UNIT 5 REGULATORY FRAMEWORK

Objectives

The main objectives of this unit are to:

- provide a general framework of the regulations governing the financial services industry;
- explain different types of regulation; and
- explain regulations that are in force for the banking, insurance and other financial services.

Structure

5.1 INTRODUCTION

At the centre of any economy, it is the process of financial intermediation and disintermediation that helps the economy to grow and function smoothly. For instance, the credit creation function of banking institutions allows the economy to expand more than what it could do without banking institutions. Financial services industry not only channels savings into productive investments, it also helps the economic activities to take place without much difficulties. For example, the cheque facility and clearing service provided by the banks help several million people to perform economic activities. Similarly, stock brokers help investors to sell and buy shares which is critical for development of financial services and financial markets. Insurance companies give protection against the risk of many unknown events like fire, flood etc., that affect the business and allow the firms to perform their activities with confidence. The financial services have thus become indispensable in running the economy. Such an important system faces two problems – cheating and instability. During the stock market scams, many investors were cheated. Recently, internet bubble attracted several investors, who lost their wealth. While such losses are partially on account of investors overvaluing the securities, it is also on account of many firms providing misleading information. Financial markets are also highly volatile and show instability in that process. In view of its importance in the economy, this sector is governed by strict regulations. Though regulations per se may not remove cheating and reduce volatility, it would certainly help to reduce its occurrence and minimise the length of volatile period.

A financial service cannot generally be tested at the time of purchase since there is a time-lag between the purchase of service and its actual effect. For example, when you buy a share through a member of stock exchange, the service completes only at the time of physical delivery of shares. Similarly, when you buy units of mutual fund and take its expert service of investment, the results of this service is known only in the future. In case of dealings in cheques, the service concludes only when the cheque amount is credited or debited in your account but the time-lag is short. The need for regulation stems from the problems of failure of the firms which provide financial services in the meantime and thus causing hardship to the purchaser. Since financial system is closely integrated and inter-linked, failure of one firm often affects other firms and thus the entire financial system is affected. Further, in a competitive market for borrowing and lending where the spread is thin, financial services firms often take high risk to maximize the return and thus are more susceptible to default. There are several other events that can imperil the interest of investors and others who avail the services. The list includes fraud, misfeasance and collapse of an institution due to mismanagement. Regulations are thus in place to safeguard the interests of the participants of the system and prevent economic instability. The second aspect assumes more relevance recently after several East-Asian economies have suffered due to the failure of the financial system.

5.2 TYPES OF REGULATIONS

The regulatory framework relating to financial services can be broadly classified into three main types. One set of regulations determine the types of activities that different forms of institution are permitted to engage in. These regulations can be called as ***structural regulations***. For example, the Securities and Exchange Board of India (SEBI) insists that merchant bankers and stock broking institutions, to separate all their fund-based activities. Similarly, the Reserve Bank of India (RBI) has prescribed the activities that commercial banks can provide to the investors. Structural regulation thus involves demarcation lines between the activities of financial institutions but many of them have in fact been eroding in recent years. Banks are now providing various services like leasing, term loan, credit cards, etc., in addition to their traditional service of working capital lending. The rationale behind expanding the activities that can be provided by the financial service companies is the desire of regulatory authorities to create greater competition.

There are regulations that cover the internal management of financial institutions and other financial service organisations in relation to capital adequacy, liquidity and solvency. The SEBI for instance has prescribed minimum net worth requirement for various financial service firms that come under its jurisdiction. The objective of these regulation is to restrict the firms without adequate resources from entering into this field. Recently, the RBI has regulated the non-banking finance companies in raising public deposits. These regulations are known as ***prudential regulations*** as they aim to evolve certain prudential norms for the operation of the industry.

There are number of ***investor protection regulations***. All regulatory agencies in the financial sector claim that the primary objective of the agency is to protect the interest of investors. It is generally perceived that investors are the weakest participants of the financial markets and hence need protection from malpractice, fraud and collapse. The information asymmetry between the investors and financial intermediary or institution affects the investors and thus regulatory agencies step-in to protect the interest of the investors. Thus, investor protection regulations are often in the nature of demanding larger disclosure of information.

The regulations can also be classified on their scope. There are regulation which deal with the macro aspects of the system. For example, legislation enacted in the parliament like Banking Regulation Act, Securities Contracts Regulation Act, etc., deal with the macro aspects of respective institutions. The regulatory authorities under the legislation evolve rules, guidelines and regulations that govern the micro aspects and operational issues. In addition to the regulations passed under formal statue and regulators, there are self-regulations from the industry association. For example, the foreign exchange dealers have their own self-regulation in addition to several other statues and guidelines that govern their activities. Similarly, the merchant bankers association is developing self-regulation that will govern their members in addition to SEBI regulation. In the US and other developed markets, there are associations for financial analysts which admit the members after they pass examination and evolve code of conducts when they desire to practice as financial analyst.

The regulations in general aim to ensure the soundness and safety of financial institutions, maintain the integrity of the transmission mechanism and protection of the consumers of financial services. The regulations also ensure freedom of operation to improve the efficiency and provide adequate scope for innovation that benefit the investors and other participants. The success of the regulation thus not only depends on its ability to ensure investors protection but is also determined by the level of advancement and sophistication the system has achieved. In other words, regulation should not block the development of financial service industry.

Exhibit 5.1 : Different Levels of Regulation on Financial Services

Level I	**Government of India**
	Appellate Authority and Regulator in certain cases
Level II	**Legislation passed in the Parliament**
	Banking Regulation Act, SCRA, Insurance Act Indian Trust Act, etc.
Level III	**Institutions under an Act of Parliament**
	UTI Act, LIC Act, GIC Act, etc.
Level IV	**Regulators**
	RBI, SEBI, IRA, Forward Market Commission
Level V	**Regulations given by the Regulators**
	RBI Directions to Commercial Banks, NBFCs Directions issued by the RBI, SEBI Regulations, Guidelines, Notification, etc.
Level VI	**Self-Regulation**
	By-laws, Rules and Regulations and Code of Conduct issued by the various Financial Service Industry Associations.

Activity 1

a) State the broad objectives of regulation relating to financial services.

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b) Give a few examples of prudential regulations relating to stock broking service.

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c) Why do we need regulators when there are comprehensive legislation covering different financial services?

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5.3 REGULATIONS ON BANKING AND FINANCING SERVICES

Financial intermediaries mobilise savings and allocate (lend) capital to different users. Savings and capital allocation are two important activities of the economy and they together determine the growth of the economy. Often, these two are used to change the direction of the economy to achieve desired results. The Governments all over the world frame the polices relating to savings and capital allocation but entrust the responsibility of monitoring them to the central bank. In India, the Reserve Bank of India, as the central bank of the country, is the nerve centre of the Indian financial system. It regulates all institutions that are connected with savings and capital allocation. By regulation, it does not mean that RBI determines the savings rate or the capital allocation ratios to different sectors or firms in the economy. While in a closed economy, these are determined by the government whereas in a free-market economy to which India is slowly moving, these are by and large determined by the market forces. The role of RBI is to frame regulations that help the orderly functioning of the institutions that raise and lend the capital. Commercial banks and non-banking financial institutions are two major set of institutions that come under the regulation of RBI.

a) **Banking Institutions**

In order to develop a sound banking system in the country, the RBI regulates the commercial banking institutions in the following ways:

a) It is the licensing authority to sanction the establishment of new bank or new branch;

b) It prescribes the minimum capital, reserves and use of profits and reserves, distribution of dividends, maintenance of minimum cash reserves and other liquid assets;

c) It has the authority to inspect or conduct investigation on the working of the banks; and

d) It has the power to control the appointment of Chairman and Chief Executive Officer of the private banks and nominate members in the Board of Directors.

The central bank also effectively regulates the credit flows through monetary policy. It controls the amount available for credit by prescribing cash reserve ratio and statutory liquidity ratio. It also takes away cash through treasury operations by periodically issuing bonds and REPOS. It also intervenes the credit flows by prescribing limits of credit availability to different sectors and industries or increase the bank rate to make credit unattractive. The list of techniques used to control the credit flows are (a) Open Market Operations, (b) Bank Rate, (c) Discretionary control of Refinance and Rediscounting, (d) Direct Regulation of Interest Rate on Commercial Banks Deposits and Loans (the RBI has recently allowed the banks to determine the rates on their own), (e) Cash Reserve Ratio, (f) Statutory Liquidity Ratio, (g) Direct Credit Allocation and Credit Rationing, (h) Selective Credit Controls and (i) Moral Suasion.

The RBI also regulates factoring, bill discounting and credit card services offered by the commercial banks and other institutions.

The Banking Regulation Act, 1949 also regulates the activities of commercial banks. The Act was passed in 1949 to consolidate and amend the laws relating to banking companies. The Act, as amended up-to-date, is a comprehensive piece of legislation aimed at the development of sound and balanced growth of banking business in the country. It has extensively enlarged the control of RBI over the entire industry. Right from the definition of the word *banking*, its licensing, functioning, capital and reserve requirements, banking operations and management structure, liquidity provisions and profit distribution and bank inspection down to the take-overs and amalgamation of the banks and their liquidation have all been extensively covered under the Act.

b) **Non-banking Financial Companies**

The non-banking financial companies (NBFC) has recorded marked growth in recent years. The Khanna committee had estimated the total deposits of NBFCs at the end of March 94 at Rs. 56,559 crore and constituted 17.4 per cent of the total deposits held by the banks. There are different types of NBFCs. The list includes loan companies, investment companies, hire-purchase finance companies, equipment leasing companies, mutual benefit finance companies and housing finance companies. The mushroom growth of these institutions has also caused many unhealthy developments in this segment of the financial system. Realising the importance of these institutions, the government instead of curbing the growth of the institutions has brought regulations to ensure some discipline while discharging their functions. The Banking Laws (Miscellaneous Provisions) Act, 1963 was introduced to regulate the NBFCs. The RBI which derives powers under the Act regulates the NBFCs as follows:

a) It requires the NBFCs of certain categories to register with it and provide periodical statements on their working;

b) It prescribes the types of companies which are eligible to raise funds from public and its members;

c) It also prescribes the extent to which the funds could be raised and the terms and condition thereof;

d) NBFCs are also required to invest certain percentage of the deposits in the approved securities and maintain reserve fund.

e) It also has the powers to determine policy and give directions relating to deployment of funds and capital adequacy norms, accounting standards, provision for bad and doubtful debts, etc.

f) It also collects periodic reports and has the powers to collect information on any aspects relating to the functioning of the NBFCs, conduct inspection of the books of NBFCs and investigate on any aspects relating to the activities of the NBFCs.

g) Finally, it has the powers to punish the erring NBFCs either imposing penalties or suspending or cancelling the license or registration and initiate appropriate actions against the management of NBFCs.

The RBI has issued three major directions to regulate different forms of non-banking financial companies and other financial institutions. They are:

a) Non-banking Finance Companies Directions, 1977;

b) Miscellaneous Non-Banking Finance Companies Directions, 1977; and

c) Residuary Non-Banking Companies Directions, 1987.

The mushroom growth of non-banking financial companies causes hardship in regulating these companies in an effective manner since the infrastructure requirement is so high that RBI is presently lacking. In order to overcome the difficulties in implementing the regulation, RBI has recently taken a number of measures especially after the failure of many such companies in meeting the deposit-holders liabilities. The compulsory registration, capital adequacy norm and mandatory credit rating are some of the recent measures aimed to restrict the growth of such companies which raise funds from the public.

In addition to the regulation prescribed by the RBI, there are several Acts and regulations that govern different types of non-banking financial companies. For example, leasing companies have to take into account the provisions of Indian Contract Act, Motor Vehicles Act, Indian Stamp Act, etc. Similarly, hire-purchase transactions are governed by the Indian Contract Act, Sale of Goods Act and Hire-Purchase Act. Though the Hire-Purchase Act is yet to be enforced, in the absence of any specific law on hire-purchase transactions, the provisions of the Act can be followed as guideline particularly, where no provisions exist in the general laws. The National Housing Bank (NHB) is empowered under the provisions of the NHB Act, 1987 to regulate the housing finance companies. The SEBI also regulates all these companies whenever they approach the market to raise capital.

5.4 REGULATIONS ON INSURANCE SERVICES

Though the government was able to dismantle the restrictions in several financial services, the insurance services are yet to see any reform despite international pressures. In the Union Budget 1997-98, the Government has made a small beginning to allow private participation in the health insurance. This sector is however expected to see major changes in the next few years and consequently, the regulatory structure will also undergo major changes.

Before the nationalisation of life and general insurance and the setting up of LIC in 1956 and GIC in 1973 as monolithic institutions, insurers were regulated under the provisions of the Insurance Act, 1938 which was administered by the Controller of Insurance. The application of the Act was greatly modified by the nationalisation of the insurance companies and most of the regulatory functions were taken away from the Controller of Insurance and vested with LIC and GIC.

In order to improve the efficiency of insurance services in India, the Government of India had appointed a committee headed by R.N. Malhotra, the former Governor of Reserve Bank of India in April 1993. The Malhotra Committee has submitted its report in January, 1994 suggesting a comprehensive framework covering the entire gamut of life and general insurance. The Committee had recommended that private and foreign companies be allowed to enter into insurance sector. It also recommended to reduce the government holding in the LIC and GIC to 50% and mandated investments from 75% to 50% for LIC and 70% to 35% for GIC and its subsidiaries. It also required the government to appoint a strong and effective Insurance Regulatory Authority in the form of statutory autonomous board on the lines of SEBI and the Tariff Advisory Committee be delinked from the GIC and function as a separate authority under the regulator.

With an objective of reforming the insurance sector and allowing private entrants, the Government of India had set up an interim Insurance Regulatory Authority (IRA) in January, 1996 and introduced the Insurance Regulatory Authority Bill 1996, in December 1996 to give statutory status. The duties, powers and functions of the IRA as per the Bill are:

i) to regulate, promote and ensure orderly growth of the insurance business;

ii) to exercise all powers and perform all functions of the Controller of Insurance under the Insurance Act, 1938; LIC Act, 1956; and the General Insurance Business (Nationalisation) Act, 1972, or any other law relating to insurance for the time being in force;

iii) to protect the interest of the policyholders in matters concerning assigning of policy, nomination by policyholders, insurable interest, settlement of insurance claims, surrender value of the policy and other terms and conditions of contract insurance;

iv) to promote efficiency in the conduct of insurance business;

v) to promote and regulate professional organisations connected with the insurance business;

vi) to call for information from, undertake inspection and conduct enquires and investigation including audit of the insurers, insurance intermediaries and other organisations connected with the insurance business;

vii) to control and regulate the rates, advantages, terms and conditions that may be offered by the insurer;

viii) to prescribe the form and manner in which books of accounts will be maintained and statements of accounts will be rendered by insurers and other insurance intermediaries;

ix) to regulate investment of funds by insurance companies;

x) to regulate maintenance of margin of solvency;

xi) to adjudicate disputes between insurers and intermediaries.

5.5 REGULATIONS ON INVESTMENT SERVICES

Investment services are primarily fund based activities. The mutual funds and venture capital funds directly fall under the investment services. Though portfolio management service is advisory in nature, the regulation on portfolio management services could be discussed under the heading of investment services as this service is closely linked with the investment services. Similarly, stock exchanges and stock broking institutions have close link with the investment activities and thus regulation on them could be conveniently discussed along with other direct investment activities. The regulatory set up consists of Securities Contracts (Regulation) Act (SCRA), 1956, SEBI Regulations and Reserve Bank of India. Before discussing the regulatory framework under each of the investment and investment related services, it is appropriate to know Securities and Exchange Board of India which is emerging as a powerful regulator of various financial services.

a) **The Securities and Exchange Board of India (SEBI)**

The complex nature of financial markets and high level of integration of different segments of the market, the National Securities Exchange Commissions have been set up to monitor the activities of financial markets and the service providers in order to ensure healthy development of the market and safeguards the interest of investors. On the suggestion of the high powered Committee on the Stock Exchange Reforms headed by G.S.Patel, the Government of India has set up the Securities and Exchange Board of India on 12th April, 1988. The Board initially functioned as advisory agency but in 1992, the SEBI has been given the legal status by the Securities and Exchange Board of India Ordinance 1992 which has been subsequently passed in the Parliament to become an Act. The SEBI Act, 1992 entrusts the responsibility of protecting the interest of investors in securities and to promote the development of, and to regulate securities market by such measure it thinks fit. The Act also listed a few activities that SEBI could perform to achieve the above objectives. They are:

a) regulating the business of stock exchanges and any other securities markets;

b) registering and regulating the working of stock brokers, sub-brokers, share transfer agent, merchant bankers and other intermediaries who may be associated with securities market in any manner;

c) registering and regulating the working of collective investment schemes including mutual funds;

d) promoting and regulating self-regulatory organisations;

e) prohibiting fraudulent and unfair trade practices relating to securities markets;

f) promoting investors education and training of intermediaries of securities markets;

g) prohibiting insider trading in securities;

h) regulating substantial acquisition of shares and take-over of companies;

i) calling for information from, undertaking inspection, conducting enquires and audits of the stock exchanges, intermediaries and self-regulatory organisations in the securities markets;

j) performing such functions and exercising such powers under the SCRA, 1952 as may be delegated to it by the Central Government;

k) levying fees or other charges for carrying out these activities;

l) conducting research for the above purpose; and

m) performing such other functions as may be required.

The SEBI has, during the period of five years of its existence since it received legal status, brought out a number of regulations and guidelines to bring an orderly functioning of the securities markets. It has also created special wings for Primary Market, Secondary Market, Mutual Funds, Surveillance, Research, etc. These regulations and guidelines serve the basic structure of regulatory framework for several financial services. The SEBI Act also provides that parties aggrieved by its order can appeal to the Central Government within a prescribed time limit. The regulations relating to different financial services connected with investment activities are discussed below:

b) **Mutual Funds**

The mutual funds in India could be broadly classified into three groups for the purpose of regulations governing the mutual funds. They are: Unit Trust of India, Public Sector and Private Sector Mutual Funds, and Money Market and Off-Shore Mutual

Funds. The Unit Trust of India (UTI) was established by the Government of India as a Trust under UTI Act, 1963. Since inception, the UTI has offered several schemes and it is governed by the UTI Act, 1963.

In 1986, the government has allowed the public sector banks to enter into mutual fund service and within a short period of time several public sector banks have commenced their mutual fund service. In these public sector banks mutual funds were governed by the Reserve Bank of India. In February, 1992, the Ministry of Finance issued a notification to the effect that all mutual funds be regulated by the SEBI and allowed the private sector entry into mutual funds service. In 1993, the SEBI brought the first mutual funds regulation which prescribed the structure of the mutual funds and other requirements. The public sector and private sector mutual funds are now governed by this regulation which is periodically revised. The SEBI (Mutual Funds) Regulations, 1993 require compulsory registration of all public and private sector mutual funds companies and approval of individual schemes offered by the mutual funds. It also requires separation of mutual funds service from investment activities which has to be entrusted with a separate company known as Asset Management Company (AMC). It has also prescribed a detailed disclosure norms to ensure transparency in the operation of mutual funds schemes. The SEBI has issued a fresh set of regulations governing the mutual funds in 1996. Since Mutual Funds are established as a Trust, they are also regulated by the Indian Trust Act, 1882.

The Money Market Mutual Funds (MMMF) and Off-shore Mutual Funds (OMC) are regulated by the Reserve Bank of India. The RBI has appointed a Task Force under the Chairmanship of Shri. D. Basu to study the feasibility of allowing MMMF to function in India in 1991 and the Task Force submitted its report in January, 1992. The RBI issued Guidelines for MMMF in April 1992. The SEBI has also issued guidelines for the money market transactions of mutual funds under its regulation.

c) **Venture Capital Financing**

Venture Capital institutions participate in the equity of companies which are not in a position to raise equity capital directly from the market due to new technology or small size of the venture in the initial stage. The venture capital institutions sell the equity in the market once the company established its standing in the market and normally, such public offers are accompanied with a similar public offering from the company. The venture capital industry in India is of relatively recent origin. It was originally in the form of special schemes of Development Finance Institutions (DFI). In the Union Budget 1988-89, the then Finance Minister announced the formulation of scheme under which Venture Capital Funds (VCF)/Venture Capital Companies (VCC) would be enabled to invest in new enterprises and be eligible for favourable treatment of capital gains and dividend. The Controller of Capital Issues (CCI) initially brought out a detailed guideline that govern venture capital funds. However, the SEBI was empowered in 1995 by the government to regulate the VCF/VCC and consequently the earlier regulation issued by the CCI was repealed on July 25, 1995.

The SEBI has brought out a detailed regulation known as SEBI Venture Capital Funds Regulation, 1996. The SEBI regulation on VCF prescribes compulsory registration of VCF, investment conditions, management of the company and maintenance of records. It also has an authority to inspect the books and investigate the charges and also take penal action against the erring VCF. In addition to SEBI regulation, the VCFs are also governed by the Income Tax Act. The VCFs are required to apply to the Director of Income Tax (Exemptions) to avail favourable treatment on dividend income and capital gains. The VCFs have to fulfil certain condition laid down under the Act to get such benefits. The Government of India has allowed the overseas venture capital companies to operate in India in 1995 and they require the approval of Foreign Investment Approval Board (FIPB).

d) **Portfolio Management Services**

The portfolio manager is one who in pursuant to a contract or arrangement with a client advises or directs or undertakes on behalf of the client (whether as a discretionary portfolio manager or otherwise) the management or administration of a portfolio of securities or the funds of the client. The SEBI has issued a detailed guideline in 1993 (SEBI (Portfolio Managers) Regulations, 1993) to regulate this advisory service. The regulation requires compulsory registration of portfolio managers before starting their service, terms and conditions of the schemes that could be offered, managerial requirement, disclosure norms and periodical reporting to SEBI.

The commercial banks are also offering portfolio management service to their customers. These services are regulated by the RBI which issued a detailed guideline to regulate this service in 1991.

e) **Stock Broking**

The stock brokers who are the members of recognised stock exchanges enable the investors to buy and sell securities in the secondary market. They also act as a broker to the companies which want to raise capital in the primary market. The stock broking service is regulated by the Securities Contracts (Regulation) Act, (SCRA) 1956 and its Rules, 1957, SEBI (Brokers and Sub-brokers) Regulation, 1992 and the by-laws of Stock Exchange where the broker is a member.

While the SCRA regulates the stock exchanges, the Securities Contracts (Regulation) Rules, 1957 prescribes the qualification for membership of a recognised stock exchange, books of accounts to be maintained by the members and the minimum number of years the documents and books are to be maintained. The SEBI regulation requires compulsory registration of members of stock exchange and prescribed net- worth requirement and capital adequacy norms, books and records to be maintained and code of conducts to be adopted by the members. The SEBI also has the powers to inspect books and records and investigate the investors and other brokers complaints against the stock broker. The sub-brokers are also governed by the same regulation and SEBI requires them to be registered through a member of stock exchange under whom the sub-broker will transact business. The by-laws of the stock exchange is in the nature of self-regulation and varies from exchange to exchange. It generally prescribes how the members have to conduct the business and deal with other members of the exchange. It also prescribes how disputes between the members and members and investors are to be settled.

In addition to the above three regulations, the members of stock exchange need to have a working knowledge on the Negotiable Instruments Act, 1881, Indian Stamp Act, 1889 as in force in their respective states, and provisions relating to Service Tax introduced in the Finance Act, 1994.

Activity 2

a) Explain the role of RBI, IRA and SEBI as regulators.

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b) How do you explain the RBI's recent move on removing interest rate ceiling and amount to be raised from the market for the NBFC on the one hand and restricting the NBFCs in raising deposits from the market?

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c) Draw a structure of Mutual Fund Service as provided by the SEBI

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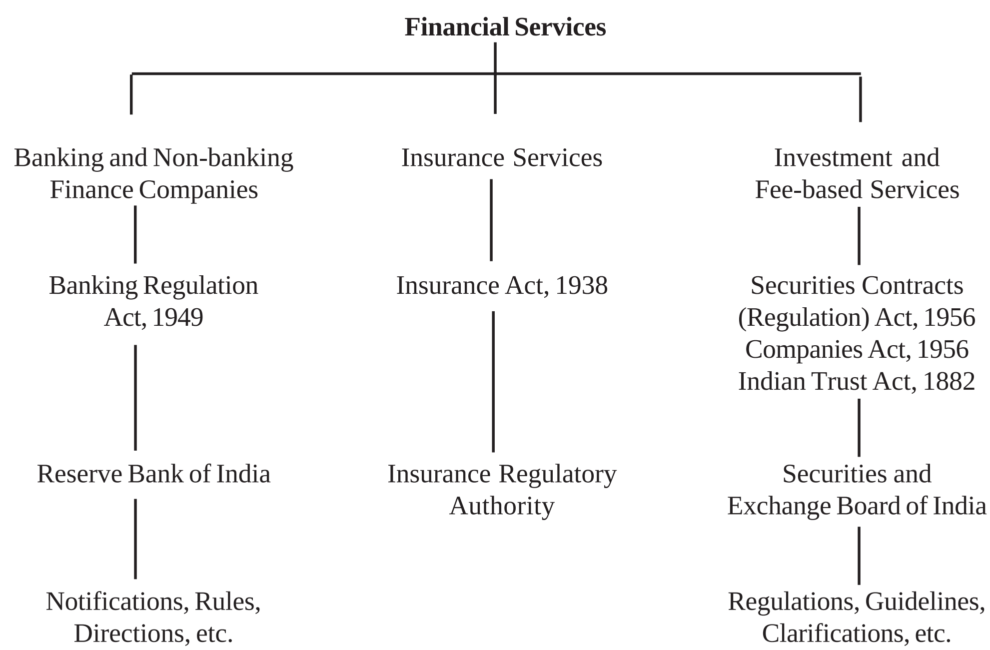
5.6 REGULATIONS ON MERCHANT BANKING AND OTHER INTERMEDIARIES

There are several intermediaries associated with management of public and rights issue of capital. While the Merchant Banker is the main intermediary, others associated with the issue management are Underwriter, Brokers, Market makers, Registrar, Advisors, Collection Bankers, Advertisement Consultants, Debenture Trustees and Credit Rating Agencies. The SEBI has issued a detailed guideline/ regulation on many of these intermediaries. They are:

a) SEBI (Merchant Banker) Regulation, 1992;

b) SEBI Rules for Underwriters;

Exhibit 5.2 : A bird's-eye view of Regulation on Financial Services



a) SEBI (Brokers and Sub-brokers) Regulation, 1992;

b) SEBI Rules for Registrar to an Issue and Share Transfer Agents, 1993;

c) SEBI (Bankers to an Issue) Regulations, 1994;

d) SEBI (Debenture Trustees) Regulations, 1993;

e) Code of Advertisement to Capital Offerings

The intermediaries are required to register themselves with the SEBI under the relevant regulations before commencing the business. These regulations have also prescribed the eligibility norms for registration, net worth and capital adequacy norm wherever relevant and code of conduct. As observed in other regulations, these regulations also empower the SEBI to inspect the books and record and conduct investigation on the affairs of the intermediaries and take appropriate action against them wherever required.

The SEBI relies on the merchant bankers most, when it comes to supervising the equity and debt offerings of companies. The Merchant Banker who acts as a lead manager to an issue is expected to examine whether all the provisions relating to SEBI by the company as well as other intermediaries are duly complied with and issue a due-diligence certificate to that effect. SEBI Guidelines for Disclosure and Investor Protection, 1992 which frames the rules relating to issue of capital is also relevant to the merchant bankers. If a Merchant Banker offers its service to an acquirer, the SEBI (Substantial Acquisition of Shares and Take-overs) Regulations, 1994 provides the procedure to be followed by the acquirer and the merchant banker for such acquisition of shares.

Activity 3

a) How are the merchant bankers used to enforce regulations relating to capital offerings and other intermediaries?

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b) How does SEBI protect the interest of investors?

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c) What are the regulations to be studied in order to offer Mergers and Acquisition services?

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5.7 SUMMARY

Financial services industry plays an important role in the economic development of the country. If there is any collapse in the financial services industry, it adversely affect the economy. The recent developments in the East-Asian countries where the failure of banks and other financial services firms have thrown out millions of people from their jobs. The securities scam of 1992 and Primary market scam of 1994 in India have affected the industries to raise capital from the public and reduced the level of investments in the economy. In order to ensure that there is no adverse effect on the economy, the financial services industry is the most regulated segment of the economy all over the world. The objective of the regulation is not to control the growth of the industry and on the contrary allows growth as well as freedom to operate subject to fulfilment of certain conditions. Despite strict regulations, the industry has recorded high level of growth all over the world and efficiency and innovation are the key to the success of the industry. Thus the objectives of the regulations are to ensure orderly growth of the industry, protecting the investors and other participants of the markets and using the industry for the development of the economy.

The regulations can be broadly classified into structural regulations, prudential regulations and investor protection regulations. While the structural regulations cover the main types of activities that different forms of institutions are permitted to engage in, the prudential regulations aim to ensure capital adequacy, liquidity and solvency of the institutions. The investor protection regulations are designed to protect the investors from the frauds, malpractice and collapse. There are three forms of regulations that govern the financial industry. At the macro level, the legislation passed by the Parliament gives a general regulatory framework and stipulate the government agency which is in charge for administrating the provisions of the Act. The regulatory agencies set up by the government like SEBI frame several regulations at micro level and these regulations, guidelines and notifications constitute the second form of regulation. The third form of regulation is in the nature of self-regulation where the industry association frame the operating system of the industry, code of conduct to their members and procedure for settling the dispute between the members.

The Banking Regulation Act, 1949, Insurance Act, 1938 and Securities Contracts (Regulation) Act, 1956 provides macro level regulation on banking, insurance and securities markets transactions. The Reserve Bank of India, Insurance Regulatory Authority and Securities and Exchange Board of India are the major regulators of the industry. They have issued a number of regulations, guidelines, notifications, clarifications, etc., that govern the activities of the financial service providers. The stock exchanges, Merchant Banking Association, Foreign Exchange Dealers Association, Equipment Leasing Companies Association, etc., have formed separate by-laws and regulations that govern their members. All these regulations play a vital role for the development of the financial service industry.

5.8 KEY WORDS

Structural Regulation determines the type of activities that different forms of institutions are permitted to engage in.

Prudential Regulation covers the internal management of financial service providers in relation to capital adequacy, liquidity and solvency.

Investors' Protection Regulation determine the nature and level of disclosure to be made by the financial service providers to the investors.

Banking Regulations consisting of Banking Regulation Act, 1949 and Directions from the Reserve Bank of India, govern the activities of the banking companies.

NBFC Regulations are those directions given by the RBI to regulate different forms of Non-banking financial companies.

Insurance Regulatory Authority (interim) was set up in 1996 based on the recommendations of the Malhotra Committee primarily to regulate, promote and ensure orderly growth of the insurance business in a free market economy.

SEBI is a statutory body that regulate the securities markets and their participants with a main objective of protecting the interest of investors.

SEBI Regulations are set of regulations and guidelines issued by the SEBI on various investment institutions and market intermediaries.

Self Regulations are those framed by various industry association that govern its members activities, code of conduct and settlement of disputes between them.

5.9 SELF ASSESSMENT QUESTIONS

1) Why scams and defaults occur quiet frequently in the financial service industry despite regulations?
2) How do you classify the existing regulations governing the financial service industry on the basis of their scope?
3) What is the role of regulations in a free market economy?
4) How does SEBI regulate fund-based and fee-based activities?
5) What are the objectives of self-regulations? Do you feel self-regulations are better than formal regulations?

Answers to Activities

Activity 1

a) The broad objectives of regulation on financial services are (i) to ensure orderly growth of the industry, (ii) to minimise the frauds, collapse and scams, and (iii) to protect the interest of the investors.

b) Prudential regulations relate to prescribing norms for capital adequacy, liquidity and solvency. For the stock broking service, the SEBI has prescribed capital adequacy norms and stock exchanges also closely monitor the member's trade exposure in the market on real time basis to ensure that they are within prescribed limit.

c) It is true that there are comprehensive legislation that cover different financial services. However, regulators are required to ensure that the provisions of the Acts are implemented. Further, financial service industry is dynamic in nature and rigid provisions of the Act may not cope up with the changing conditions. As regulators who derive power from the legislation can respond fast to the changes and thus more desirable.

Activity 2

a) While the Reserve Bank of India regulates the commercial banks and non-banking financial institutions, the Insurance Regulatory Authority (IRA) regulates the insurance sector. The SEBI regulatory role is bigger than the other two since the number of investment institutions and market intermediaries are not only very large but also operationally different from each other. SEBI regulates all the investment institutions and market intermediaries.

b) The RBI in an effort to free the interest rates in the economy has taken a number of steps. It has first partially removed the interest rate setting on commercial banks. Keeping this logic and trend, it has removed all the restrictions on interest rates relating to NBFC's deposits. However, this concession was misused by several NBFCs leading to rate-war and finally few NBFCs were not able to meet their commitment. As a regulator, the RBI introduced certain prudential regulations that will ensure capital adequacy, solvency and liquidity.

c) The SEBI requires the sponsor of mutual fund to register as a trust under Indian Trust Act, 1882. While the Trust will offer the schemes, the schemes are managed by an Asset Management Company (AMC). In other words, the SEBI wants the fund management should be in the hand of professionals and be separated from the mutual funds. Thus, the SEBI's structure on mutual funds consists of sponsor, trust and asset management company.

Activity 3

a) Since the number of capital offerings and the intermediaries involved with them are large, the SEBI requires the lead manager of the issue to ensure that all its regulations are complied with by the issuers and other intermediaries as far as the issue is concerned.

b) The preamble of the SEBI Act, 1992 has clearly stated that the objective of the formation of SEBI is to protect the interest of investors. The Act provides a number of activities that the SEBI has to undertake to achieve this primary objective. The SEBI has so far succeeded in bringing all the intermediaries under compulsory registration with the SEBI, prescribed capital adequacy norms and disclosure. The regulator believes that these three will protect the interest of investors.

c) With the number of mergers and acquisition (M & A) activities increasing, this will be a major area of service to the financial intermediaries. The regulations that are connected with the M & A are SEBI (Substantial Acquisition of Shares and Take-overs) Regulation, Securities Contracts (Regulation) Rules and provisions of Companies Act relating to shares transfer and registration.

5.10 FURTHER READINGS

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SEBI Act and SEBI Regulations.