Reforming financial regime governance

chapter 11

The previous three chapters offered a diagnosis of challenges in financial governance regime that inhibit Indian firms from exporting IFS. This chapter offers an alternative path for progress to be made on this frontier. It dwells on the normative economics of financial sector policy at the level of ideas. Based on these, specific recommendations that need to be implemented for an IFC are made in Chapter 15.

1. A shift toward principles-based regulation

India's strategy for financial regulation deploys *rules based regulation* – the same strategy used in continental Europe and, to a significant extent, in the US. It consists of building up a large repository of subordinate law through codification of detailed rules and regulations by specialised regulators. These define the permissible features of financial products and services and the functioning of financial markets in detail. Such a prescriptive approach avoids legal ambiguity through precise codification. Rules-based regulation has two strengths. First, it provides greater legal certainty to market players, who are able to abide by clear rules governing all aspects of their business. Second, it enables financial regulators and supervisors to operate in a non-discretionary manner. As the manual of rules defines all permissible activities, the act of supervision reduces to ticking off a long checklist, and objectively verifying whether specific rules have been complied with or not. However, over the decades, important weaknesses of rules-based regulation have become visible:

1. Sophisticated compliance officers of finance companies are frequently able to find ways of pushing the edge of the envelope while not violating the letter of the law. Supervisors focused on codified rules cannot look beyond the letter of the law to its spirit. In recent years, many large financial firms in New York engaged in activities which were unfair to customers and did not meet minimum ethical standards. However, most of these firms were still able to argue that no laws had been violated and supervisors could not disagree though both knew that the spirit and intent of the law had not been honoured.
2. From the viewpoint of detection of fraud, or of impending firm failure, supervisors need to have an overall understanding of the business of the firm. They need to understand its business plan and its sources of profit to form a judgment about the incidence of malpractice or probability of default. Rules-based regulation requires supervisors to focus on minutiae. It obscures the woods from the trees. This leads to reduced awareness and inferior perceptions about financial firms in the minds of supervisors.
3. Rules-based regulation inhibits innovation. Every new idea on products, services, markets or even new ways of doing business requires going to the regulator requesting a modification of rules. This tends to eliminate the temporary profits obtained by innovative firms who obtain an edge over their competitors by coming up with new ideas, which (in turn) tends to reduce investments into research and development.
4. Rules-based regulation induces corrosive political economy, where firms seek to influence the evolution of rules into pathways which favour themselves.

High quality regulation and supervision is a *sine qua non* for IFS. It determines the competitiveness of an IFC. If an IFC lags in innovation, through slow governance

processes, and through weak incentives for firms to invest in innovation, then that IFC will lose competitiveness and global market share. If regulators and supervisors at an IFC are unable to block fraudulent or unfair behaviour by firms, and are ineffective in setting up a sound risk management system for markets and firms, then the IFC will lose reputation as well as global market share by becoming a pariah.

The alternative to rules-based regulation – *i.e.*, '*principles-based regulation*' or PBR – was first introduced in the UK in 1997. It involves less detailed prescription of what is allowed and what is not in every activity or market, less codification, less rigidity of rule-book interpretation, and a greater reliance on practice and precedent. The prime exponents of this approach are the UK, Ireland and Australia. However, the ideas underlying this new regulatory approach are being applied all over the world, including in established IFCs like Singapore. The same ideas have been adopted in Japan. But they have been less effectively implemented there. Japan has had difficulty erasing the legacy of US-style rules-based regulation with the meticulous application to detail that Japan's supervisors appear loath to relinquish. That stance has inhibited Tokyo's role as an IFC. It serves as a lesson for Mumbai as well.

The bedrock of PBR is that the regulator articulates broad principles and avoids codifying details of allowable products, markets or business plans. Under PBR, the top management of financial firms is held accountable for ensuring that the business plan of the firm, and all its activities, are consistent with the principles defined by the regulator – *i.e.*, not just with the broad letter of the law but with its intent and spirit. It removes incentives for financial firms to play an adversarial game (induced by rules-based regulation) of 'beat-the-regulator' to become competitive. Under PBR unsavoury business plans for financial market operations cannot be rendered palatable by clever compliance officers. By its very nature PBR ensures that such game-playing does not take place. With PBR, supervisors are inevitably called upon not to think of supervision in terms of checklist compliance. They are required instead to understand a financial firm's: sources of profit; core businesses processes; corporate adherence to 'principles' based on its management commitment, its corporate culture and the corporate sanctions applied to rule-breakers; as well as the strength and depth of its compliance processes. Principles-based supervisors engage in broader and deeper continuous interaction with the financial firms being regulated to understand their businesses and to anticipate how they are evolving as markets change. They are often consulted by the firms they supervise about new products and ideas informally but do not have the powers to block those ideas from being tried out. Their influence is through relationship and persuasion rather than through policing.

The main strength of PBR is that it fosters innovation. It encourages greater competition among financial firms that are able to introduce new ideas into markets rapidly. The malpractices that occur when supervisors focus on checklist compliance are avoided. However, PBR imposes onerous demands on, and requires adequate protection for, the staff of supervisory agencies. They are required to understand each regulated firm, and make discretionary judgments about whether its business plan and *modus operandi* are consistent with the principles established by the regulator. This requires an elaborate system of transparency and checks-and-balances, in order to prevent abuse. No approach is perfect. Rules-based regulation poses no such risk for supervisory staff apart from the risk of performance failure. PBR, on the other hand, places greater burdens of knowledge, responsibility and accountability on supervisory staff. PBR runs the risk that: (a) supervisory staff might misuse their discretion; and (b) they may need to be shielded sufficiently to be confident about exercising discretion and not become convenient political scapegoats when things go wrong.

Applying a historical perspective, the use of PBR at the FSA is not that unique. As Jayanth Varma has pointed out, it is only in modern times that regulation by the US-SEC has turned into *de facto* over-prescription. In its early years, the US-SEC had enormous flexibility and competence, with a more flexible, accommodating

philosophy much like PBR. The SEC was a product of the civil law era in US administration (the New Deal). But Chairman Douglas made the SEC the most successful and least prescriptively oriented of all the New Deal agencies. The US-SEC in its heyday – the Douglas and Landis eras – stands out as an exemplar of the flexible PBR approach. This period probably laid the foundations of the enormously successful US financial system. It would probably not have emerged as such if the existing US approach of over-prescription and harmfully intrusive legislation had been applied in the formative years.

The European Commission has also become an outpost of excessively prescriptive approaches to financial regulation. It stands out in sharp contrast with the FSA. The shift at the SEC and on the continent towards over-prescriptive rules-based regulation has helped London to achieve success as the world's premier IFC [1].

PBR requires a regulator to make informed judgements based on an understanding of firms, their customers, and the markets in which they operate. In making judgements about outcomes, and about what constitutes minimum standards, PBR requires a broad degree of consistency in terms of the quality of outcomes that firms deliver; rather than consistency in detailed requirements about processes. Firms are expected to adopt approaches to delivering outcomes that meet high regulatory objectives.

There has been some movement towards principles-based regulation in the US also. For example, in 1974 the US Congress created the Commodity Futures Trading Commission (CFTC) for oversight of derivatives exchanges. This resulted in regulatory bifurcation in the US, with spot markets being regulated by the SEC and futures markets being regulated by the CFTC. A key milestone for the CFTC was the Commodity Futures Modernisation Act (CFMA) of December 2000. This law radically changed the approach of the CFTC, away from a rules-based system towards a principles-based system. The CFMA defines 8 'designation criteria' and 18 'core principles'. Under the CFMA, a futures exchange only has to certify to the regulator that it is starting a new product or rule, with a notice of at least one day in advance. If the exchange wants to request an approval, the agency has 45 days to give it.

In contrast, stock exchanges in the US cannot change products or rules without a notoriously slow approval process at the SEC. In a speech in June 2006, Commissioner Walt L. Lukken said the CFMA gave exchanges the flexibility required to foster innovation, saying:

> "While the CFTC monitors whether a core principle is ultimately met, the exchanges with their hands-on experience are given discretion to tailor their rules to their special circumstances".

2. Reducing the artificial segmentation of financial firms, products, services and markets

How can the problem of segmentation in Indian finance be addressed? In four ways.

2.1. The holding company approach

In an international setting, financial firms exploit economies of scope and scale by operating in all sub-segments of financial product/services markets. Global LCFIs have reaped competitive advantage in the global IFS market as a consequence. In some jurisdictions, such as the UK, the integration of all financial regulation under a single regulator has facilitated the integration of a range of financial activities in unified financial firms. But many countries have fragmented regulatory architecture, as in India. In such instances corporate structures need to be contrived to support the creation of a virtual unified financial firm that is able to operate in any or all areas of the financial services business. The most expedient of these is the "holding company

[1] Across the Irish Sea is an even more remarkable financial regulator in Ireland (IFSRA). It has a reputation exceeding that of the FSA in terms of applying the rule of common sense alongside common law. It is increasingly seen as one of the smartest and most flexible securities regulators in the world.

Box 11.1: *Principles-based Regulation in the UK*

The way in which the FSA operates in regulating the City of London is important in understanding regulatory issues surrounding IFS provision owing to innovations in regulatory strategy. PBR was pioneered in the UK. But it appears to have taken root in several OECD countries. It is now a well respected regulatory doctrine around the world. The US is also likely to apply it before too long if the initiatives now in train come to fruition.

In May 1997, fundamental financial reforms were announced in the UK. The Bank of England was made an independent central bank with the sole objective of setting the short-term (base) interest rate with accountability for hitting a publicly stated inflation target (of keeping inflation under 2%) through an open and transparent process. All functions other than setting the short rate were removed from the Bank of England.

All financial regulation that was previously undertaken by nine separate agencies was unified under a new single regulatory/supervisory agency called the Financial Services Authority (FSA). It was seeded with the 500 people from the Bank of England who used to do banking supervision from there, and the staff of all other existing financial regulators.

By 2006, it is increasingly clear that the FSA approach has worked in the UK. The FSA has managed to steer clear of three kinds of problems: the populist regulator who likes to play to the gallery by currying favour with ordinary citizens; the conservative regulator where the default answer to all questions concerning innovation is 'no'; and the US-style approach of introducing enormous legal-overheads on the production of financial services. Whereas the UK was afflicted by recurring failures and crises concerning foreign banks in the financial system in the 1970s and 1980s, these have been conspicuous by their absence since 1997.

The first innovation of the FSA is its mandate. The law asks FSA to attain four equally important objectives: (1) Maintaining market confidence (2) Promoting public understanding of the financial system (3) Securing an appropriate degree of protection for consumers; and (4) Combating financial crime. The law codifies little about markets and products. It focuses on broad principles. It is interesting to see that that the objective of the FSA is one of securing *appropriate* consumer protection, not infinite consumer protection at any cost.

The FSA is tasked with making markets work to deliver benefits to firms and consumers. It accepts that some failures neither can, nor should, be avoided. Failures are part and parcel of what makes markets work and provide an important source of future learning. The mandate of the FSA is designed to avoid the loss of efficiency from the conservative instinct of setting up a license-permit raj, or the periodic heavy handed front-page-headlines crackdown on finance which happens with populist regulators.

The integration of all financial system regulation at FSA makes it easier to transmit knowledge on success from one part of the FSA (say banking) to another (insurance). Internationally, most banking regulators view securities markets with suspicion or hostility. However, the global economy is shifting away from banks to securities-market dominated financial systems. The merger of banking and securities into the FSA has ensured that FSA-regulated banks are not hindered from deep integration with securities markets. Instead of discouraging integrated LCFIS, the FSA is perfectly happy to see them bloom.

'Principles-based' or 'light-touch' regulation was originally conceived at the Bank of England prior to the 1997 reforms. The main insight it applied is that it is neither feasible nor desirable to write down detailed rules governing every market and every product. Under this philosophy, it is simply not possible, nor even necessary, for regulators to try to anticipate every change or innovation that might occur in financial markets; especially given the sheer size of the number of participants, the changing needs of an even greater number of sovereign, corporate and individual users of financial services, and the inexorable global integration of national financial systems. Attempting to do so simply inhibits innovation and detracts from competition. Instead it is important to focus on broader strategic issues and let firms worry about regulating themselves on points of detail – but under the continuous watchful eye of friendly and co-operative FSA supervisors, should things go pear-shaped.

Debate about 'light-touch' vs. traditional regulation is essentially an argument about the relative costs and benefits of over-prescription vs. flexibility. The contrasting US approach on the part of all regulators, except those for derivatives markets where most financial innovation takes place, attempts to codify a full set of rules covering every product and market mechanism in fine detail. The alternative strategy, adopted by the FSA, is one of articulating broad principles, and leaving market players to continually innovate on the details through which these broad principles will be achieved.

A conceptual goal of the FSA is that the top management of a financial firm must primarily look at markets and innovate, without worrying about the regulator. This is strikingly reminiscent of India's experience with dismantling the control raj in manufacturing, where the reforms were about turning the gaze of the CEO away from the government towards the market. PBR consists of applying that approach to finance. The FSA places a complex burden upon the financial firm and upon its own staff: that of understanding broad principles and adhering to them in spirit. In return, detailed rules governing every minute detail of every activity in finance have been eliminated. CEOs of financial firms in London innovate on an everyday basis without needing to continually approach the regulator for permission associated with every change in the business plan.

Large complex firms (LCFIS) are linked to specialised relationship-management teams in the FSA which provide a single point of contact. The team at FSA that deals with the large firm is given three tasks: (i) understanding the sources of profit of the firm; (ii) understanding that the business plan and processes are consistent with the principles of the FSA; and (iii) verifying that the processes of the firm perform satisfactorily and that risk is being managed properly in the broadest and narrowest senses. The FSA team makes regular presentations to the board of the regulated company about their understanding of the areas of concern. This improves the pressure on the FSA team to have a sound understanding of the regulated firm.

This approach makes two kinds of demands upon the staff of the FSA. They are required to understand the regulated firm in a manner akin to a strategic management consultant, a responsibility not replicated or attempted at a conventional regulator in India. Further, FSA staff are empowered to act based on their own discretionary judgment.

There is an interesting contrast between a principles-based approach and a rules-based approach. In a rules-based approach, as is practiced in India or in the US, it is all too easy to have rigid checklists that RBI or SEBI staff must verify by ticking boxes on long laundry lists when they interact with a firm. This gives supervisory staff plausible deniability when anything goes wrong. This, of course, does not uncover or solve underlying problems.

The FSA approach emphasises the need for intelligence and judgment on the part of regulatory staff, not just a mechanical checklist of rules. The FSA approach requires top quality professional staff, that have considerable operating experience in financial firms, and are capable and senior enough to apply their own judgement independently without fear or favour. In order to help achieve this, FSA wages are decoupled from civil service wages, and linked to median wages in the private sector. More than half of FSA's staff comes from the financial industry, through a continuous two-way flow between the FSA and the industry.

Box 11.1: *continued . . .*

With the concentration of monopoly regulatory power at the FSA, there is enormous concern about accountability and checks on the power of FSA and about the possibility of regulatory capture. This has been accommodated through numerous checks-and-balances. The first is that of having staff that understand fully real world finance, and hence avoid automatically falling back on saying 'no' as the default option when faced with any complex idea. A statutory 'practitioner panel' watches the FSA and writes reports about areas where things are going wrong. There is a tribunal for appeal on enforcement matters, much like the Indian Securities Appellate Tribunal (SAT). Finally, when there are **policy** disputes between the industry and the FSA, the UK Treasury (its Ministry of Finance) plays the role of a tribunal.

The UK finance industry accounts for 8% of its GDP. If FSA stifles the innovation or competitiveness of this industry, it impacts directly upon GDP growth. Apart from that, the City of London is extremely influential politically and government takes its interests very seriously. This generates incentives for top policy makers and politicians running for election to take interest in sound financial regulation, and ensures the global competitiveness of London as an IFC. It also constitutes an effective feedback loop between export orientation and high quality provision of the 'public good' of regulation.

One practical example of the debate between a rules-based approach and a principles-based approach concerns the operations of hedge funds. The FSA approach emphasises the enormous positive contribution that hedge funds to market liquidity and market efficiency. The FSA has emphasised supervising hedge funds through prime brokers. Prime brokers are typically arms of (regulated) investment banks, and provide hedge funds with a range of services, including securities lending, leveraged-trade transactions, and cash management. They are close to the market, so they can keep regulators informed; and, because their money is at risk, have an interest in keeping abreast of what hedge funds are doing.

This approach relies on the self-interest of, and intelligence from, prime brokers, instead of trying to write down rules and send out government employees to visit hedge funds and comprehend what each of the 8,000 hedge funds of the world is doing.

The FSA approach is both instantly appealing and attractive, yet extremely challenging in implementation. The idea that CEOs of financial firms can think about innovation and not undertake regular pilgrimages to the Treasury, the Bank of England, the FSA, and other offices of government agencies to further their firm's business interests is enormously attractive.

At the same time, the UK approach is daunting on many fronts. The principles based approach can reduce the legal certainty on which firms operate. It places discretionary power in the hands of regulators and supervisors all the way down the line.[a] It requires these officials to have high quality understanding, judgment and probity. And, it requires that they be shielded from a witch-hunt when discretion is exercised and things go wrong.

The most important testimony about the UK approach is the fact that in the last decade, London has emerged as the world premier financial centre, once again overtaking New York after a 50-year hiatus. That process has, of course, been assisted by other factors such as terrorism in New York, Sarbanes-Oxley, and the civil law approach of the EU. However, there is little doubt that the far-reaching decisions of 1997 in reforming the Bank of England and the FSA transformed the position of London on the global financial stage.

[a] In the classification scheme of Pritchett and Woolcock (2004), the hardest problems of governance are those where there are many interactions between civil servants and private citizens, and there is discretion in the hands of the civil servant.

structure". If the structure of regulation prohibits commercial banks from fund management, then the solution involves a mother corporation that has two wholly owned-subsidiaries, one a commercial bank and the other a fund manager. The virtual financial firm would then be engaged in both businesses while satisfying the separate regulators covering each area of business.

In the most refined case, the holding company would be a listed company, with a corporate HQ engaging in pursuing the business strategy of a unified financial conglomerate. From the viewpoint of the shareholder and the CEO, the firm is a unified multi-product financial firm, with a series of wholly-owned subsidiaries present in areas as required by regulatory rules. The CEO and the board of the holding company would make decisions about allocating capital and forming business strategy for the virtual firm. The strategy would be executed by multiple subsidiaries. The CEO of each subsidiary would then be roughly equivalent to the chief of each major operating business division of the virtual unified firm.

In order to achieve these goals, the holding company must be required to comply only with the Companies Act and with exchange listing requirements; in the event that it is listed. It should be subject to no financial regulation from any regulator. The fact that a subsidiary of the holding company may be a bank should give the banking regulator no power over the owner of the bank, *i.e.*, the holding company. Further, regulations governing banks, insurance companies, *etc.* need to accept 100% ownership in the hands of holding companies that can have dispersed shareholding and public listing requirements along the lines applied to any other company in any other line of business. Apart from regulatory constraints, the other constraints faced with a holding company structure in the Indian environment are:

Box 11.2: *Case Study – Principles-based regulation in the UK for treating customers fairly*

As an example of how PBR works, consider consumer protection, or what the FSA calls "Treating Customers Fairly" (TFC)[a]. The FSA has defined six desired outcomes from its work in the TFC area:

1. Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to corporate culture
2. Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly
3. Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale
4. When consumers receive financial advice, the advice must be suitable and tailored to take explicit account of their circumstances
5. Consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and also as they have been led to expect
6. Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

These six principles define what the FSA requires the financial industry to do for consumer protection. FSA emphasises the responsibility of the senior management of finance firms – and not just their compliance departments – to embed these objectives within the business strategy, culture and behaviour of their firms. The FSA holds the top management of each firm accountable for meeting these six desired outcomes, and not seek to micro-manage firms on how these outcomes are achieved.

This principles-based approach provides financial firms with more flexibility to decide how best to run their businesses, while meeting FSA regulatory objectives. Firms are better placed to judge the detail of how best to deliver those outcomes in the marketplace, and thus deliver fair treatment to their customers in a way that is consistent with their commercial objectives. FSA argues that providing flexibility rather than prescribing detailed processes enables firms to compete and innovate more effectively in product design, in the quality of customer service, and in achieving economic efficiency.

FSA works on improving financial capability and awareness of consumers, and the provision of clear information by firms and by the FSA to consumers, to help consumers to pursue their own best interests by playing an active and informed role in the markets for financial products and services. Enforcement actions are taken against firms and their senior management when they fail to achieve high level outcomes.

As part of the move to a more principles-based approach, FSA is working on removing a significant volume of detailed rules on consumer protection. Detailed rules on money laundering, and on training and competence for wholesale business have been removed. The Authorisation Manual is being dismantled. It intends to further implement a radical simplification of investment Conduct of Business rules, rules on financial promotions and rules on complaints handling.

When firms ask FSA to define minimum standards, in the quest for legal certainty and predictability, the FSA response is that the Principles and other high level rules are themselves minimum standards, and that FSA sees these minimum standards primarily in terms of outcomes, not of prescribing detailed inputs and processes.

Predictability is enhanced by statements of good and poor practice and through case studies illustrating ways in which firms have successfully met requirements. Such statements of good and poor practice help senior managements of firms to think for themselves about how best to meet high level requirements within the specific circumstances of their own activities and business models. By publishing examples of good and poor practice on either side of an acceptable standard, FSA indicates to firms both where the minimum standards lie, and that there are alternative ways of delivering them. In doing this, FSA respects the confidentiality of 'proprietary' good practice that firms have developed to give themselves a competitive advantage.

[a] See `http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0724_cb.shtml`

A. Tax consolidation of accounts. Under Indian GAAP, a listed holding company has to present stand-alone *and* consolidated accounts. However, for income-tax purposes, such a consolidation of accounts is not presently permitted. At a conceptual level, it would be desirable to tax a group on the basis of its overall financial performance incorporating the performance of all subsidiaries put together. Worldwide there are a number of jurisdictions, such as the US, UK and others that tax a corporate group as a single unit. Although the scope and approach may vary from one jurisdiction to another, tax grouping allows offset of profits and losses within the group, with a few countries extending the concept to cover foreign subsidiaries. Hence, there is a case for introducing a group tax regime, that is simple to administer, and involves low compliance costs. Flexible rules need to be specified governing intra-group transactions and corporate reorganizations. The regime can prescribe conditions, such as minimum holding periods and condition for qualifying for group level consolidation, consistency of financial years, entry and exit issues *etc.*

B. Dividend tax credit. When a subsidiary company pays dividend to its holding company, it pays a dividend tax of 14.025% in India. A dividend payout by the holding company to shareholders incurs a second dividend tax of 14.025%. This vitiates the viability of the holding company structure.

C. Leverage by the holding company. Section 293 of the Companies Act, 1956, specifies that, without consent of shareholders, a company cannot borrow more than the

Box 11.3: *Principles Based vs. Rules Based Regulations (PBR vs. RBR)*

1. Principles Based Regulation (PBR) is outcome oriented
2. It differs from Rule Based Regulation (RBR) which is process driven.
3. PBR is based on the idea that the regulator is not always best placed, or better placed than market participants, to judge what is best, or what is right and what is wrong in terms of products, instruments, services, practices or market functioning.
4. PBR is based on the premise that competition and innovation in rapidly evolving markets driven by technology should not be inhibited by over-prescriptive regulation.
5. PBR allows for greater flexibility in devising internal corporate business and compliance processes to cope with changes in rapidly evolving markets
6. RBR invariably prescribes permissible business processes in micro-detail and changes too slowly in response to market changes.
7. The overall effectiveness of PBR is critically dependent on the ethical and governance standards that prevail in the financial and corporate worlds in any country.
8. The higher such standards are in a given operating environment, the better is compliance with PBR and the better its overall outcome.
9. In an environment accustomed to RBR, regulators see PBR as posing high regulatory risks
10. They fear that the operating flexibility that PBR permits could be misused in environments with insufficiently high standards of internal corporate ethics, compliance and governance.
11. With RBR, market participants leave it to regulators to specify what those standards should be through detailed rules.
12. But experience suggests that RBR does not necessarily or automatically instill or encourage high standards of ethics or governance to be applied in any particular environment.
13. What RBR appears to encourage is the development of capabilities aimed at evading rules through technicalities and loopholes. This weakens incentives for better self-regulation within the regulated industry and induces a tendency for market competition to be driven by a propensity for cleverly evading rules faster than the competitor.
14. The key to determining the regulatory tone in a particular environment, and deciding whether PBR is more suitable than RBR in a particular country circumstance, depends on the standards applied by the regulated industry in: monitoring itself, ensuring that all players in the industry conform to rules that protect the reputation and integrity of that industry; and ensuring that the best global standards of corporate ethics and governance are applied by all players.
15. PBR is particularly well suited to the regulation of securities markets, which regulators that are RBR driven (such as in the US) have now explicitly recognized.
16. PBR does not mean lax regulation and supervision. Compliance under PBR depends as much on the spirit as the letter of the law. For that reason, compliance with PBR is different and more demanding than the "checkbox" compliance under RBR.
17. Violation of rigid but specific rules is much easier to establish than broader principles that are more open to subjective interpretation.
18. PBR requires greater knowledge on the part of regulators, an obligation to remain up to date with changes in rapidly evolving markets, as well as more accountability and responsibility to be exercised by supervisors in exercising judgments than RBR which focuses too much on the use of detailed checklists for compliance assessment.

total amount of its share capital and free reserves. This restriction is archaic. It needs to be removed, particularly for listed companies where mature corporate governance processes are in place. At the minimum, this restriction needs to be rephrased to make a link to the share capital and free reserves of the consolidated balance sheet.

D. Restrictions on intra-group transactions. The ultimate goal of a holding company structure is to support listing and running a corporate headquarters for a set of finance companies, each of which complies with the requirement of a separate regulator. The ultimate objective is to create a virtual financial firm that spans the financial services universe. However, Section 297 of the Companies Act constrains the utilisation of the services of any group company by another group company. When group companies have a common directorship, prior approval of the central government is required prior to availing such services. This requirement needs to be reconsidered in a modern corporate governance environment.

2.2. Reforms in financial system regulatory architecture

One important source of segmentation in Indian finance is the turf separation created by having multiple regulators. Reforms to regulatory architecture could be undertaken to mitigate these problems. India needs to choose between two paths. One is to consolidate down to four regulators covering finance with one each for: (a) ***banking*** with a regulator separate from the monetary authority; (b) ***capital markets***, with a merger of securities markets functions on the fixed income, currency and commodity markets into a single securities and derivatives market regulator; (c) ***pensions*** with the consolidation of

Box 11.4: *The politics of US regulatory architecture*

In the US, regulation of all derivatives – financial or commodities – is placed under one agency (the CFTC). Regulation of financial spot markets is under another (the SEC). This separation is derived from history and sustained by political economy.

The CFTC is overseen by the House and Senate Agricultural Committees, owing to the historical origins of the CFTC. In 1974, when the agency was created, futures trading was synonymous with agricultural commodity futures trading. That world is, of course, long gone; US derivatives exchanges trade every manner of derivatives imaginable including currencies, interest rates, energy, weather, *etc.*

The members of the House and Senate Agricultural Committees tend to obtain significant political funding from the derivatives exchanges. The Chicago exchanges in general, and the Chicago Mercantile Exchange in particular, are top donors. In the 2006 election cycle in the US, four exchanges appear on the list of the top 20 securities industry donors. All but one of the four are futures exchanges. The CME has been on the top 20 list for the last three election cycles.

Box 11.5: *Costs of compartmentalisation, and benefits of unification, in the 'exchange ecosystem'*

	Segmented model				Unified model
	Equity	Fixed income	Currency	Commodities	
Exchange	NSE, BSE	NDS, Clearcorp Dealing Systems	Clearcorp Dealing Systems, Reuters, IBS	NCDEX, MCX, NMCE *etc.*	All 8–10 exchanges would compete in trading all products. (This assumes NDS will be put out as one more exchange).
Clearing corporation	NSCC, BSE Clearing House	CCIL	CCIL	None	All three clearing corporations would compete in offering clearing services for all products
Depository	NSDL, CDSL	SGL	n.a.	NSDL	All three depositories would compete for all demat services. (This assumes that SGL will be put out as one more depository).
	Problems: Lack of competition, lack of economies of scale, lack of economies of scope. Conflicts of interest owing to functions held within the State at NDS and SGL. Heightened costs for financial firms.				Benefits: More competition, economies of scope and scale for both exchange institutions and member firms. Improved functioning of NDS, SGL and the State, owing to elimination of conflicts of interest.

pension regulation into a single pensions regulator; and (d) the ***insurance*** regulator.[2] Such a quartet might reduce the extant degree of segmentation and regulatory turf protection in Indian finance; but it would not eliminate them.

Alternatively, India could choose to integrate all financial regulation into a single FSA-style agency. The experience of London suggests that that IFS provision is encouraged by the unification of all financial regulation into the FSA. The principle of the FSA is that it is able to take a complete view of all activities of all finance companies and a holistic view of trends in financial market development. At the same time, there are problems of accountability and governance as well as regulatory monopoly associated with creating an FSA-style agency.

[2]While the PFRDA is not yet a statutory regulator, the present direction of policy thinking in the field of pensions envisages such a role for it (Shah and Patel, 2005).

2.3. Shift away from "entity-based regulation" towards domain based regulation

Until an FSA-style agency comes about, care needs to be taken in identifying rules that induce segmentation in Indian finance and removing them. For India to succeed in IFS provision, it has to be understood that the end goal is for India to have efficient, globally competitive financial firms which are able to do what is needed to compete effectively in all IFS markets. The goal is not to make regulatory life less complicated by maintaining the tidy status quo of segmented financial firms that fall neatly within current regulatory domains, and are easy to control, supervise and regulate. This requires, for example, treating a 'primary dealership' as one of the many business activities of a financial firm, and not requiring that standalone firms be created which do nothing but primary dealership. The strategy for regulation needs to be one

where the banking regulator regulates the business of banking, but does not regulate all the activities of a financial firm that chooses to call itself a "bank".

2.4. Organisation of the asset management industry

The very nature of the asset management industry enables large economies of scale to be captured. The costs of managing a bond portfolio of Rs. 1 trillion are not a thousand times larger than those of managing a bond portfolio of Rs. 1 billion. They may not even be ten times larger. Hence, when a firm manages a larger quantum of assets, it is able to quote lower prices when expressed as basis points of assets under management (AUM). As an example, in the world market, the price for index fund management for $1 billion of assets is roughly 1 basis point or 0.01%. At present in India, there is no index fund with a size of $1 billion, and hence index funds in India cost much more than 1 basis point.

Asset management functions are performed in almost every sub-segment of finance: banking, insurance, pensions, mutual funds, hedge funds, *etc.* The fragmentation of finance owing to regulatory architecture induces huge diseconomies of scale in asset management. That will hamper the competitiveness of Indian firms in an international setting.

Considerable progress can be made on this problem by separating out the 'front end' through which assets are sourced for management, from the back-end 'factory' where assets are managed. The front ends embed specific contractual structures, and regulations, such as insurance companies as opposed to mutual funds. However, the task of fund management that takes place in each of these firms is done in the same kind of factory. The difference between a mutual fund and a pension fund lies in the front-end, not in actual asset management.

This suggests the creation of a new industry of Asset Management Companies (AMCs) that are ***wholesale*** fund managers. This industry should be regulated by SEBI. The customers of AMCs might be restricted to wholesale customers who put up a minimum of (say) Rs. 100 million (or Rs. 10 crores or US$ 2.25 million equivalent) for management. A small set of professional trustee companies – perhaps three to five – should supply supervisory functions over an industry composed of perhaps 50–200 AMCs.

Once this industry is in place, it should be possible for banks, insurance companies, mutual funds, hedge funds, FIIs, pension funds, EPFO, *etc.* to outsource their asset management to one or more of these companies. What is envisaged, of course, is a market-driven process. There should be no compulsion that an insurance company must outsource fund management to an AMC. However, any regulatory barriers that impede outsourcing should be removed, so that the in-house versus outsourcing decision is made by every financial firm in India on the grounds of pure economic efficiency.

It is important to maintain a distinction between the regulatory structure that applies to an insurance company and the regulatory structure that applies for the wholesale AMC. The insurance regulator has a legitimate focus on the risk profile of the portfolio of the insurance company. However, the relationship between the AMC and the insurance company has no link to the complex obligations of the insurance company.

As an example, an insurance company might place Rs. 1 billion with an AMC for managing an equity index fund. The regulatory focus on the AMC would then be restricted to verifying that the index fund is being correctly managed. As an example, in a mutual fund setting, the costs associated with retail investor protection should be concentrated into the *mutual fund*. When the MF outsources to an AMC, this contract should be struck at the low prices seen in wholesale fund management, and the burden of regulation associated with retail investor protection should not fall upon the AMC .

With such a structure, wholesale AMCs could achieve significant economies of scale by tapping into assets from many institutional funding sources. In such an environment, when an insurance company evaluates the decision of managing assets internally, as opposed to outsourcing that

activity, it is likely to find that the charges of the wholesale AMC are much lower than the costs of internal asset management. This would encourage the outsourcing of assets for management from a large number of financial firms to save their own costs and achieve economies of scale in the AMC industry. Such a move would immediately make asset management in India globally competitive. Asset management companies in India with over $5 billion in assets under management would be cost-efficient by the standards of the global money management industry. But, for that to happen, appropriate institutional structures for wholesale AMCs would need to be created and economies of scale captured in the domestic market before such services could be globalised.

3. Creating an environment conducive to exit

As argued above, the foundation of competition policy is a ceaseless process of creative destruction, where every year, some financial firms fail and exit from the business, while new financial firms enter into the business every year. This ceaseless churning appears messy since newspaper headlines dwell on firm failure. However, it is the only way to achieve a globally competitive financial sector.

This requires a corresponding paradigm shift on the attitude towards both entry and exit. Financial regulators in India today are often fearful of exit. The death of a financial firm is seen as a failure of the financial governance regime. This attitude needs to shift towards an approach where the death of financial firms is seen as proof that a properly competitive environment is actually in place.

There is ample international experience on how a sound approach towards exit can be constructed. It comprises the following key elements:

1. Regulatory concerns about the failure of financial firms are focused only on banking, insurance and defined benefit pensions. In these areas, a framework of deposit insurance – with sound pricing of the insurance and administration in a way that avoids moral hazard – is of the essence. This needs to be coupled with a prompt corrective action (PCA) framework, where strictures are placed upon weak firms well before failure; such as a prohibition on accepting new business when underlying risk capital is too low. Listing is a powerful tool through which stock market speculators monitor firms, and produce daily estimates of their failure probabilities. A policy of requiring listing, and the establishment of procedures within regulators of monitoring stock prices, would help generate early warnings about distress based on which PCA can be taken.
2. In the securities markets, clearing corporations which manage counterparty risk are a powerful tool for preventing firm failure from having systemic repercussions. India has made excellent progress through the establishment of the National Securities Clearing Corporation (NSCC) and the Clearing Corporation of India (CCI). The scope of these institutions, and the competitive market structure of the clearing corporation business, need to be steadily extended.
3. A host of sophisticated finance activities can be encouraged under firms organised like hedge funds, where customers are restricted to sophisticated investors. Once this is done, the death of such firms imposes no political problems upon the government.

4. Retail vs. wholesale markets

Financial regulators around the world are concerned about investor protection of "small households". Ordinary households lack the specialised financial knowledge or incentive to understand complex financial products that might be mis-sold or embed dubious practices encoded in fine print. If the regulator does not protect the interests of ordinary households, then the flow of savings from millions of households into modern finance will not take place. This legitimate concern induces regulators to be particularly cautious before permitting

products to be sold to retail investors. This, in turn, induces a bias toward caution and conservatism and slows down innovation.

This problem has traditionally been seen as a difficult trade-off faced by the regulator. On one hand, financial innovation produces superior products for end-consumers. Yet, along the way, new products need to be screened carefully by the authorities to avoid episodes where households are defrauded and bolster public confidence in modern finance. One way of dealing with this issue, and fostering innovation without sacrificing the protection of small investors, is to cultivate a separate policy stance for sophisticated 'wholesale' players in the financial markets who do not have the same knowledge deficits as retail investors and do not need the same degree of protection. In India, a threshold of Rs.1 crore (or Rs.10 million) might be appropriate in defining a 'wholesale' transaction. Once this is done, in a broad range of settings, the stance of regulators should be to permit a free flow of innovation.

The best example of this approach is the hedge fund. Mutual funds are specifically designed for retail investors and they are regulated and supervised intensively. This level of scrutiny imposes costs of compliance and opportunity cost of trading strategies which are prohibited by the government. The hedge fund is the unregulated alternative to the mutual fund. But it can be restricted to deal only with customers who put up more than Rs.10 million of assets for money management. The argument is that any customer who has more than Rs.10 million of assets under management with a hedge fund has the knowledge and capability to understand what the hedge fund manager is doing before investing in it. The government does not need to protect such a customer. Once such a separation is created between mutual funds and hedge funds, there will be healthy competition in the capital market. Large investors will have a choice between mutual funds and hedge funds. If the benefits of regulation outweigh the costs, then large investors will continue to patronise mutual funds. If the costs of regulation of mutual funds are larger than the consequent benefits, then large investors will shift to hedge funds. The economy would then benefit from a low cost organisation of money management and from increased competition.

Hedge funds are appealing when it comes to exit in the event of failure. If a money manager such as a mutual fund has a large number of small retail customers, then the government inevitably gets involved in the resolution of failure. In contrast, hedge funds will have only a small number of wealthy customers. That makes it politically feasible for the government to watch impassively when a hedge fund fails. The hedge fund manager goes out of business and a few rich customers get hurt. Government is not obliged to intervene on their behalf and no issue of public interest policy arises. Under such a framework – that distinguishes between the capabilities and interests of wholesale vs. retail investors – the principle of *caveat emptor* applies to the former and strong regulatory safeguards protect the latter permitting financial markets to be regulated in a manner that encourages aggressive competition, with free entry and exit of different kinds of financial firms while protecting those that need protection. Another well-known recent example where 'wholesale-retail' differentiation has been successfully applied is in the exchange industry in the US. There the CFTC has eased the entry criteria and softened considerably the regulatory regime for exchanges in which only large financial firms, and not small individual investors or ordinary households, are permitted to participate. This two-track approach makes entry possible for a range of internet-oriented start-ups which compete against the established exchanges, without needing to incur all the costs and particularly the regulatory burdens associated with the established exchanges.

A fast-paced, globally competitive financial sector, in which rapid innovation occurs, can be a useful laboratory where new products and services can be quickly tested in wholesale markets restricted to transaction sizes of at least Rs.10 million. Successful ideas from such tests can later be approved for the retail market by the

regulator. From an IFS perspective, almost all IFS transactions are likely to be bigger than Rs.10 million. Hence, a rapid pace of innovation in ***wholesale*** markets is quite consistent with a focus on export of IFS. But this approach has an important downside, in the context of organised arms-length financial markets, where secondary market liquidity is formed by pooling millions of orders, small and large. The fragmentation of liquidity between segregated retail and wholesale markets would reduce liquidity.

India's key strength – *i.e.*, its vast retail market – will not be able to play in areas where retail participation is prevented. Hence, while this wholesale versus retail approach has merit in some areas such as money management, there is a need of caution when it comes to the securities markets, where unification of all orders into a single order book yields maximum liquidity and thus international competitiveness.

5. The role of exchange-traded vs. OTC derivatives in the BCD nexus

Derivatives can be traded on an exchange or bilaterally negotiated on the 'over the counter' (OTC) market. Trading on exchange requires standardised 'plain vanilla' products, is anonymous, utilises a clearing corporation to eliminate credit risk, and is fully transparent. The trading computer ensures that each buy order is matched with the lowest priced sell order. OTC trading permits unlimited flexibility in the contract, lacks anonymity, generally involves counterparty credit risk, and is generally non-transparent. There is never a certainty that one privately negotiated purchase was contracted at the best price available on the non-transparent market.

Currency futures were the first situation where the idea of the exchange-traded futures market was applied to a financial underlying. For many years, currency futures were not particularly successful when compared with OTC currency forwards which dovetailed well with the primarily inter-bank character of currency trading. With interest-rate derivatives, while exchange-traded interest rate derivatives are enormous worldwide, they continue to be smaller than their OTC counterparts.

Despite these international empirical regularities, the following seven factors suggest a greater role for exchange-traded derivatives in an Indian IFC:

1. The present OTC market in India largely trades plain vanilla products. For trading plain vanilla products, the exchange traded environment induces transparency and liquidity at no cost in flexibility. Indian currency forward trading is already halfway to the exchange-traded framework, with the Clearing Corporation of India Ltd (CCIL) performing the services of a central counterparty. The only further step required in shifting from a forward market to a futures market is the introduction of transparent trading at an exchange venue.
2. Even though the global currency futures market is small when compared with the global currency forward market, recent research has shown that it plays a disproportionate role in price discovery. Rosenberg and Traub (2006) find that the currency futures market might contribute as much as 85% of the price discovery. This reflects the role of transparency in price formation. Traders who might place orders on the opaque OTC market find it advantageous to constantly watch the transparent futures market. A transparent trading venue seems to matter disproportionately for overall price discovery, even if the turnover at this public marketplace is relatively small.

   Similar evidence for the role of exchange-traded futures on the interest rate market is found in Mizrach and Neely (2005) who estimate that over 50% of the price discovery on the US long bond market takes place in the exchange-traded product in the period after 1998.
3. Exchange-traded derivatives have become particularly important in the new world of algorithmic trading and internet trading, both of which dovetail

better with electronic exchange-traded products. The new order flow that is created owing to these two channels tends to be concentrated on exchange-traded products.

4. In an environment where India's regulatory and supervisory capacity in the derivatives market is still nascent but evolving, exchange-traded markets pose a simpler problem with full transparency, with standardised contracts being traded, and where credit risk is removed by the clearing corporation. In comparison, sound regulation and supervision of more opaque OTC markets makes greater demands upon regulation and governance.

   In particular, public sector financial firms are vulnerable to questions about lowest-price procurement when a transaction takes place on an OTC market. In contrast, when a computer does order-matching, lowest-price execution is guaranteed. As long as public sector financial firms are important in India, an emphasis on exchange-traded derivatives will elicit greater participation.

5. Apart from filling a major gap in the structure of its financial system, another key reason for building a BCD nexus in India is to enter the export market for IFS: i.e. attract global order flow into: (a) the INR yield curve; (b) trades in contracts of the INR vs. other global currencies; and (c) credit risk management products trading in India. The clubby world of the global forward market – where counterparties know each other, face credit risk from each other, and have conversations on telephone – will be more difficult for India to break into, given that these human relationships are well established at the three established GFCs and other IFCs like Tokyo, Frankfurt and Paris.

   It is more feasible for India to compete in the world market for order flow into exchange-traded derivatives. This is a more meritocratic market, where transaction charges and impact cost are all that matters; being plugged into certain human networks matters less. As an example, it appears more feasible to attract users of currency futures and currency forwards trading all over the world to send orders electronically into an order-matching system operating in Mumbai, rather than seeking to obtain market share in the global OTC market.

6. Exchange-traded derivatives fit well with non-institutional customers, who are not able to access the telephone networks through which OTC trading takes place. This issue is not unique to India: e.g. in Japan, individuals have come to play a substantial role in currency trading in recent years, through the currency futures market.[3] Given the importance of non-institutional players in Indian finance, an emphasis on exchange-traded derivatives will help in harnessing their participation and thus liquidity.

7. Finally, exchange-traded derivatives trading plays to India's strengths in running exchange institutions. NSE, BSE, NSCC, CCIL are a strong set of institutions, and can compete in the global market for exchange-traded derivatives.

Some of these seven issues are unique to India. However, some of these issues are presently at work in reshaping the international derivatives market. As a consequence, currency futures have experienced considerable growth. BIS data shows currency futures turnover has grown from $2.8 trillion in Q3 2005 to $4 trillion in Q2 2006.

India needs both exchange-traded derivatives and OTC derivatives. However, these arguments suggest that particularly in the early years, a special focus should be placed on obtaining world-class liquidity on the exchange platform. This is where India's IFS export opportunity lies, and this is the 'raw material' using which OTC derivatives are made. **The right sequencing is to first have a liquid electronic trading screen, after which an OTC market can spring up based**

[3] On the subject of individuals in the Japanese currency futures market, see `http://tinyurl.com/ycgbm2` on the web.

on utilisation of the prices and liquidity produced on this screen.

6. Regulatory impact assessments

In the foreseeable future, India could be headed for a four-way separation of financial regulation, with separate agencies performing regulatory and supervisory functions for Banking, Securities, Insurance, and Pensions. The merits of a larger all-inclusive unification – such as emulating the UK-FSA – can be debated *ad nauseam* in the Indian context. The HPEC would prefer not to trigger or indulge in that debate as it diverts from its main concern – *i.e.*, that of establishing a successful IFC in Mumbai as swiftly as possible. Regardless of whether FSA-style unification is attempted or another form of regulatory architecture is applied, an IFC in Mumbai will still require world-class financial regulation and supervision (in terms of policy, approach, attitude and practice) in either case.

One tool for improving the quality of regulatory agencies is a periodic process of "Regulatory Impact Assessments" (RIA). These are now commonplace in OECD countries. Each RIA is essentially a cost-benefit analysis carried out independently every 3–5 years to review regulatory architecture and implementation. The term 'architecture' describes the boundaries of the agency, its legal foundations, and its mandate, while the term 'implementation' refers to how the agency translates these goals and conceptual framework into successful, globally competitive regulation and supervision. Each RIA needs periodically to compare Mumbai against peer IFCs, and examine how architecture and implementation can be evolved so as to improve India's ability to produce IFS for the global market.

7. Strengthening the legal system supporting an IFC

The legal system comprises legislature, laws, courts and judges. In a finance setting with independent regulators, an appeals mechanism is required for all actions of the regulator. The difficulties confronted by the Indian legal system in tackling sophisticated IFS are well known. The system lacks specialised domain knowledge. Legal processes are drawn out over excessively elongated periods of time. Recent reports indicate that over 30 million cases are currently pending resolution in India.

From an IFC perspective, the most useful strategy may be the creation of specialised courts that combine (a) highly experienced arbitrators equipped with specific IFS domain knowledge, and (b) streamlined workflow leading to minimal delays. Extending the scope of the present Securities Appellate Tribunal (SAT) might be a useful way of addressing these concerns. SAT already has judicial capacity with specialised domain knowledge in securities markets. It processes cases with obvious efficiency at an impressive pace. Going beyond SEBI, there is a possibility of utilising SAT for processing appeals against FMC and PFRDA also.

Applying the same logic, SAT's scope and remit could be extended to covering IFS as well with SAT adding an IFS Appeals Tribunal (IFSAT) to its extant role. SAT could have its remit expanded to deal with appeals not just for capital markets transactions but cover banking, securities, insurance and pensions as well. A larger role for arbitration would help strengthen the legal system[4]. Arbitration is a key mechanism through which faster and superior contract enforcement can be achieved between private agents who have disputes about private contracts.

From the viewpoint of a global participant utilising Indian financial services, legal risk induces a risk premium; it reduces the competitiveness of India as a venue for IFS production. Effective arbitration procedures give private agents a way to bypass the constraints of the courts. The Indian Arbitration and Conciliation Act was passed in 1996, with the intent of enabling

[4]The ideas and facts here greatly draws upon "What next for Indian arbitration?" by A. Ray and D. Sabharwal, of the International Arbitration Practice Group at White & Case, London, which appeared in Economic Times, 29 August 2006.

and strengthening this channel[5]. However, two decisions of the Supreme Court have dealt severe blows to the 1996 Act: (1) the Oil & Natural Gas Corporation v Saw Pipes (2003) 5 SCC 705[3]3 [6] and (2) SBP& Co. v Patel Engineering (2005) 8 SCC 618 [7].

As a response to these problems, the Arbitration and Conciliation (Amendment) Bill, 2003, currently pending before Parliament, proposes to introduce a new section that would allow an award to be set aside "where there is an error apparent on the face of the arbitration award giving rise to a substantial question of law". Although this new ground for challenge is narrower in definition than the Saw Pipes ruling, it still affords losing parties an opportunity to approach the courts in an attempt to second-guess arbitral tribunals. This could lead to a position not dissimilar to that under the 1940 Act and complete a full circle for Indian arbitration. The problems of Patel Engineering case prima facie, do not appear to have been addressed in this Bill.

The last (but not least) component of the legal system is lawyers. At present, there are some significant weaknesses in the development of legal skills by the present Indian education system, particularly when it comes to the legal aspects of sophisticated finance. The internationalisation of Indian finance will induce new kinds of pressures upon the legal fraternity. On one hand, legal skills will be demanded in global finance that go well beyond the skills developed in dealing with Indian financial law. In addition, many global financial firms might feel comfortable utilising the services of the same global law firms they use in other IFCs when doing certain transactions out of India. This is perhaps analogous to FIIs favouring foreign brokerage firms when operating in India.

This suggests that India needs to open up on the issue of foreign law firms operating in India. Such measures will help simultaneously in three directions. It will improve the legal knowledge available in the country, particularly on the interfaces between finance and law. It will help global financial firms feel comfortable with operating in Mumbai, since they would find familiar global legal firms. It would have the same impact on improving the skills, technology and competitiveness of the Indian legal services industry that permitting FDI in manufacturing had on Indian industrial firms.

Developments along these lines are already taking place. On 6th October, 2006, the Minister for Commerce and Industry said that a panel of lawyers had been constituted under the UK-India Joint Economic and Trade Committee (JETCO) to work with a similar group in the UK to deliberate on opening up the legal services sector.

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[5]The 1996 Act was designed primarily to implement the UNCITRAL Model Law on International Commercial Arbitration and create a pro-arbitration legal regime in India. Prior to its enactment, there was widespread discontent over the excessive judicial intervention allowed by its predecessor, the 1940 Act. The 1996 Act attempted to rectify this problem by narrowing the basis on which awards could be challenged, thereby minimising the supervisory role of courts, ensuring finality of arbitral awards and expediting the arbitration process.

[6]Saw Pipes addressed a challenge to an Indian arbitral award on the ground that it was "in conflict with the public policy of India". Despite precedents suggesting that "public policy" be interpreted in a restrictive manner and that a breach of "public policy" involves something more than a mere violation of Indian law, the Court interpreted public policy in the broadest terms possible. The Court held that any arbitral award which violates Indian statutory provisions is "patently illegal" and contrary to "public policy". By equating "patent illegality" to an "error of law", the Court effectively paved the way for losing parties in the arbitral process to have their day in Indian courts on the basis of any alleged contraventions of Indian law, thereby resurrecting the potentially limitless judicial review which the 1996 Act was designed to eliminate.

[7]In Patel Engineering, the Supreme Court subsequently sanctioned further court intervention in the arbitral process. The case concerned the appointment of an arbitrator by the Chief Justice in circumstances where the parties' chosen method for constituting the tribunal had failed. The Court held that the Chief Justice , while discharging this function, is entitled to adjudicate on contentious preliminary issues such as the existence of a valid arbitration agreement and is entitled to call for evidence to resolve jurisdictional issues. Significantly, the Court ruled that the Chief Justice's findings on these preliminary issues would be final and binding on the arbitral tribunal, making a mockery of the well-established principle of Kompetenz-Kompetenz – the power of an arbitral tribunal to determine its own jurisdiction – enshrined in section 16 of the 1996 Act. This encourages parties to sabotage the appointment process of arbitrators, make spurious arguments about preliminary issues and use evidentiary hearings in courts to delay arbitral proceedings.