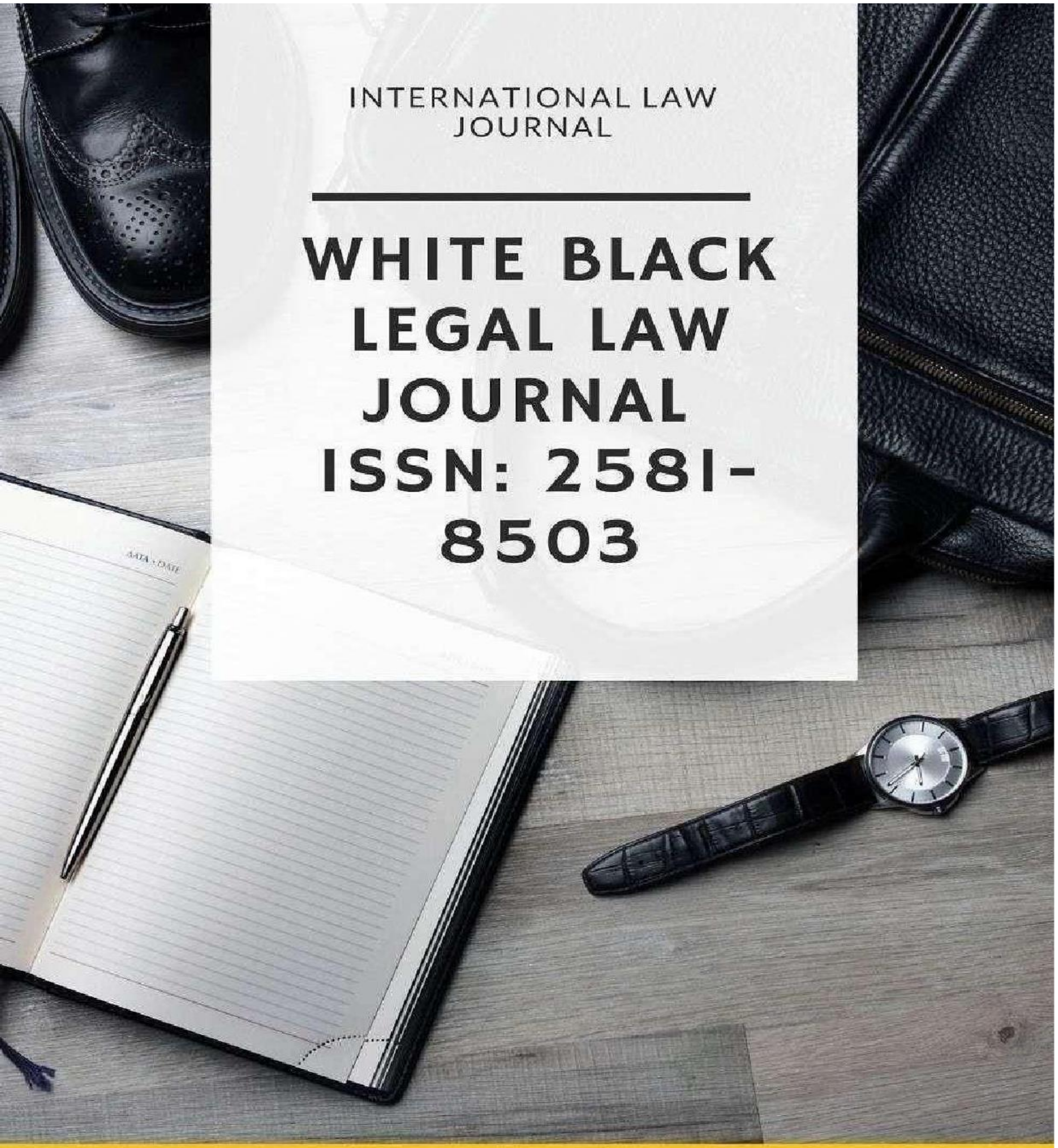

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LEGAL LIABILITIES AND CORPORATE GOVERNANCE OF INVESTMENT BANKS IN COMPLEX FINANCIAL DERIVATIVES. CRITICAL ANALYSIS UNDER THE INDIAN AND INTERNATIONAL REGULATORY FRAMEWORKS.

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ABSTRACT

Evolution of the sophisticated financial derivatives has significantly changed the business of investment banking, providing the opportunity to make money and new risks to be absorbed to financial systems by investment bankers. In India and the international financial markets, an investment bank is a bank that deals mostly in the trading and distribution of derivative products, such as swops, options, future, credit derivatives, and structured product. These instruments have however brought about grave concerns regarding legal liability, failure of risk management and deficiencies in corporate governance due to the complexity, opaqueness and leverage of these instruments. This research paper critically examines legal roles and forms of governance in investment banks when dealing with complex financial derivatives within the Indian and international regulatory frameworks. It looks at what the regulatory authorities such as the Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI), the Basel committee of Banking Supervision (BCBS) and other global law and regulations such as MiFID II and Dodd-Frank act have done to mitigate the systemic risk and market transparency. It is also the paper where the main financial scandals and controversies where derivatives are concerned are reviewed including mis-selling, insufficient disclosure of risk, and problems with valuation and mis-use of internal controls, to define the weak points in the governance of investment banking companies. A special accent is attached to the regulatory issues in the accounting of derivatives, suitability issues and the enforcement of regulatory requirements in relation to the recent regulatory issues in the banking sector about forex derivatives and internal hedging contracts. The research is comparative and analytical in nature to determine the global best practices in risk governance and fiduciary responsibility and regulation oversight to strengthen the emerging financial regulatory system to be adopted by India. The paper now concludes that within the more integrated international markets, there is the need to have effective corporate governance, robust compliance programs and enhanced legal accountability

to mitigate the risks caused by derivatives as well as protect financial stability.

INTRODUCTION

The investment banking sector is now an extremely complex artefact of the financial system, in part due to the creation of the field of financial engineering, and the wide variety of applications of complex derivatives. The derivative products such as forwards, futures, options swaps, credit default swaps, structured products are now present in the capital markets and are utilized in risk transfer, price discovery, liquidity augmentation and also in portfolio hedging. However, the same characteristics which make these instruments effective in financial terms are large sources of legal, operational and systemic risk, given the complexity, leverage and obscurity. Corporate governance and legal liability are of special concern in regard to investment banks which play significant roles in intermediating, market making and proprietary trading of derivatives, and in case of financial distress, mispricing, or mis-selling. The investment banking activities that involve dealing with derivatives are aligned according to the Indian regulatory framework primarily the securities and exchange board of India (SEBI) and the reserve bank of India (RBI) and the Companies act 2013 and the prudential guidelines of Basel III. International regulatory oversight is affected by legislation such as the Markets in Financial Instruments Directive II (MiFID II) in the European Union and the Dodd-Frank Wall Street Reform and Consumer Protection Act in the United States and Basel Committee requirements on capital adequacy and risk management. These regulatory arrangements notwithstanding, various financial crises in the years, at least the global economic crisis in 2008 have demonstrated how regulatory shortfalls, insufficient disclosure and internal controls in investment banks can cause systemic financial instability.

The biggest issue in this respect is the establishment of the legal liability scenario where substantial losses or displacement of the market is experienced in the case of derivative transactions. The liability is likely to arise because of the negligent risk management and lack of fiduciary duty or breach of disclosure, misrepresentation in structuring a product or inabilities to meet regulatory standards. There arises complications in conflicts of interest in investment banks, where the aspect of being advisors and market players introduces an additional governance and accountability issues. Hence, corporate governance mechanisms within these institutions are critical in facilitating that the board undertakes oversight, internal risk management, compliance and ethical trading behaviors.

THEORATICAL COMPARISION

The explosion of scale and complexity of the derivative markets, particularly in foreign exchange markets, interest rate swaps and equity-linked products in India have exposed a lack of adequacy in the enforcement of the legislature and administration of the institutional risk. Mis-selling derivatives to corporate customers has highlighted the loopholes in assessing the suitability, reporting risks and internal approval steps by financial institution. The issues show the need of better governance practices and legal framework on derivatives transactions.

In this regard, this study works on a critical examination of legal liabilities and corporate governance structures of investment banks within convoluted financial derivatives marketplaces. It adopts a relative point of view and weighs of the construction of the regulatory structure in India versus that in other nations and their ineffectiveness in alleviating risks, boosting transparency and imposing responsibility. The paper also looks at how poor governance and regulatory failures caused the financial turmoil and also looks at how far the financial markets can be repackaged to induce better law followance, risk management and safeguarding of the investors in more intricate markets.

In the modern financial markets, the investment banking industry serves as a centre whereby the creation of capital, risk sharing, liquidity and price discovery take place. However, the increase in the use of complex financial derivatives has changed the risk profile of investment banks to establish various exposures that cannot be easily measured, disclosed and effectively regulated. All the different forms of complex derivatives such as interest rate swaps, credit default swaps, collateralised debt obligations, structured notes, and synthetic derivatives are aimed at risk reduction, but introduce counterparty risk, market risk, liquidity risk and operational risk. These instruments are very complex and substantially reliant on valuation assumptions, model parameters and market volatility which make it very difficult to legally and governance-wise value the instruments. In this regard, legal responsibility would encompass not only the direct breach of contract, but also other obligations, such as fiduciary duty, misstatement, refusal to perform, risks managing negligence, and not doing what the regulation requires. It is the internal control systems of investment banks, therefore, that are expected to function as corporate governance systems in ensuring accountability, transparency as well as discipline in risks. However, history has revealed that the governance structures and regulations were weak even during global financial crisis and that they have contributed to the systemic weaknesses of the derivatives trading.

JUDICIAL PRONOUNCEMENT

Multi-layered regulatory frameworks have been developed to deal with the risks posed by the derivatives in investment banking both in India and within the international jurisdictions. The capital markets in India have also been subject to regulations in terms of trading in derivatives by the Securities and Exchange Board of India (SEBI), the exposure of banks to derivatives, especially in relation to foreign exchange, interest rate, and credit derivatives by the Reserve Bank of India (RBI). The Companies Act 2013 puts the governance requirements on board structure, audit committee and risk management committee. Moreover, Basel III capital adequacy requirements provide prudential safeguards through requiring banks to possess sufficient capital buffers to reimburse market and credit risks arising out of derivative positions. The SEBI guidelines are more concentrated on investor protection, suitability, norms of disclosure of risks, and margering systems and the RBI guidelines are more concerned with internal risk controls, board supervision, and stress testing mechanisms. Nevertheless, in spite of such a comprehensive regulatory framework, practical concerns on enforcement, especially concerning the nature of derivative instruments and absence of real time risk measurement on embedded risks, persist. Investment banks can possess a number of subsidiaries, jurisdiction and trading desks leading to absence of transparency of risk and aggregation of exposure information. This creates lack of connection between regulation and action whereby compliance is rather a facade rather than reality.

Other regulatory standards in derivatives markets at the global level also exist and include the Dodd-Frank Wall Street Reform and Consumer Protection Act in the United States and the Markets in Financial Instruments Directive II (MiFID II) in the European Union. The DoddFrank Act established a centralized repository of all standardized OTC derivatives, new reporting on trading aspects, and an increase in capital requirement of swap dealers and other major players in the market. It has also established a regulatory control of the earlier unregulated derivatives markets to aid in the risk of systemic control and transparency. The level of protection afforded to investors by MiFID II is vastly improved through the provision of pre-trade and post-trade transparency regulations, product governance regulations and more stringent reporting regulations on financial instruments. Basel III builds on these frameworks with the addition of liquidity coverage ratios, leverage ratios and standards for counterparty credit risk management. These advanced regulatory environments, however, have seen financial institutions show their ability to engage in regulatory arbitrage by organising offshore, inventing synthetic products and leading complex derivatives products which do not meet the regulatory threshold. It implies that although the regulatory frameworks are becoming more and more complex, they are always reactive and have trouble catching up with financial innovation.

Comparative analysis of Indian and International regulatory framework shows that there are significant differences in approach and intensity of enforcement. India is a conservative regulator with its focus being institutional regulation, and controlled market innovation rather than financial innovation. It not only dampens over-exposure to speculation, but also restricts the growth of sophisticated internal risk modelling in financial institutions. The Indian investment banks are more likely to adhere to checklists of regulatory requirements rather than risk management systems. International investment banks, on the other hand, under Dodd-Frank and Basel III regimes create very advanced internal risk management systems, such as Value-at-Risk (VaR) models, stress-testing frameworks, scenario analysis tools, and real-time risk dashboards. These systems enhance the risk awareness, but they also introduce the risk of the models themselves since mathematical assumptions can make people feel safe. The case of the global financial crisis of 2008 demonstrated that even the most advanced institutions failed to anticipate systemic risks that were engineered into the mortgage backed securities and credit default swaps since they overtrusted their quantitative models and were governed inadequately. It is very important to note how corporate governance of investment banks has contributed towards mitigation of risks that are caused by the use of derivatives. Board oversight, independent risk committees, strong internal audit and good segregation of risk taking and risk monitoring functions are essential for effective governance structures. Board of directors are expected to determine risk appetite, accept derivative trading strategies and make sure that the regulatory requirements are met. But in reality, governance failures often happen because the information the board has is not equal to the information that senior management has, especially when the board is not as knowledgeable as the management, for example in highly technical aspects like derivatives trading. The fact that derivative structures are complex, and many of the board members may lack the financial expertise to value such reports, and will have to be guided by the internal management reports which might have underestimated the risk exposure. Also, compensation regimes in investment banks can be used to tackle the incentivization of short-term profits to the detriment of long-term risk stability, to promote moral hazard and too much risk-taking. Poor whistleblower policies and absence of the autonomy of compliance units are other factors that worsen the governance problems.

Legal claims of derivative transactions have some multiple sources of liability, namely, contractual liability, tort liability (negligence-based), regulatory liability and fiduciary liability. The investment banks would be responsible of selling complex derivative products to less sophisticated clients, particularly when they fail to disclose the risks associated with them, or when they fail to do a reasonable suitability test. Liability could also occur as a result of misrepresentation of financial disclosures of risk exposure and inappropriate hedging of risks in derivative instruments as well as inaccurate valuation of derivative instruments. Indian courts have long been oriented towards the ideas of fairness, openness and good faith in financial transactions, whereas there is less experience of derivative related cases than in other courts. Nevertheless, in the circumstances of financial institutions, India has recordly been stronger in embracing superior knowledge as an enhanced obligation of care towards the client, particularly in the structured financial products.

Cases in India and other countries provide a useful clarification of responsibility and regulation of financial markets. In India, no specific case law applies to complex derivatives but general financial and corporate law applies. Authorities on the matter have in many circumstances made it very clear that disclosure is an indispensable attribute of a good financial transaction and that in respect of misrepresentation, or failure to disclose material risk, there can be a civil liability. Although this was primarily a tax case, the case of Vodafone international holdings v Union of India (2012) showed the importance of transparency structuring in complex cross-border transactions in addition to the importance of proper due diligence in the financial transactions. Similarly, in Miheer H. Mafatlal v. Mafatlal Industries Ltd. (1997), the Court affirmed the right of judicial intervention in corporate restructuring but it was barred by the criterion of fairness, transparency and absence of fraud which indirectly implies the requirement of disclosure of information. The Court emphasized the consideration of stakeholders and procedural fairness in corporate restructuring in case of Hindustan Lever Employees' Union v Hindustan Lever Ltd, which in a conceptual sense is applicable to financial governance as well.

The standards of liability in the international judicial arena after the financial crisis of 2008 give greater insights into liability standards internationally. Both the United States and the United Kingdom have seen courts deal a lot on matters relating to mis-selling of mortgage-backed securities, credit default swaps and structured investment products. Financial institutions were identified to be lax in risk disclosures, misrepresentation of the intricacy of products, and lack of adequate suitability evaluations in such cases. The decisions of this nature reiterated the principle that the investment banks should not be relieved of their duty of care owed to their clients despite being financially sophisticated. Regulatory measures by the U.S. Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) also strengthened accountability frameworks by imposing fines that were large on institutions as a result of misconducts on derivatives.

Both Indian and international regulatory framework have a dire policy-practice gap. The regulatory frameworks have been well structured, yet they fail because of the issues of enforcement, complexity of the technology and organisational interest. Derivatives markets are dynamic and evolve at a faster rate than the regulators can match. With the introduction of new financial instruments such as synthetic derivatives, algorithms trading strategies as well as AI-driven financial models, the complexity is another layer to the field, and regulators cannot effectively perform their duties. Moreover, cross-border trade activities present a challenge in respect of jurisdiction in that financial institutions may take advantage of the jurisdictional differences. Such regulatory fragmentation provides a chance to arbitrage- which undermines the functioning of these global governance structures.

The investment banks use internal control systems extensively to control their exposure to derivatives from risk management standpoint. These are the risk committees, compliance departments, internal audits and quantitative risk models. However, there are those systems that are fallible. Internal risk models are often constructed using historical data and statistical assumptions and may not be accurate in accounting for extreme markets. Useful as stress testing frameworks are, they do not have the capacity to anticipate shocks to the system. Secondly, aggregation of risks is frequently not done entirely across trading desks, subsidiaries, and may lead to lack of aggregation of total exposure. The 2008 global financial crisis made it clear that, even the well regulated institutions may fail when the risk management systems are not in tandem with the market behaviour.

At the very beginning distinguish between simple and complex derivatives. The more basic derivatives include standardised futures, forwards, swaps and options. The advantages of the same are self-evident. Examples: forward contracts are futures contracts. Plain options refer to options which are bought or sold without any risk at a given price. Fixed payments are floated by simple interest-rate swaps. Providing the incentive structure can be a value to people who are not highly financial savvy but the products could lose.

Complex derivatives vary. Examples are embedded optionality, leverage, conditional payoffs, non-linear exposures, barriers, knock-ins/knock-outs, range accrual, digital, and callable, quanto structures, correlation exposures, credit triggers, and asset-class combinations. There is no risk and asset go right. A small adjustment of the market would change the value of low. Until there is a break period and the product is determined to be hazardous. When it is not a good arrangement, it may result in them losing earnings just after a few months, with consumers losing. Legal applicability is added by non-linear structure of intricate derivatives.

Complicated derivatives require leverage. The leverage puts the parties at risk in the market with a minimal investment. Among various options a client can take is to consider a zero cost structure to them in the view of premium but a non-costly structure to them in the view of risk. Corporations are allowed to take insurance regarding the movement of currency and make a payment alternative. Unlucky things can be even more costly to the business than anticipated. Free is not equivalent with risk free. This difference is important when dealing with sophisticated derivative litigation since most customers do not know that there can be a substantial amount of underlying risk with a low- or no-premium solution.

Nominal value is important as well. You pay on the amount of paying notoriety. Immediately risky amounts are varying. The parties should not be trading a nominal of 100 crores of a certain interest rate swaps. This hypothetical value is used to trade the disparities in the payment of the interest. May cause a breakdown of communication. There is no principle transfer, rather underrating of risk by the clients. Others can contribute to the risk since they do not gain notional value. When engaging in legal strategies, the following should be taken into account: mark to market, exposure in the future, collateral requirements, and close-out amounts.

Also important is mark-to-market risk. The values of derivatives are influenced by the conditions in the market. Derivatives can be profitable or unprofitable when they come to maturity. The mark-to-market value can be paid in event of an early termination of the contract. The amount of OTC derivative is computed by banks in various ways. Neutrality, egotism and auditability result in legal issues. This will threaten the pricing power of the bank as the client is not able to refute or understand the evaluation.

CONCLUSION AND FINDINGS

Collateral and margin limits enhance risk. There would be collateral calls of derivatives with small initial payments due to adverse market movements. The derivative-hedging firm might have to offer some liquidity to cater to the margin requirement. If it is not met, it could lead to default or premature termination. Therefore, there is more to derivative risk than payment risk. And there is Liquidity risk (interim). Even a successful product may have liquidity issues before it is on hand. The boards and senior management should not be surprised because although it may still have a good commercial exposure, the firm may be affected because of liquidity pressures.

In conclusion, the most challenging issue of current financial regulation is the legal obligations and corporate governance in investment banking involved in complex financial derivatives markets. Regulatory frameworks such as the SEBI regulations, RBI guidelines and the Companies Act provisions form a structured governance environment, and international frameworks such as the Dodd-Frank, MiFID II and Basel III enhance global standards of risk management, but there is still no alignment in the design and implementation of these regulations. The market environment of investment banks is highly dynamic and complex and may be characterized by the greater rate of new financial products development as compared with the development of new regulations. Litigation tends to occur after financial harm has been inflicted, and judicial decisions across the jurisdictions prove the necessity to be open, disclose, and have fiduciary liability. Therefore, enhanced corporate governance frameworks, more technical caliber of the board, enhancing real-time reporting mechanisms of the regulating sector and motivating long-term risk steadiness are vital in reducing derivative-related risk. Without these reforms, these systemic weaknesses within the investment banking will remain as a significant threat and deteriorate the financial stability, protection of investors and integrity of the Indian and global financial market.