

8. **Public Debt Management** – The Commission felt the need for a framework for specialised debt management to look into the liabilities of the government and formulate strategies for low cost financing in the long run.

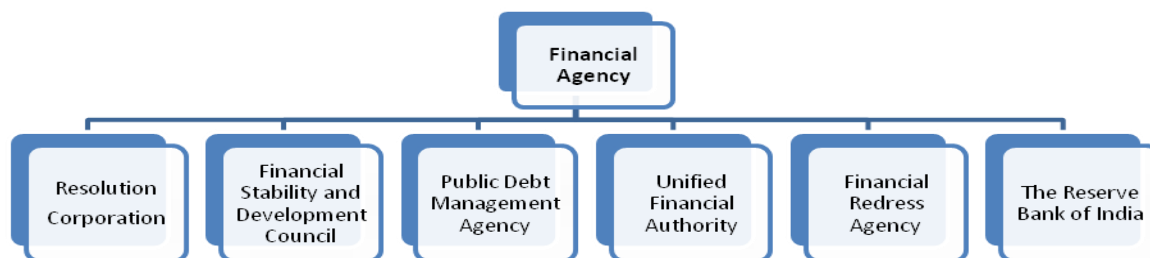
9. **Contracts, Trading and Market Abuse** – The framework with regard to contracts, properties and securities market needs to be reviewed

To be able to accomplish functioning of the regulatory framework envisaged above, the Commission felt that the structure of the regulators also needs to undergo change. The Commission has proposed seven agencies to comprise the financial

regulatory architecture. This would mean some of the existing regulators shall merge with others. The agencies shall include the following:

1. The existing RBI shall continue to exist with modified functions.
2. The existing SEBI, FMC, IRDA and PFRDA shall merge into a unified agency.
3. The existing securities appellate tribunal shall be subsumed into FSAT.
4. The existing Deposit Insurance and Credit Guarantee Corporation of India (DICGC) will be subsumed into Resolution Corporation.
5. A new Financial Redressal Agency (FRA) shall be created.
6. A new Debt Management Office will be created.
7. The existing FSDC will continue to exist with modified functions.

The Indian Financial Code drafted by the Reform Commission puts all of the regulators above under the definition of '***Financial Agency***'. The Financial Agency shall include:



The objective of the Commission was to review and redraft the legislations governing India's financial system. Apart from proposals for construction of sound financial framework and establishing sound regulatory governance environment, the Commission formed certain working groups which would carry out extensive research on specific issues and carry out deliberations engaging several experts and stakeholders from the relevant financial sector. This enabled the Commission to get information on the current state of the financial sector, the constraints and

developments and enabled the Commission to analyse the need for institutionalising or renovating the current financial structure.

The Commission identified five areas which required detailed analysis and set up working groups which were chaired by the members of the Commission; the five areas were i) Banking, ii) Securities, iii) Public Debt Management, iv) Payment Systems and v) Insurance, pension & small savings. The recommendations of these working groups also form part of the Report published by the Commission in March, 2013.

The broader recommendation was that the primary statute must lay down the broad principles and the details may be a delegated legislation. Below we are discussing some of the key recommendations of these Working Groups (WG).

Recommendations on amendments in SARFAESI Act and DRT Act

a. DRTs in India require an over-haul. The purpose of setting DRTs was speedy recovery of debts by setting special tribunal system. However DRTs in India are plagued with the same problems as civil courts.
b. The threshold limits for application of Recovery of The Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (RDDBFI) must not be stated in the Act. The Central Government must have the power to determine the limit through rules. In addition, the capability and efficiency of Debt Recovery Tribunals (DRTs) must be measured on an ongoing basis and limitations must be addressed efficiently. The threshold limit after which cases may be filed before the DRT may be decreased only if the efficiency and capability permit.
c. Separation of ownership of Urban Co-operative Banks from Urban Co-operative societies and the banking arm of the co-operative society granted same privileges as banks under SARFAESI and RDDBFI.
d. Section 14 of the SARFAESI Act currently does not provide for a time frame within which the petitions are to be disposed off by Chief Metropolitan Magistrate or District Magistrate. The WG recommends that two months time frame may be provided for disposal of petitions.
e. The SARFAESI Act or the rules do not prescribe for the documents required for filing a petition for enforcing security. The Debt Law Amendment Bill, 2011 provides a list of documents to be filed along with Section 14 petition

under SARFAESI and the WG recommended the list of documents to be filed with a Section 14 petition.

f. The WG recommended the proposals made by the Debt Law Amendment Bill, 2011 wherein, the District Magistrate or the Chief Metropolitan Magistrate is allowed to authorise any officer subordinate to him to take actions for enforcing security interest under section 14 of the SARFAESI Act.
g. The WG endorsed the recommendations of Raghuram Rajan Committee Report, 2009 with regard to priority of claims in insolvency and bankruptcy proceedings. The recommendations of Raghuram Rajan Committee Report included:
    i. While it is important to protect employee claims such as overdue wages, there must be a limit, say six months, to which such pay is protected. After the expiry of this period employees must also join the ranks of unsecured creditors.
    ii. The government, which has substantial powers to recover arrears to it prior to bankruptcy, should not stand ahead of secured creditors.
    iii. Statutory priorities of a firm should be well disclosed so that creditors can act well in time, before they get crowded out by other claims.
h. Section 5 of SARFAESI Act to be amended to allow sale of assets from one ARC to another.
i. Section 9 of the SARFAESI Act to be amended to allow issue of convertible debt by ARCs.
j. SARFAESI Act to be amended to include all such secured creditors who are regulated entities.

Recommendations on Stamp Duty Law

While stamp duty was not within the purview of the Working Groups, however the need for rationalisation of the stamp duty laws was felt. A solution proposed by the Working Group was introduction of transaction tax and abolition of stamp duty completely.

Recommendations for Banks and NBFCs

a. The definition of banking should be guided by the principle of deposit taking activities. Where the public places deposits with any entity, which are redeemable at par with assured rates of return must be considered as

banking. Entities undertaking such activities must obtain a bank license and /or be subject to the regulatory purview of the banking regulator.

b. Any entity that accepts public deposits has access to clearing and RBI repo window in a bank.
c. In case of companies accepting deposits, the members deliberated that the RBI Act prohibits the partnership firms from accepting deposits and the same prohibition should be extended to corporates as well. This would require amendment to Section 58A of the Companies Act, 1956 and similar amendment in proposed Companies Bill, 2011 as well.
d. NBFCs accepting deposits shall require obtaining license to operate as a bank and will fall within the regulatory purview of the banking regulator.
e. Foreign banks with branches in India must set up Wholly Owned Subsidiaries in India and the transition process should be made easy and convenient in India to ensure that there is no loss on account of capital gains or stamp duty.
f. Any co-operative society accepting deposits exceeding a specified value must follow the provisions of the relevant legislation.
g. The current mode of operations of banks under Bank Subsidiary Model (BSM) is inadequate and there should be a shift towards the Financial Holding Company (FHC) model as a preferred model for financial sector in India. The FHC model mitigates the risks spilling over to the bank from other entities in the group.
h. Move towards the FHC model as with appropriate accounting and reporting standards, it will help in identification of systemic risk buildup in large financial conglomerates.

Recommendations on Securities and Securities Market

a. The definition of securities should be broad enough to cover new instruments that emerge from the process of financial innovation and should include wide range of unlisted tradable instruments for the purpose of market abuse regulations. There should also be a broad range of exemptions from registration requirements.
b. The registration requirements should be entity neutral and not restricted to companies.
c. There is a need to prevent redistribution of shares by the original recipient of shares; otherwise indirectly offer may be made to large number of persons.
d. 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.

e. It is necessary to exempt others to qualified institutional investors who do not need as much protection as retail investors.
f. 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.
g. 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.
h. 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.
i. 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.
j. The scope and objectives of takeover regulations must be laid down in statute. In particular:
    i. The regulations should cover all acquisitions of 25% of the voting rights as well as creeping acquisitions by controlling shareholders.
    ii. 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.
    iii. While the long term goal is therefore a regime of 100% open oers, 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.
    iv. 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.
    v. The regulator should impose appropriate disclosure requirements on the acquirer to allow the shareholders of the target company to make an informed decision.

k. 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.
l. 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.
m. 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.
n. To facilitate more flexible and modern legal forms of organisation, suitable amendments may be required in taxation and other laws.

Most of the recommendations made by the Working Group seem to be addressing the nuances of the loopholes in the present day legal framework dealing with each of the issues. As also identified by the Commission, we are still detailing with antiquated laws which have been amended from time to time to address the then financial sector's needs. However there are several over-arching acts, rules, regulations, circulars and more that form the present day legal framework for the financial system which is sometimes overlapping, sometimes leaving ambiguity and so complex that it cannot be easily interpreted by a layman.

The Report of the Commission was published in two volumes. While, the first volume dealt with the key recommendations explaining a need for reworking on the framework applicable to the financial sector, the second volume[2] of the Report codified it in a draft law. The draft law is called the "***Indian Financial Code***" and is made of sixteen parts and 87 chapters. The broad framework which makes the code is as follows:

1. Establishment of the agencies, roles, responsibilities and regulatory governance.
2. Objectives and principles of financial consumer protection
3. Objectives and principles of prudential regulations
4. Principles relating to contracts, trading and market abuse which included regulations on insurance contracts, derivative contracts, issue and listing of securities and more.

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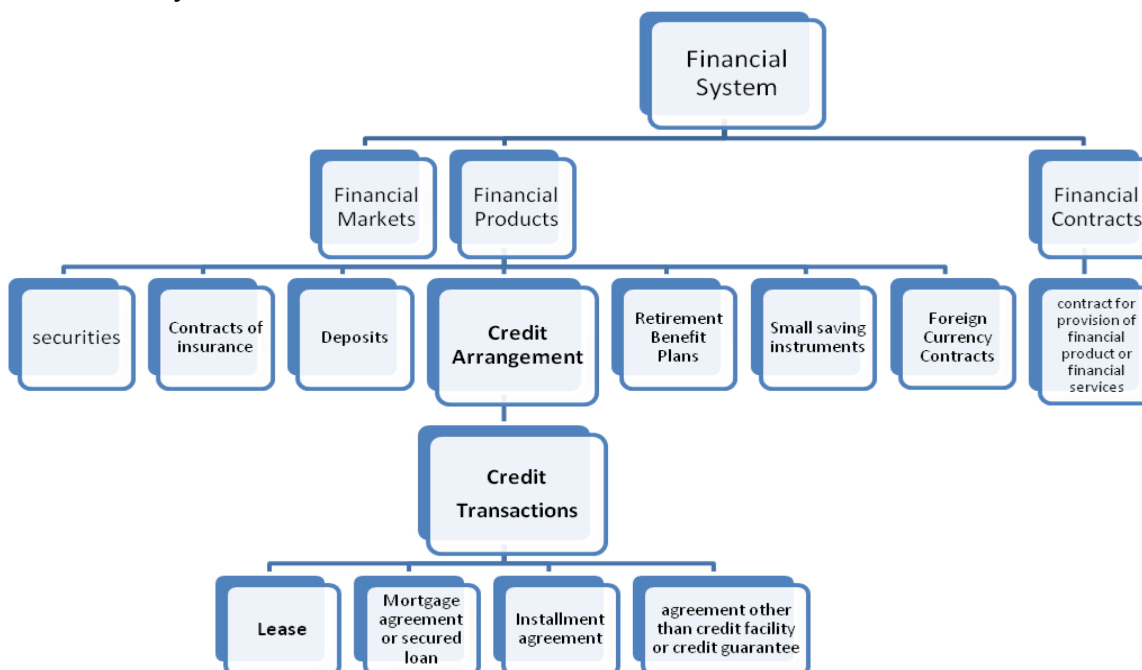
[2] Report of the Financial Sector Legislative Reforms Commission, Volume II: Draft Law, March, 2013 http://finmin.nic.in/fslrc/fslrc_report_vol2.pdf

5. Objectives, roles, responsibilities and functions of.
6. Roles, responsibilities, functions of Corporation Board with respect to resolution of financial service providers, Financial Stability and Development Council, Reserve Bank of India, Public Debt Management Agency and Tribunal

The Indian Financial Code consolidates all the laws relating to the financial sector, sets out the roles, responsibilities and functions of the regulatory agency and brings about coherence in the regulatory framework relating to the sector.

Indian Financial Code on leases

In the Indian Financial Code, lease has been defined as a "***credit transaction.***" The definition of credit transaction includes a lease, mortgage guarantee or secured loan or an instalment agreement or any other agreement other than a credit facility or credit guarantee, in terms of which payment of an amount owed by one person to another is deferred thereby attracting a liability to pay a charge, fee or interest to the credit provider in respect of the agreement or amount that has been deferred. The Indian Financial Code lays down the entire framework of the financial system and how leases as a part of the credit transactions shall form a part of the larger financial system. The financial system has envisaged under the Code is represented schematically below:



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