Fraudulent financiers, beware

PREMIUM

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The Securities Ordinance can deal with malpractices, encompassing virtually all collective investment schemes.

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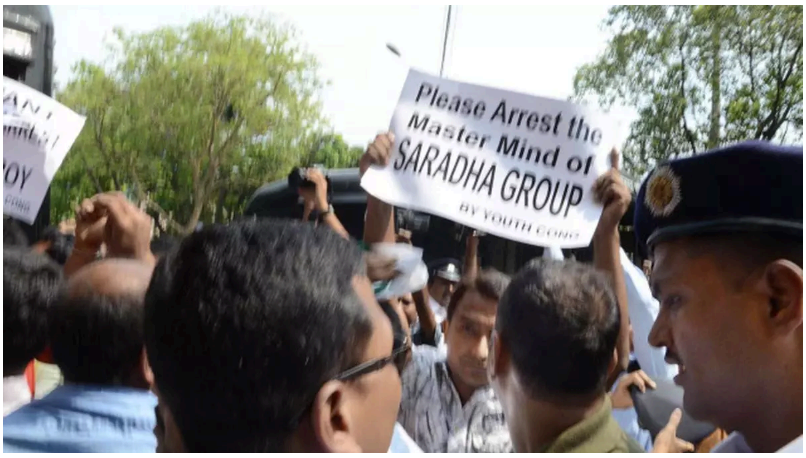

Let's hope Saradha-like scams do not recur.

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A person enjoys investing in or through a regulated market. This is because a regulated market theoretically does not have manipulated turbulence and offers a mechanism to rescue an entity in case of exigencies. Occasionally, however, because of ignorance or greed, the person gets into unregulated markets and receives the shock of her life. Thereafter, she does not venture to return even to regulated markets. This scenario largely explains the stagnant investor population in the country over the last two decades.

The unregulated market is the bane of the extant regulatory architecture. The financial market has about a dozen regulators and each of them has jurisdiction over a defined set of elements such as entities, activities, schemes, products. With the best of intentions, we end up with regulatory gaps, that is, some elements remain outside the regulatory jurisdiction.

It is because either it is not possible to identify exhaustively all the elements of the market and assign them to specific regulators, or new elements emerge after such assignment. For example, plantation schemes emerged in the mid-1990s outside the regulatory jurisdiction and collected thousands of crores of rupees from innocent investors.

When it reached the proportion of a scam, the law was amended in 1999 to bring plantation schemes within the regulatory jurisdiction of the Securities and Exchange Board of India (SEBI).

By definition

The regulatory gap also arises from the way various elements are defined in the law. For example, the law defines 'securities' to mean certain identified instruments such as shares, bonds, debentures and so on. Unscrupulous entities came up with products which were not in the list in this definition and thereby escaped regulatory jurisdiction. When a new product surfaces, or when the Government wishes to introduce a new product, the law is amended to include those products within the ambit of securities. Through this approach, the legislature notices the development of new elements in the market and then brings them within the regulatory jurisdiction through legislative interventions.

Another approach is to define the elements in such a manner that obviates the need for frequent legislative intervention. For example, at the time of enactment, the legislature could not possibly visualise all intermediaries who would need to be regulated in the future. The SEBI Act, 1992, therefore, empowered SEBI to register and regulate not only the intermediaries listed in the Act, but also intermediaries associated with the securities market in any manner.

This allows SEBI to regulate the intermediaries who are not listed in the Act, should the need arise, and new intermediaries that may emerge in future, without an amendment to the law. This approach leaves no regulatory gap.

The Securities Laws (Amendment) Ordinance, 2013, promulgated on July 18, has adopted the second approach to bridge and avoid the regulatory gaps. For example, the 1999 amendment defined the collective investment scheme (CIS) for the first time to mean a scheme offered by a company and having certain features.

The market came up with non-company structures that offered schemes with the very same features. Such schemes remained out of the regulatory jurisdiction and the investors in such schemes had no recourse. The ordinance has removed this deficiency by dispensing with the requirement of a company for a CIS. Now a scheme offered by any person and having the specified features would constitute a CIS.

Getting around the law

The law describes various

elements such as CIS and chit funds in a particular manner and has assigned these elements to different regulators. If an element, existing or emerging, does not fit any of those descriptions, it remains outside the regulatory jurisdiction. For example, if a person pools funds in a manner that is not a fixed deposit, insurance contract, chit fund, CIS, pension scheme, NBFC, mutual fund, nidhi company and others which are regulated, such pooling would have remained outside the regulatory ambit.

Taking advantage of this gap, unscrupulous entities came up with elements such as ponzi schemes, time share schemes, gold purchase schemes, emu farming, goat farming, multi-level marketing schemes, real estate development schemes and so on. The ordinance has removed this deficiency by providing a sweeping definition of CIS to mean any scheme for pooling of resources.

This is only subject to the condition that the scheme must have a corpus of at least Rs.100 crore . Thus, any pooling of funds above Rs100 crore is a CIS. Any scheme meeting the specified features is also a CIS irrespective of the size of the corpus.

It is still possible for unscrupulous people to come with a scheme for pooling funds involving a corpus of less than Rs100 crore and not meeting the specified features so as to be outside the definition of CIS. To deal with such an eventuality, the ordinance empowers SEBI to bring any scheme satisfying certain conditions to be specified in regulations, within the definition of CIS. This means that no novel way of raising resources can escape regulatory jurisdiction.

Quintessential protector

This way of defining CIS is a precursor to the Indian Financial Code which endeavours to obviate any regulatory gap. It defines 'security', for example, to mean a transferable financial instrument and includes certain specified instruments. It would now be impossible to issue an instrument which is not a 'security' and remain outside the regulatory jurisdiction.

The ordinance practically

eliminates the regulatory gap and thereby an unregulated market and is, therefore, a quintessential investor protection legislation. It has a few other welcome measures such as a special court for the speedy trial of violations of securities laws, disgorgement of unlawful gains from miscreants and its possible distribution among the victims of the misdemeanour concerned, and substantial enhancement of SEBI's powers to protect the interests of investors in securities. As rightly stated in the press release associated with the ordinance, this demonstrates the firm commitment and resolve of the Government to curb irregularities and frauds in the securities market.

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