

# *Legal Reforms: The Regulatory Perspective*

---

*N.V. Deshpande<sup>1</sup>*

## **Introduction**

An active debt market requires a broad based and well diversified investor base. Innovation and deregulation have introduced new elements of risk in market operations. Apart from counterparty risk, interest risk, price risk and settlement risk have assumed greater significance and larger proportions. Therefore, issue management techniques, as also secondary market activities like trading, clearing and settlement systems have to be efficiently and prudently organised and regulated. A notable difference between established financial markets and emerging ones is found in the extent to which their legal infrastructure has been developed. Legal regimes develop their laws and regulations to reveal the social, economic and political attributes and aspirations of the society to which they apply. In India, no doubt legal regimes developed suitable laws and regulations, but they were tailored to meet the needs of a planned economy rather than that of a free market. The change in the direction of the economy necessitates reorientation of not only the laws, but also lawyers in this jurisdiction, who may have little or no experience of the new legal regime and take time to understand the issues they raise. Herein comes the reforms connected with

---

<sup>1</sup> Legal Advisor, Reserve Bank of India  
*Paper presented in October 1997*

legal aspects of securities market activity, which not only enable smooth development of the market and efficient management of new risks, but also ensures a level playing field for competitiveness among players and information efficiency through computerisation.

### **Public Debt Act, 1944**

The Indian debt market can be conveniently classified into three broad categories – Government Securities, Public Sector Units (PSU) Bonds and the Corporate Debt Market. The law relating to Government securities and their management is laid down in the Public Debt Act, 1944. As the procedures prescribed there are archaic and time-consuming, the public have been put to inconvenience. In the wake of the tremendous increase in the volume of public debt, the Reserve Bank, agency banks and treasuries were handicapped in improving customer service. A thorough and comprehensive review was undertaken by a Committee appointed by the Reserve Bank of India. This Committee recommended a new legislation, repealing the existing Public Debt Act. The shortcomings noticed are briefly discussed below :

- The proposed legislation, to be called "The Government Securities Act", is intended to redress the woes of individual, small investors, as well as of entities like trusts. The present Act requires a chain of endorsements to be scrutinised to ensure that the successive endorsements through which the last holder derives his title are regular. This involves examination of sale power of all previous holders. It is necessary to delete Section 4 and make Section 36 of the N.I. Act applicable and thereby recognise the title of only the last holder without examining the regularity of the previous endorsements.
- The Government Securities in the form of promissory notes are not allowed to be issued to trusts under the existing Act. This is causing difficulties to trusts like Provident Funds, etc. which generally acquire G.P. Notes from brokers. This needs to be corrected.
- The existing provisions preclude the claims of legal representatives of deceased sole holders on the basis of any documents other than the probate,

## LEGAL ISSUES

---

succession certificate or letters of administration. The scope of this provision should be broadened to include claims on the strength of decree or orders of court and such other documents as may be prescribed.

- At present, nomination facility by a holder of Government security in the form of stock is available only in respect of special schemes introduced by Government of India and not available in the case of Government Securities of market loans. The nomination facility may be made applicable to individual or joint holders of stock in respect of all Government loans.
- A minor, at present, can hold Government security through a guardian. Therefore, a claim can lie by a father, or, if the father is dead, the mother, in the case of a Hindu minor, and father of a Mohammedan minor. In all other cases, guardianship certificate is required to be obtained under the Guardians and Wards Act. This has become a major irritant. By including a specific provision of "father or mother" in the proposed legislation, uniformity may be brought about in respect of all minors holding Government securities, as in the case of Public Provident Fund Scheme, 1968.
- The Joint Parliamentary Committee, which inquired into the irregularities in securities and banking transactions, observed that the Subsidiary General Ledger (SGL) form can be compared to cheques whose bouncing is now a penal offense. To prevent misuse of SGL transfer forms, dishonor of SGL forms for insufficient balance in SGL Account can be made a penal offense, and such account may be debarred from trading in Government securities, either temporarily or permanently.
- With computers being used on a large scale, it is necessary that entries in machine readable forms, microfilms, facsimile copies of documents, magnetic tapes and computer printouts in the computerised environment, are accepted as evidence in the Courts of law, etc.
- The existing Act and Rules thereunder do not provide for payment settlement. Introduction of Delivery Vs Payment System (DVP) would require provision for payment settlement. For this, an amendment may be needed to the Act and the Rules.

It is hoped that the new Act proves more market friendly and boosts the investor's confidence in Government securities.

## DVP System

Presently, a settlement in securities transactions is recorded through the submission of SGL transfer forms without a direct link with the cash settlement between the buyer and seller, when done outside a DVP system. A developed DVP system contemplates a synchronised settlement of the transfer of securities with the cash payment. For this purpose, the transfer forms must be modified to include the payment amount. When the electronic system edits the transaction after checking the seller's securities balance, it must also check the buyer's funds account to determine if there are sufficient funds to make payment. If both accounts have a sufficient balance, the transaction will be processed and accounts will be properly updated. If there is an insufficient securities balance for the seller or an insufficient funds balance for the buyer, the transaction will be rejected to be re-entered later.

In a DVP system, it is necessary to formulate and establish an overdraft policy to determine the securities processing procedures that will be followed in the book entry system. A daylight overdraft is caused when payments made for securities transfer that have been received by a bank exceed the payments received from securities that have been delivered. Some central banks are reluctant to permit daylight overdrafts in a securities account, but that by itself, does not solve the problem. In an active market, a dealer may have bought and sold securities in large amounts. If his purchases are processed prior to his sales, he may lack sufficient funds causing transactions to be rejected. This may not enable him to deliver securities and receive payment and may make it impossible for the expected receiver of funds to complete his transactions. A chain of failed transactions could thus gridlock a vibrant market. The overdraft problem therefore presents a difficult option between risking system gridlock and exposure to credit risk. It is suggested that daylight overdraft could be preferred to risking system gridlock, if the credit risk could be reduced by an appropriate legal framework. Two methods could be employed to reducing the risk. Firstly, each player may be allowed a specific credit limit, proportionate to his financial worth, and overdrafts could be allowed up to that limit. Secondly, each participant may be

allowed to pledge securities to the central bank to secure daylight overdrafts through a simple securities transfer mechanism, which incidentally, may not be against payment. To release the securities from the pledge sub account, the withdrawal would have to be duly authorised by a proper official.

### **Electronic Clearance, Settlement and Depository System**

The Nadkarni Committee recognised a need for establishing a secondary market for PSU bonds where transactions can be put through in a transparent manner and reliable market prices of these instruments can emerge. To achieve this purpose, two major recommendations were made, viz. allowing Ready Purchase Operations (REPOS) carried through limited use of Bankers Receipts (BRs), and establishing, in a phased manner, a centralised agency to operate an ECSD System. Following the submission of the Nadkarni Committee Report, a high level committee on the capital market, consisting of the RBI Governor, Chairman of SEBI and Secretary, Ministry of Finance, Government of India, accepted the need for established ECSD as a precursor to the re-introduction of the Repo facility. However, the interim arrangement suggested for restoration of Repo transactions, based on the use of BRs was not found acceptable. The Depositories Act, 1996 has cleared the decks and set a pace by removing major legal obstacles in the setting up of ECSD mechanism. It is now only a matter of time that a full-fledged ECSD becomes a part of the market mechanism.

### **Repo Transactions**

Although there are different types of repo transactions available in the international repo market, in India the only type of repo prevalent is Buy/Sell back, where agreements are entered into simultaneously for the sale and repurchase of securities at different prices. The repo transactions essentially involve a contract between a holder of securities, who wants to raise funds and an investor (purchaser) for sale of the securities to the purchaser and repurchase of the securities later at a fixed price on a fixed date. The transactions thus involve a forward contract in securities.

### Prohibition of Forward Contracts

Under Section 16 of the Securities Contracts (Regulation) Act, 1956, the Central Government has, vide Notification dated 27<sup>th</sup> June 1969, prohibited forward contracts in securities except with the permission of the Central Government. Under Section 28 of the Act, the provisions of the Act do not apply to the Government, Reserve Bank of India, any local authority or any corporation set up by a special law, or any person who has effected any transaction with or through the agency of any of these authorities. Apparently, in view of the exemption under Section 28 of the Act, the prohibition under the Government Notification should not apply to the RBI, statutory corporations like nationalised banks, some of the financial institutions, and any person who effected a transaction with or through these agencies. The present position is that, except for a limited number of agencies, repos, being ready forward transactions, are not legally permissible. Further, even for the permitted agencies, repo transactions are permitted only in the specified securities; the repos in other securities being unlawful.

### Supreme Court on Repos

The legality, or otherwise, of repo transactions, came into limelight in the context of the irregularities in securities of 1992. The Supreme Court had the occasion to consider various aspects of repo transactions in a recent decision, “BOI Finance Ltd. vs. The Custodian” reported in “AIR 1997 S.C. 1952.” The conclusions arrived at by the Supreme Court are as under :

- “The ready forward contract is severable into two parts, namely, the ready leg and the forward leg. The ready leg of the transaction having been completed, the forward leg, which alone is illegal, has to be ignored.
- With the ready leg having been performed the illegality of the forward leg contained in the agreements cannot affect the transfers which had already taken place.
- Infringements of the instructions issued by the RBI under the Banking Regulation Act prohibiting the banks from entering into buy-back

## LEGAL ISSUES

---

arrangements do not invalidate such contracts entered into between the banks and its customers.”

### Prohibition under SCR Act

According to the Court, what the notification issued under Section 16 of the Securities Contract Regulation Act did, was to prohibit the entering into of a forward contract, i.e. sale at a future date for a fixed price. While it expressly permitted sale of securities by spot delivery, represented by the ready leg in the present case, it is only the future sale or the resale of the securities at a later date which the notification did not permit. As regards the question of securities being listed or otherwise for applicability of the said notification, arguments were advanced before the Court. However, that question has not been considered by the Court. As submitted by appellants, the matter proceeded “on the assumption that the aforesaid notification applied to the securities in question, even though they were not listed on the stock exchange.”

### Severability of ready forward transactions

According to the Supreme Court, the case before them was that of one agreement, which envisaged two sale transactions. Execution of each transaction envisaged the transfer of title in the security. For arriving at this conclusion, the Supreme Court accepted the submission made on behalf of the Appellant banks, based on the provisions of Section 57 of the Contract Act. It was submitted that when the void part of an agreement can be properly separated from the rest, the latter does not become invalid. The ready forward transaction consists of two parts. In the ready leg, there is a purchase or sale of the securities at a stated price which is executed on payment of consideration for the spot delivery of the security certificates together with transfer forms. The full and absolute ownership of the title in the securities vests in the purchaser, entire property in the security passing immediately upon such delivery and payment. According to the Court, Section 57 would be attracted to the present case, the effect of which was that the first set of promises constituted a binding contract, though the second was void and unenforceable. It was noted that some of the banks which had purchased securities had sold them. According to the Court, there was nothing in the terms of ready forward transaction which

prohibited the banks, if they had sold the securities, from purchasing the securities of the same value from the market and selling the same to the broker in order to complete the second leg of the transaction. This, according to the Court, shows that two legs of the transactions are severable.

It was held that “the latter part of the agreement could not have been entered into and is clearly severable and cannot affect the transfer of the title which had already taken place at the time of the execution of the ready leg” (page 36-37 of the judgment).

### Position in law if the transactions are not severable

Having concluded that the ready forward agreement was clearly severable, the Court also considered the legal position on the assumption that the agreement was not severable. It was concluded that even on the assumption of non-severability, the position in law is that, the ready leg having been performed, the illegality of the agreement would not affect the transfer which had already taken place. Following grounds can be deduced to support this conclusion :

- Privy Council decision in “Sajan Singh vs. Sardara Ali (1960 A.C.167)”. It was held therein that if the law were not to allow the plaintiff to recover, in that case, it would leave the defendant in possession of both the property (lorry) and the money he had received for it, which, however, was not the law.
- Even though the contract may have been illegal, the transaction of sale was independent of that and did not, in any way, affect the transfer of title in the securities.
- If, pursuant to an agreement to do an illegal act, a transaction, in part, takes place which would otherwise be valid if there was no such prior agreement, then notwithstanding the illegality of the contract, the said completed transaction itself cannot be regarded as invalid.

Applying the legal principles, the Court held that the appellants in the present case have based their claim by relying not on the terms of the

ready forward contract, but on the payment of market price against delivery of the securities. "The claim to title is independent of the ready forward agreement". (page 50). The appellants, when paid the market price and took delivery of the securities, had become owners of the same. "When the transfer of title has taken place, the agreement between the parties preceding this cannot invalidate the transfer". (page 51).

### Other points raised but not considered

Some of the issues, on which arguments were advanced before the Court, but have not been considered in the judgment, may be noted as under :

- As regards the nature of ready forward transaction, it was submitted on behalf of the appellant banks that such transaction is basically a funding transaction, which proposition was not disputed by the Respondents. The judgment however, does not take note of the nature of the transaction from this angle. On the other hand, the judgment proceeds fully on the basis of it being a security transaction, where the title to the securities passed to the purchaser, under the first leg of the transaction.
- The judgment does not refer to the scheme of Securities Contracts (Regulation) Act, and in particular, its applicability to all securities.
- The judgment also does not refer to Section 28 of SCR Act which exempts, inter alia, the corporations established by law, from the applicability of the Act. It may, however, be pointed out that the position of the public sector banks being corporations established by law, and as such covered by Section 28, was not controverted during the course of arguments.

### Legalising Repos

From the above, the current legal position is that the forward or second leg of a repo transaction will be legal and valid only if it is not hit by the Government Notification prohibiting repos. Hence, unless the said Government Notification is withdrawn, it will not be possible for most intending parties (other than the few permitted ones), to lawfully participate in repos. Moreover, the securities now permitted for repos is limited. In the circumstances, the first basic legal requirement for developing repos is to withdraw the Government Notification dated 27<sup>th</sup> June, 1969.

### “Documentation”

The next question is about the legal infrastructure for facilitating repo transactions smoothly. Although repos are secured transactions, they are not risk less. Hence, the law should provide safeguards against risks associated with repos – the two main risks being default by the counterparty, and the issuer risk.

- *Counter Party Risk*

The credit risk involved in repo transactions is offset to a great extent by the fact that on default by counterparty, the cash investor can liquidate the securities received. Similarly, the seller of securities holds cash against no return of securities by the purchaser. However, when the realisable value of securities does not match the exposure, such off-setting is not adequate. Illiquid issues, defect in title and unforceability of contractual terms pose other problems.

- *Issuer Risk*

The market volatility of the security (market risk) and the risk of default by the issuer, are the main risks falling in this category. If proper legal documents are available on default by issuer, the counterparty would remain bound to make good the fall in market value of security.

Many legal regimes across the world do not require repo agreements to be documented. The legal infrastructure varies with the social, economic and political conditions of the societies in which they operate. In India, although there is a developed legal system, owing to the planned economy and the prohibition of forward contracts, the legal infrastructure providing for suitable documentation has not developed yet.

There are three different types of popular master agreements now available in the international market as under :

1. *Public Securities Master Association Repurchase Agreement (PSA MRA)*: This was published in 1996 and is governed by New York Law.

## LEGAL ISSUES

---

2. *The Public Securities Association / International Securities Market Associations Global Master Repurchase Agreement (PSA/ISMA GMRA)*: The current version was published in 1995 and is governed by English law.<sup>2</sup>
3. *Private Label Documentation*. These are developed by institutions in-house for use solely with repo transactions or in combination with other activities. The governing law would depend on the agreement and the preference of the institution concerned.

Master agreements as above set out the legal relationships between parties and general positions applicable to all repos to be documented thereunder, namely, defining terms, the delivery and payment obligations of the parties, margin mechanics, rights of substitution, treatment of income on securities involved, notice provisions, etc. Specific terms for each repo transaction may be documented separately under a confirmation.

As can be seen from the foregoing, it is essential to settle and standardise the matters to be covered under a legal agreement governing a repo transaction. The matters to be covered in such agreement may be summed up as under :

- Provision for the absolute transfer of title to securities (including any securities transferred through substitution or mark-to-market adjustment of collateral).
- Provision for daily marking-to-market of transactions.
- Provision for appropriate initial margin and for the maintenance of margin whenever the mark-to-market reveals a material change of value.
- Provision specifying clearly the events of default and the consequential rights and obligations of the counterparties.
- Provision for full set-off of claims in the event of default between the counterparties.
- Provisions clarifying the rights of the parties regarding substitution of collateral and the treatment of coupon and interest payments in respect of securities subject to it, including for example, the timing of any payments.

---

<sup>2</sup> See, Claude Brown and Julie O'Neill, *Legal Risk Analysis for Repurchase Transactions in Emerging Markets* (1997)5 JIBFL page 212. JIBFL= Butterworth's Journal of International Banking & Finance Law/May, 1997

A master repurchase agreement as above, is comprehensive and allows obligations under all outstanding repos to be set-off against each other upon default or insolvency of the counter party. It is essential to develop a similar type of system of documentation in India to enable repo in securities to gather momentum, liquidity and depth.

In short the two basic legal requirements for development of the repo market in India are :

- Withdrawal of the notification dated 27 June, 1969, prohibiting forward contracts, and,
- Development of a master agreement and related documentation for repo transactions, in that order.

### **Stamp Duty**

It is necessary to consider remission in stamp duties on the transfer of debentures since it is a major impediment in active trading and market making in debentures. However, this being a State matter, each State can consider it to boost such market making in their State. It is however desirable if there is uniformity in such stamp duty, with a ceiling after a certain amount.

### **Regulating Private Placements**

Lately, raising resources through private placements has become very popular. Resources are raised through merchant banking intermediaries, who place securities with a small number of corporates and high net-worth individuals. The private placement market has been witnessing an emergence of innovative debt instruments like step-down and step-up debentures, liquid income debentures, sub-ordinated bonds, etc. It is felt that a sound development of the private placement route needs regulatory norms and standards, like disclosure requirement in the memorandum of information, protection of investors' interests, transparency in retail private placement issues, etc. As the secondary market has remained illiquid, it calls for policy intervention on behalf of the Regulators.

## Securitisation of Loan Assets

Securitisation of loan assets is a method by which banking and financial institutions can improve their capital adequacy by liquidating risk assets of good quality at a profit. Securitisation will become increasingly feasible as interest rates fall.

### Statement of Problem

The securitisation of loan assets involves the resale of such assets to investors by the primary holders of such assets. Securitisation is particularly well developed in the USA, but is also becoming attractive in Europe. Securitisation is typically provided without recourse to the primary asset holder, which implies that the subsequent holder of the asset takes a risk on the repayment principal and interest on the original loan. Good quality loan assets are readily securitisable; however, it is also possible to “bundle” assets of varying quality and securitise such bundles.

If loan assets are to be sold in India, this conveyance transaction will attract Stamp Duty under the State Stamp Acts, as "conveyance" is an entry under the State List of our Constitution. This has impeded a smooth securitisation program as Stamp Duty payable on conveyance is generally set very high by most State Governments. An alternative mechanism for effecting securitisation would be for banks and financial institutions to sell the "economic and beneficial interest" in the loan asset (viz. the receivable on the asset). This would be done essentially by the credit institutions setting up a trust under the Indian Trust Act and constituting itself as the trustee for the investors. Further, the Trust can conveniently be set up in (say) the Union Territory of Delhi where a declaration of Trust attracts only a nominal stamp duty. The Trust will issue securities in the form of Pass-Through-Certificates (PTCs) which will be in the nature of promissory notes transferable by endorsement. As soon as certain loan assets have been securitised, as the present value of the loans in the books of the credit institutions fall to zero, the loan has effectively been liquidated in the books of the institution and replaced by cash or other consideration received. The accounting system will need to recognise the transaction in this matter, most suitably by permitting a suitable Note to the Accounts to be included.

### Procedure for Securitisation

- Identification of loans given by the credit institutions for securitisation and “bundling”.
- Declaration of trust by the credit institution for constituting itself as a trustee for the investors and for declaring that it will hold for them in trust the receivable (instalments of principal, interest, etc.) arising from the securitised loans. A trustee is essential to the transaction to take care of the interests of the investors whose numbers are expected to be large.
- The credit institutions will issue to the investors (by private placement or public issue) securities, known as Pass-Through-Certificates (PTCs) in the form of promissory notes of specified denomination for the total amount of securitised loans (for example, if the total amount of securitised loan is Rs.1,00,000, then 1000 securities of the denomination of Rs.100 each will be issued by the credit institution). The cash flows from the underlying mortgages is “passed through” to the holders of these securities in the form of periodic payments of interest, principal, etc. PTCs may attract stamp duty on the face value and are transferable by endorsement and delivery requiring no stamp duty on such transfer.
- The credit institution receives the consideration amount from the investors for the securities issued to them. On receipt of such amount, it is vital that the accounting system recognises that the securitised loans will go off the balance sheet of the credit institution.
- An additional issue needing attention is that as the PTCs are not unconditional (being without recourse), they do not strictly come within the purview of the definition of “promissory note” as contained in Section 4 of the Negotiable Instruments Act. However, the Indian Stamp Act does recognise the concept of a promissory note where the promise is conditional for the purposes of stamp duty. It is increasingly felt that this definition is now recognised in emerging case law. It would be desirable for this point to be made explicit, if necessary, by harmonising the definition of “promissory note” as contained in the Indian Stamp Act and the Negotiable Instruments Act. In the absence of suitable guidelines the current legal interpretation appears to be that the PTC is a transferable security but not a negotiable one.

- Securitisation is common in several countries with major financial systems and its main merit lies in permitting risk diversification. Further, when interest rates are falling, loans given at an earlier, higher interest rate, can be very advantageously securitised to yield capital gains for the bank or financial institution. Securitisation would thus be a facilitating approach to enhance bank profitability.
- Going by the recent press reports, several nationalised banks have placed a proposal before the Government to securitise all bad debts of Government companies in their books by converting them into low interest bonds of varying maturities<sup>3</sup>. The Government is reported to have categorically ruled out this proposal as “untenable” and “unviable”, since, if it is accepted, the banks will stop trying to recover their dues and the PSUs at fault will make no attempts to make themselves financially more viable<sup>4</sup>. If the Government agrees to the proposal, while it may wipe off NPAs from the books of the banks to that extent, and transfer the entire bad loan portfolio, at a low yield, the issue of additional bonds by the Government will add to its borrowing program and adversely impact its fiscal deficit.

## Conclusion

The legal reforms in this area have to necessarily be a gradual process, whereby the legal changes will have to be slowly introduced, phasing out existing procedures. It may happen that emerging market jurisdiction will not be able to develop legal systems to cope up with innovative and sophisticated financial products by the time they are required to address them, causing a time lag resulting from the inertia which is characteristic of most legal systems. This position however seems to be inevitable and cannot altogether be avoided, if the reforms have to be gradual. In fact, success so far achieved in the financial sector reforms and its durability can be fairly and squarely credited to the carefully measured step-by-step approach.

---

<sup>3</sup> Economic Times dated 30.9.1997

<sup>4</sup> Economic Times dated 2.10.1997