THE ROLE OF CAPITAL MARKET INTERMEDIARIES IN IFSCA: A GLOBAL PERSPECTIVE AND THE WAY FORWARD

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ABSTRACT

In the Globalised 21st century world, the nature of financial services is evolving at an accelerated pace. With the emergence of new markets in the developing nations, there has been an increase in access to market financing and innovations. Major Financial Centres across the globe have played a significant role in facilitating this growth. In the recent years, India too has adopted a similar mechanism to attract investment and embrace financial developments. The Indian parliament has formulated the International Financial Services Centres Authority Act, 2019. However, it was only after issuing certain regulations in 2021 that the IFSCA took charge of the financial sectors within its domain. One such regulation was IFSCA (Capital Market Intermediaries) Regulations, 2021. It laid down provisions on capital market intermediaries, their registration procedure, obligations and responsibilities which was earlier guided by SEBI.

This paper analyses this very regulation of 2021 and delves into the thin distinction between investors and capital market intermediaries. It evaluates how there arises conflict of interest between these intermediaries and whether these regulatory efforts serve the purpose. It attempts to compute the ambit of IOSCO principles in IFSCA (Capital Market Intermediaries) Regulations, 2021. It thereafter, compares this aspect with other developed financial centres around the globe and proposes an in-depth study of setting up of a successful IFSCA in India. It thereby recommends on how to make the IFSCA at par with the successful financial centres.

Keywords: International Financial Services Centre Authority, Global Financial Centre, Capital Market Intermediaries, IOSCO, Securities and Exchange Board of India, account aggregator, broker dealer, debenture trustee, discretionary portfolio manager and investment banker.

INTRODUCTION

The post liberalisation India has witnessed the unparalleled emergence of financial institutions and financial services. There has been an unprecedented growth in industrialization and globalization of the Indian economy. The buoyancy of the capital market too has taken a sharp spike and due to this, foreign institutional investors have shown a lot of interest in the Indian capital-market. This can be evidenced by the growth in volume of funds raised.[1] Therefore, a need was felt to make the Indian Financial markets at par with the global equivalents.

As a result of this need, India stepped up into the map of global-Financial-Centres. In the last two decades, with the advent of technological advancements in the global market, India has marked its presence by setting up an IFSC in Gujarat International Financial Tech (GIFT) City. The International Financial Services Centres Authority (IFSCA) was set up through legislation in 2019, to regulate the functioning of the IFSC. The regulation of capital markets in IFSC too falls under its purview. Hence, the regulation of financial intermediaries becomes of utmost importance for the authority as they are the middleman between two parties in a financial transaction. They facilitate proper mobilization of savings into investment. They match demand and supply; they also help in resource allocation in the best possible and smooth manner. As a result of which, Intermediaries occupy a pivotal space in today's capital market domain.

Therefore, considering the sensitivity of the market and the future of IFSC, it is imperative to keep a vigil on the growth of intermediaries. This paper analyses and elaborates on the IFSCA (Capital Market Intermediaries) Regulations, 2021 from the aforesaid stand-point in detail.

IFSC: A BACKGROUND TO SETTING UP THE 'IFSCA'

Theoretically, the origin of Financial Service Centres lies in Offshore Financial Centres. These are essentially the response of governments in developed countries to control capital flows through the imposition of restrictive domestic regulations. It started popping up in the late 1960s and early 1970s in finically advanced countries with the objective of providing government with the control over monetary policy and create a business environment to promote capital flow. Whilst most such places confined their business to their immediate local horizons, a few extended their activities Internationally. New York, London, Singapore, Frankfurt, Tokyo, Hong Kong are a few developed IFSCs around the world. Overtime, with

[1] Mayank Manish and Archana Goel, *Capital Market Intermediaries*, IJESMR, 4(4), Pg 41, April, 2017.

50% of the world's cross-border transactions ($21-$32 trillion) passing through IFCs, they are a major node of transactional financial-economic network.[2] Therefore, it becomes important to know the exact meaning of the term and analyse it accordingly.

1. Meaning:

The meaning of a financial centre is bound up in the definition of a city. Accordingly, cities or districts of cities having the facilities to conduct finances can be referred as a financial centre. On these lines, an IFC can be said to have: [3]

1) has a heavy concentration of financial institutions.
2) offers a highly developed commercial and communications infrastructure, and
3) where a great number of domestic and international trading transactions are conducted. International financial centres (IFCs) have come to represent a major economic stake. The advantages that they bring, especially in terms of jobs, incomes and wealth concentration, to the countries and cities that host them seem highly desirable.

Thus, IFC is a jurisdiction that provides International financial services to non-residents and residents in any currency except the one in that country's currency.[4]

2. IFSC in India:

In the Indian context, Special Economic Zone Act 2005 provides for IFSC. According to it, IFSC seeks to bring financial services transactions that are currently carried out overseas in other IFCs. It aims to connect the Indian financial entities with their overseas branches. It offers a centre which has been designated for all practical purposes as a location having the same eco system as the entities present offshore location, which is physically on Indian Shore.[5] On these lines, there are three broad 'imperatives' for promoting IFS in India.

The first arises from India's deepening linkages and interdependencies with other-economies of the world. This can be termed as the 'geo-economic' imperative. The second concerns the need for more efficient financial intermediation. Which may be termed as 'efficiency'

[2] Garcia-Bernardo, J., Fichtner, J, *Uncovering Offshore Financial Centers: Conduits and Sinks in the Global Corporate Ownership Network*. **7,** 6246 SCI REP, (2017).
[3] The Growth of India's Financial Services, (*Gift City Website* 2016), Accessed 12 March, 2022 [http://giftsez.com/giftcoltd.aspx]
[4] Ahmed Zoromé, *'Concept of Offshore Financial Centers: In Search of an Operational Definition,'* INTERNATIONAL MONETARY FUND, 2007.
[5] Dipesh Shah and P.K. Chugan, *Key Requirements for Setting up a Successful International Financial Services Centre (IFSC) in India*, (NICOM, 2016) accessed on March 12, 2022.

imperative. While the third concerns the 'human capital' imperative. Accordingly, there have been several reports, the one such is the 2007 report of the Percy-Mistry Committee, which estimated that India is losing US $ 50 billion per year (2015), which will grow to US $ 120 billion by 2025.[6] India has placed heavy reliance on foreign funds to finance its Current Account Deficit. This over the time, thereby, has weakened India's position globally and has had adverse implications for its economic and strategic space. Therefore, the Mistry committee's report suggested that Development of IFSC in India is the need of the hour.[7]

3. Setting up of the IFSCA:

The approval for setting up IFSC in GIFT City, Gujarat was received in 2011. However, the operating guidelines for IFSC were issued only in April 2015 Union budget. Following this, the regulators issued separate regulations to operationalize IFSC in India. Be it the Securities Exchange Board of India (SEBI), Reserve Bank of India (RBI) and the Insurance Regulatory and Development Authority of India (IRDAI), all issued regulations under the provisions of the Special Economic Zone Act. However, this was against the very idea of having a single regulator in IFSC. Having multiple regulators, i.e., RBI, SEBI, IRDAI necessitated a high degree of inter-regulatory coordination. This was detrimental to the growth of the IFSC and hence required a dedicated and unified regulatory intervention. Accordingly, in Union Budget 2018, a Unified Authority for regulating all financial services in the IFSCs was legislated. This authority was given the name of International Financial Services Centres Authority under the IFSC Authority Act, 2019. It thereby fills the lacuna of a unified regulator and provides a world. class regulatory environment by fostering ease of doing business in IFSC.

CAPITAL MARKET INTERMEDIARIES: A BRIEF SCAN

Historically, in the era of the closed markets, intermediaries were not common. This was because the buyers and sellers transacted in close proximity to one another. Therefore, the "middleman" was not required for any transaction. However, over the years, the financial market has expanded to a large extent. As a result, it is not possible for buyers and sellers to have direct-dealings. Thus, contemporary capital markets are dependent on market intermediaries. They are guided by regulators of respective countries, all of which base their

[6] Report on the HPEC making Mumbai an IFC, Percey Mistry Committee, Ministry of Economic Affairs, 2007, accessed on 15 March, 2022. [https://dea.gov.in/sites/default/files/appendix.pdf]
[7] *Ibid*.

principles on the International Organisation of Securities Commissions (IOSCO). Before understanding it in context of IFSC, it is first needed to understand the concept itself.

1. **Meaning:**

In layman's terms, market intermediaries are the bridge between capital providers and capital seekers. Accordingly, other than the issuer and the investor, whoever is operating in the capital markets may be considered a market intermediary. The regulatory aspect of these intermediaries, is provided under SEBI (Intermediaries) Regulations, 2008. It elaborates on Intermediaries under Section 11 (2) (b)[8] and section 12(1)[9] to include:

"*Stock brokers and sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers, DPs, custodians of securities, credit rating agencies, asset management companies, clearing members, trading members.*"[10]

However, it specifically excludes foreign institutional investors, foreign venture capital investors, mutual funds, collective investment schemes & VC funds from the definition.[11]

On these lines, courts have also held that "persons associated with market would include everyone who has something to do with the securities market."[12] An example of this are the audit firms. Even though, these firms do not have any direct association with share market activities, they fall under the purview of associated with 'securities market.'[13] The court in *Price Waterhouse & Co. v. SEBI*,[14] gave the reasoning that the auditing accounts of a company has a 'direct impact' on the investor's interest and market stability, thereby they are ought to be associated with the securities market, though 'not as intermediaries.'

2. **Role:**

The primary need for market-intermediaries is to match its demand and supply forces. In simpler words, they facilitate proper mobilization of savings into investment. These intermediaries facilitate economies by providing investment opportunities. They confront the

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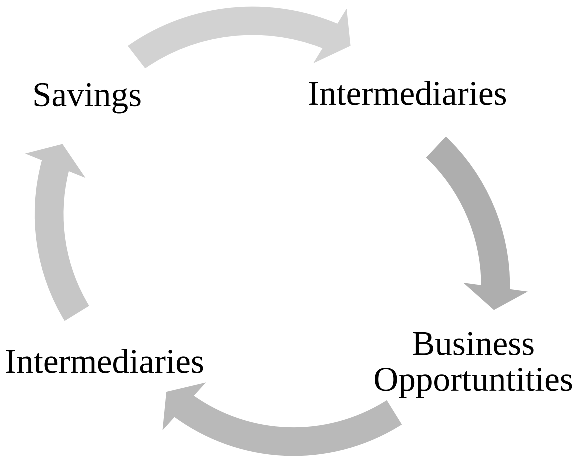
[8] SEBI (Intermediaries) Regulations, 2008, § 11(2)(b)
[9] SEBI (Intermediaries) Regulations, 2008, § 12 (1)
[10] *Ibid*.
[11] Karnavati Fincap v. SEBI, (1996) 10 SCL 5 (Guj.).
[12] Price Waterhouse & Co. v. SEBI, [2010] 103 SCL 96 (Bom.).
[13] *Ibid*.
[14] [2010] 103 SCL 96 (Bom.).

critical challenge of the allocation of savings to outlay in investments. And thereby facilitate in resource allocation in smooth manner. This can be elaborated from the following flow chart:



Economies that are able to match their resources to appropriate investment opportunities are successful. They create novel business avenues and the generation of more wealth and progress. Thus, it wouldn't be wrong to say that intermediaries can make or break economies.

In the current age of business investors and issuers are no longer homogenous. Issuers and investors today are diverse and depict heterogeneous characteristics. Therefore, to manage such diverse groups and connect them with each other, a mature market is needed. In doing so, the middlemen ought to be sophisticated and true to the client. Even considering that both investors and issuers rely heavily on intermediaries to operate in the securities market, the trust needs to be maintained by all the intermediaries at all cost.[15]

Many investors do not have adequate information, knowledge, or expertise. Even the issuers do not have adequate resources to reach out to each individual investor. Therefore, in such a case, intermediaries have a large role to fill the gap between the issuers and the investors. This makes them not only a crucial but also a sensitive pillar of the bridge named securities market.

[15] Priyanshi Singh, *Role of Intermediaries in a Securities Market*, ACADEMIKE, accessed on 12 March, 2022. [https://www.lawctopus.com/academike/role-intermediaries-securities-market/#_ednref8]

CAPITAL MARKET INTERMEDIARIES IN IFSC: ANALYSING THE 2021 REGULATION

The International Financial Services Centres Authority (IFSCA) was setup under the Department of Economic Affairs, Ministry of Finance, Government of India by a legislation in 2019. It was developed with an aim to regulate the financial services and institutions in IFSC. It will function as a unified regulator. Thereby it is empowered to exercise the powers of RBI,[16] SEBI,[17] IRDAI[18] and PFRDA. As a result of this, the IFSCA has power to regulate the intermediaries in capital markets. However, this was not always the scene, before the legislation of IFSCA, the capital market intermediaries in the IFSC were regulated by SEBI under the SEBI (International Financial Services Centres) Guidelines, 2015.[19] However, it was not serving the purpose of having a dedicated regulator in the IFSC regime. Therefore, in 2021 the IFSCA proposed a Capital Market Intermediaries) Regulations. Soon it was passed and took the shape of IFSCA (Capital Market Intermediaries) Regulations, 2021. (The regulation)

According to the 2021 regulation, the following capital market intermediaries are covered to function in IFSC:[20]

- **a)** Broker dealers
- **b)** Clearing members
- **c)** Depository participants
- **d)** Investment bankers
- **e)** Portfolio managers
- **f)** Investment advisers
- **g)** Custodians
- **h)** Credit rating agencies
- **i)** Debenture trustees
- **j)** Account aggregators; and
- **k)** Any other intermediaries as may be specified by the IFSCA from time to time.

The regulation also lays down for the Code of Conduct for the Capital Market Intermediaries under which they are mandated to maintain all standards of integrity, dignity and fairness in

[16] Reserve Bank of India.
[17] Securities and Exchange Board of India.
[18] Insurance Regulatory and Development Authority of India.
[19] SEBI (International Financial Services Centres) Guidelines, 2015
[20] IFSCA (Capital Market Intermediaries) Regulations, 2021, § 4.

the conduct of its business.[21] They are needed to be prompt, ethical and professional in manner. Intermediaries shall thereby exercise due-diligence and ensure proper care while dealing with their clients at IFSC. There have to examine the Grievances of investors and redress promptly. They need to enquire adequately and provide true and adequate information to investors. Along with this, intermediaries shall also ensure that copies of prospectus, offer documents and other details are provided to the investors. Most importantly, the regulation provides to maintain utmost confidentiality of transactions of the clients. Despite having all this, there are certain lacunas with the regulation. It needs to cover the aspects of the below mentioned challenges in future amendments.

CHALLENGES & BEYOND

The setting up of the IFSCA in India is a watershed moment for the Indian Financial Sector. However, despite this move, there persist a number of challenges to make the IFSC at par with the global equivalents. There are number of challenges even with regards to the intermediaries in the Capital markets. The important ones are elaborated as below:

1. **Conflict of Interest:**

Intermediaries in Capital markets have always had this challenge of minimising the conflict of Interest. The one in the IFSC would not be an exception to this. Conflict of Interest is basically a situation where pecuniary or other competing interests prevent a party from acting in a certain manner.[22] But still is otherwise legally or ethically appropriate. However, there is no universally accepted definition of Conflict of Interest. It can arise when there are multifaceted interests of an individual and all of there are inter se conflict.

Speaking in terms of market intermediaries, such conflicts arise because of the vast and diversified client base. The aspect of endless product innovations, undisclosed and complex market mechanics also contribute to it. Therefore, when an intermediary gets in simultaneous operations in multiple services for many clients, there arise a conflict of Interest.[23] The intermediary will tend to invest the client's funds in a manner that facilitates the expeditious recovery of the credit, regardless of the investment objectives of the client. Conflict of Interest

[21] IFSCA (Capital Market Intermediaries) Regulations, 2021, Sch. III. Part A.
[22] Ibid.
[23] Ekta M. Chotaliya, *Financial Intermediaries in Securities Market: An Indian Perspective*, IJARCSMS, vol. 2, Pg. 8, 2014.

can also occur in case of Churning wherein the intermediary is involved in excessive trading on a client's account just for maximising the income and commission.

2. **Use of Client's funds for proprietary trade:**

Intermediaries give advice to their client's, however, sometimes these advices can be motivated. They may advice something that is contrary to the demand of real circumstances. They thereafter, use the funds earned by commission to trade as per the real market conditions for their own benefit. More often than not, this taken place when the intermediary is operating in different capacities. An example of this can be an intermediary working as both market analyst and investment advisor and also as a stock broker undertaking proprietary trades. Therefore, the IFSCA needs to keep a check on this practise in the Capital market.

3. **Insider Trading:**

Insider Trading is another prevailing challenge that the IFSCA might face. Though the IFSC (Capital Market intermediaries) Regulations, 2021 mention about the same, it does not elaborate on this aspect. As per the SEBI (Insider Trading) Regulations, 1992, any dealing in securities by an insider on price-sensitive information is prohibited. Accordingly, in IFSC, any sharing of unpublished price-sensitive information would be considered under prohibition. Although the Insider-Trading-Regulations isn't specific to intermediaries, it condemns dealing in securities by intermediaries.

4. **Rapid Growth of Intermediaries:**

In the recent years, there has been a sheer growth in the number of intermediaries in Indian Capital Market. Thereby, it becomes difficult to identify the genuine and authorised intermediaries from the fraudulent ones. Therefore, it becomes essential both for the SEBI and IFSCA to keep a check on the same. They are required to publish a comprehensive updated database of all registered intermediaries, similar to what Singapore does.[24]

5. **Fixing the accountability:**

Another important challenge for the IFSCA is fixing the accountability of intermediaries. This when coupled with Managing conflicts of interests of intermediaries becomes an onerous

[24] Zame, W, *Efficiency and the Role of Default when Security Markets are Incomplete*, AMERICAN ECONOMIC REVIEW 1164 (2004). [https://ideas.repec.org/a/aea/aecrev/v83y1993i5p1142-64.html]

challenge. Thereby intensifying the complexities and diversities of the market. Therefore, it may be stated that conflicts of interests relating to intermediaries is a blend of rule-based and principle-based regulations.[25]

SETTING UP A SUCCESSFUL IFSC: TAKEAWAYS FROM GLOBAL EQUIVALENTS

In the financial arena, infrastructure places a very important role. However, developing the same is very expensive and cumbersome. Therefore, IFSCs have been created that naturally seeks to keep costs down by grouping many related activities in one location. There are many factors which contribute to its success. In order to understand it in a better way, we need to analyse the Global Financial Centres Index. This index was created by the City of London Corporation and Z/Yen Group in 2006. Since then, there have been 31 editions to it. The latest one was is the Global Financial Index 31st edition, which lays down as to what makes a successful financial centre.[26] According to it, there are five key areas of financial centre competitiveness:

1. **Business Environment**: Regulation, tax rates, levels of corruption and ease of doing business.
2. **Infrastructure:** The cost and availability of quality infrastructure, property and transport links.
3. **Market Access**: Levels of trading, clustering effects of having many financial firms in one centre.
4. **People:** The availability of good personnel and the flexibility of the labour markets.
5. **General Competitiveness**: The concept that the whole is 'greater than the sum of the parts.'

Apart from this, the Alternate Dispute Resolution (ADR) Mechanism is also needed. Considering that financial disputes cannot wait for years in the court of law for judgement, the IFSC requires a quick and efficient Alternate Dispute Redressal mechanism. Having all these components would make GIFT IFS one of the major centres across the world. It would not only bring enormous investment but would also foster the job creation in the country. Thereby, IFSC should be driven by Ministry of Finance with co-ordinated efforts in same direction by the IFSCA. This would ensure a focused attention and would enable it to derive value to the future.

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[25] Supra note at 15.
[26]Mike Wardle, *The Global Financial Centres*, Z/YEN GROUP INDEX 31, accessed March 30, 2022.[https://www.longfinance.net/programmes/financial-centre-futures/global-financial-centres-index/]

CONCLUSION

India has been working in unison to enable IFSC for offering business and regulatory environment at par with the global IFSCs. Government views this development as a time for India to ripe the IFSC and enhance capital flows through it. As it not only provides benefits to residents but also to non-residents as well. This is done for the businesses that are currently outside of India by allowing them to have an Indian presence. Therefore, having such an influx in financial services related businesses will foster qualified professionals working abroad to come to India. It'll even give Indian-professionals an opportunity to pursue global careers by residing in India. The capital market business that are currently not being done in India will get an opportunity to come to India. Thereby, developing IFSC might result in getting back capital market business which could have possibly been conducted but was shifted to other countries.

On these lines, the role of intermediaries in the IFSC capital market becomes of utmost important. The IFSCA (Capital Market Intermediaries) regulations, 2021 has been formulated in this regard. Still, the challenges of Insider trading and conflict of Interest would persist.

Therefore, considering that regulations and rules alone cannot remedy all situations, the rules need to be supplemented with enduring principles and an ethical business culture. Financial entities need to create a robust internal control system. They are needed to have self- regulation which would minimise the conflict-of-interest crisis. It would also mitigate risks while scrutinising India's regulatory approach towards the IFSC thereby fostering its ultimate growth. There clearly lies a lot of business potential in the IFSC. Despite the fact that India has been late to enter the IFSC regime, a collaboration between the Government and the financial industry would make the Indian IFSC regime reach the its intended heights.