Policy framework for Finance SEZs

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Contents

1 Rationale **2**
1.1 The global finance business and India's place in it 2
1.2 Loss of market share in the rupee and the Nifty 3
1.3 Improving India's financial globalisation 4
1.4 Refinement of policy directions for the full country 5
1.5 The analogy with export processing zones 5

2 Statement of objectives **6**

3 Requirements for building financial services exports **7**
3.1 Law and regulation 8
3.2 Contract Enforcement and Dispute Resolution 11
3.3 Capital control issues 13

4 Strategy for policy **13**

5 The road to implemention **15**
5.1 Law and regulation 15
5.2 Contract enforcement and dispute resolution 17
5.3 Capital Control Issues 20
5.4 Taxation 20
5.5 Implementing Finance SEZ in phases 22
5.6 Actions required 23

6 Finance SEZs in the context of India's economic policy strategy **24**

1 Rationale

1.1 The global finance business and India's place in it

Finance is one of the world's biggest industries. The bulk of global financial services production takes place in a few international financial centres: New York, London, Singapore, Hong Kong and Tokyo. Finance production in these cities creates high wage jobs and wealth. In addition, high quality financial services supports high GDP growth in the hinterland. As an example, the presence of Hong Kong as an international financial centre assists Chinese companies.

India is a large user of financial services, by virtue of a large and growing GDP and a high rate of investment and savings. At present, India is consuming financial services produced onshore as well as offshore. India requires sophisticated financial services to fuel growth in the future. The financial system determines the allocative efficiency of the use of capital; a sophisticated financial system improves the GDP growth obtained out of a given flow of investment.

Apart from this perspective of India as a *consumer* of financial services, India also has an unusual opportunity in *producing* financial services, on a global scale, for four reasons:

- The skills required – Trading and risk taking, English, Mathematics, Computer Science, Law – are all things that the Indian workforce is good at.
- People of Indian origin are at the top of all global financial firms, and can easily utilise India in their plans.
- There is no established international financial centre in Indian day time. For some hours a day of the Indian daytime, India is the only rival in global finance competition.
- India has a vast hinterland economy, which small city-based financial centres like Singapore or Dubai lack. In this respect, India is like New York (with the US as its hinterland), London (with Europe as its hinterland) and Hong Kong and Shanghai (which have China as their hinterland).

These ideas were explored by the Percy Mistry Committee report, *Mumbai as an International Financial Centre*, in 2007. This report argued in favour of fundamental reform of finance, and stated that India has an opportunity to compete with London and New York if this were done.

Box 1: Loss from export of the Rupee Derivatives market

We assume that the grand total revenue stream associated with an order is 0.15%. This combines revenues of financial intermediaries, lawyers, accountants, etc. One unit of trading volume involves two orders, one to buy and one to sell. The total revenue is thus 0.3% of trading volume. Global activity on rupee derivatives is estimated at $70 billion per day. Applying the estimate of 0.3% of turnover as the revenue stream, this yields the estimate of ₹1,334 crore per day or ₹200,142 crore per year, for trading in rupee derivatives trading, is going to locations outside India. A substantial part of this trading can be captured by Indian firms, if appropriate regulatory and tax regime exists.

The Percy Mistry report articulates the long-run aspiration for what India should be. At present, no city in India can compete in this global market owing to problems of capital account restrictions, financial regulation, taxation, and urban governance. Hence, the strategy at the Ministry of Finance has been to treat the Percy Mistry report as a long term objective and undertake a gradual reforms process which takes the country towards this ultimate goal: of competing with London, New York, Singapore and Hong Kong.

While this remains the long-run goal, there is a case for the establishment of Finance SEZs, where improvements could be made on capital account restrictions, financial regulation, taxation and urban governance. The ability to setup sound policy frameworks in Finance SEZs could reduce the delay faced before India gets into the business of competing and exporting international financial services.

1.2 Loss of market share in the rupee and the Nifty

A greater urgency has developed on these questions in recent years owing to the *hollowing out* of key financial markets in India. The problems of Indian capital controls, financial regulation and taxation have led to a flight of trading in the rupee and Nifty out of the country. Roughly half of the global trading in the rupee and in the Nifty is now taking place outside India, at locations such as Singapore, Dubai, London, etc. These cities have developed active markets in India-related finance, owing to sound frameworks for capital controls, financial regulation and taxation.

These developments have significant implications. The simplest adverse implication is the loss of income in India (See box 1). Similar revenues are

associated with other India-related financial products such as Nifty, foreign borrowing by Indian companies, etc. In all these areas, India has a natural advantage. At any other location in the world, it is more difficult to understand the Indian rupee or the Nifty and thus effectively provide trading and associated services on these financial products.

It is important to pursue an array of actions through which some of this revenue stream could come back to India. On 7 June 2013, the Ministry of Finance setup a 'Standing Council of Experts on the International Competitiveness of the Indian Financial Sector' to understand and address the policy problems associated with these worrisome developments.

One element of addressing this problem is the establishment of Finance SEZs in India, through which some or all of this activity could come back to Indian soil, and generate revenues for Indian factors of production. Competing in the global financial system for India-related financial products is a subset of the larger problem of exporting financial services from India.

1.3 Improving India's financial globalisation

At present, global fund managers sit in Singapore or London, and invest in India. Indian companies go to London or New York to raise money. This inevitably favours the biggest and most famous companies who are well known in the eyes of foreign investors.

There is strong evidence of such 'home bias' by global investors against investing in most Indian companies. While large firms are well known to fund managers in Singapore or New York, thousands of other Indian companies do not get noticed. To the extent that India-related fund management takes place from Finance SEZs which are physically located in India, this will reduce home bias: The teams which work in these fund management organisations will be more likely to know hundreds of Indian companies.

This is analogous to the role played by Hong Kong for intermediating global capital flows into China. It is very difficult for fund managers in New York to know about individual Chinese companies. However, teams have been placed by all global firms in Hong Kong, from where they are better able to engage with the Chinese economy, and deliver equity and debt capital to thousands of Chinese companies.

When bad times come, foreign investors in New York or Singapore are more likely to be jittery about India. When fund management teams are physically

located in India, they are likely to have a better understanding and not react in knee-jerk ways.

When Indian firms raise equity and debt capital outside India, the financial services revenues associated with these activities accrue to the UK or Singapore economies. Salaries and tax payments take place outside India. To the extent that Finance SEZs in India are able to compete for this business, the salaries and tax payments would stay in India.

1.4 Refinement of policy directions for the full country

A substantial process of financial sector reforms is underway, with the implementation of the draft Indian Financial Code (IFC) that has been drafted by Justice Srikrishna's 'Financial Sector Legislative Reforms Commission' (FSLRC). This involves many new ideas in the law and the institutional infrastructure. The Ministry of Finance is steering this process and doing project management which leads up to this goal.

Implementing those ideas *now* in Finance SEZs is a way for those ideas to be test-driven on a relatively modest scale. This can be a pilot project before these ideas are applied on an all-India scale. There is a possibility of finding improvements on those ideas and thus learning from the test run.

1.5 The analogy with export processing zones

Export processing zones were first done in 1965 in Kandla and 1973 at SEEPZ. At the time, India was not ready for removing trade restrictions; customs duties were very high and import of many things was banned.

SEZs like SEEPZ had free trade with the world. This was a valuable learning ground where Indian firms learned how to do production in a globalised setting. Kandla and SEEPZ helped the policy community in India get used to the idea of trade openness. With a lag, these policies were applied on an all-India scale.

In similar fashion, in the long run, India will have full capital account convertibility and India will have the Indian Financial Code (IFC). This is the inevitable direction of economic reforms in India. Finance SEZs are a controlled environment in which these reforms can be implemented first, and thus increase the familiarity with these reforms in the eyes of financial firms, government agencies, global investors, etc.

Exchange	Limits
India	15% or 100mn (Higher)
DGCX	$400mn
SGX	$330mn
CME	$2,000mn

Table 1: Position limits on the INR-USD Pair in various exchanges

2 Statement of objectives

From this point of view, we may articulate the objectives of Finance SEZs as being three fold:

1. To create high value jobs by having production of financial services take place on Indian soil.
2. To create an avenue into financial globalisation, akin to Hong Kong, which would benefit the Indian economy and give policy makers an enhanced set of instruments for competing with China's moves on finance and on the international role of the Chinese Yuan.
3. To implement the new work that is on the agenda for financial economic policy at the Ministry of Finance, so as to be a laboratory where controlled experiments with new ideas in policy take place, and feedback can then be used by the Ministry of Finance to alter course for the future.

One concrete example, which will help build intuition, is the operations of a securities exchange within a Finance SEZ. This exchange should be able to compete for global customers with DGCX in Dubai or SGX in Singapore. It should be able to offer services to *Indian* users of global exchanges. An example of restrictions preventing the growth of the currency derivatives market is the position restrictions placed on currency derivatives in India on the Indian Rupee. In spite of being the natural home of the Indian Rupee, the position limits on the INR-US pair are the *lowest* in India (See table 1).

In addition to the significantly lower position limit regulations in India, pose an unique challenge of producing underlying exposure documentation for positions in excess of USD 15mn. Position limits vary by type of participants – exporters and importers position limits are also defined by their past export and import trends.

It should not have taxation related problems by virtue of enjoying residence-based taxation. It should not have capital controls, thus permitting global

customers to participate with practical frictions that are no worse than those seen with sending an order to Dubai or Singapore. It should have modern financial regulation, so that the product bans and restrictions that bedevil the Indian financial system are not a bottleneck. It should have a trustworthy regulatory system so that there is global confidence: in the absence of market manipulation, in the certainty of uture payments being made as promised, in fairness of investigations and in access to efficacious and fair judicial review.

If such an exchange can be built in a finance SEZ in India, it would be able to trade a comprehensive array of Indian and global products (without suffering from the restrictions presently imposed by Indian financial regulators). An array of securities firms and hedge funds would spring up who would trade on this exchange. It would attract orders from all over the world. This would represent exports of financial services.

There are, of course, numerous aspects to financial services. However, this example serves to fix intuition about all aspects of one important sub-component of the financial services exports which can take place from a finance SEZ in India.

It is difficult to have banks in finance SEZs as these would not have access to lender of the last resort facilities from the RBI. For some time, we may envision a world where global banks will open branches in Indian finance SEZs but there will not be *de novo* banks who are licensed to operate there.

3 Requirements for building financial services exports

As discussed in the previous section, the analogy with SEZ's for manufacturing does not fully apply to a financial services SEZ. Unlike goods, where exemption from various Indian laws was enough; financial services require some active steps from the government. These steps can be classified into three broad areas:

1. Law and regulation
2. Contract enforcement and dispute resolution
3. Capital control issues

Box 2: Legal and Regulatory regimes are intertwined with the products of a Financial SEZ

The buyer of a currency futures in Singapore is not just buying a product: He is also buying the regulations in Singapore, which assure him that the market will not be manipulated and that the contract will be honoured. Laws, regulations and their enforcement, at the place of production, are integral to the decision to buy a financial service or product that is made in a certain location. Singapore provides a strong regulatory regime protecting the integrity of the markets, a quick and efficient dispute resolution system through arbitration under a modern arbitration law and a strong enforcement mechanism which implements arbitration awards if the losing party refuses to cooperate. All these legal systems form a significant part of the *quality* of the derivatives and other financial instruments being sold in Singapore. Any financial SEZ in India will have to compete with financial centres like Singapore in providing similar *quality* of financial services.

3.1 Law and regulation

In the case of exports of goods, the technical characteristics of a particular product are entirely embedded in the product. The buyer of a ball bearing can do technical tests and determine all the technical characteristics of the ball bearing. Ball bearings have no connections with the laws or regulations that prevail in the place of manufacture.

This is not the case with financial services. As the Percy Mistry report has emphasised, *law and regulation of the home country are integral to the financial service or product* (See box 2).

For this reason, every attempt at constructing an international financial centre has gone along with an attempt at strengthening laws and the regulatory framework. As an example, when Dubai setup Dubai International Financial Centre (DIFC), an array of actions were taken on law and regulation (See box 3).

Box 3: DIFC using international legal expertise to develop

The high-level legal framework for DIFC was developed by US firm Skadden Arps. The overall design concept behind DIFC laws was to examine and build upon the best practises across the major financial centers like New York, London, Singapore, Hong Kong etc as well as some of the leading institutions like BIS, IMF, IOSCO, FATF etc. To draft the laws and regulations governing operations of DIFC, the UK magic circle law firm Clifford Chance was appointed.[a] The DIFC laws consist of a clear, fully transparent legal framework based on internationally accepted and understood concepts of business and fair dealing. The laws and regulations is also designed to be flexible enough to encourage and facilitate new product development and innovation in the region to enable DIFC licensed financial institutions to keep abreast with developments in international financial markets. These include the following laws:[b]

1. Regulatory Law 2004
2. Markets Law 2012
3. Law Regulating Islamic Financial Business 2004
4. Trust Law 2005
5. Collective Investment Law 2010
6. Investment Trust Law 2006

To support and enrich this legal framework DIFC has built a new court which hears adjudicates private disputes. The new court was staffed with well respected jurists from across the world so as to inspire credibility.[c] To provide appropriate regulatory checks and balances a separate tribunal (Financial Markets Tribunal) has been constituted to hear appeals against decisions made by the Dubai Financial Services Authority with modern rules of procedure.[d]

[a] See, Dubai International Financial Center, *Dubai International Financial Center appoints top global law firm*.
[b] See Dubai International Financial Center, *Independent Legislative Framework Based on International Standards*.
[c] See Dubai International Financial Center, *About DIFC Courts*.
[d] See Financial Markets Tribunal, *Rules of Procedure*.

Box 4: Making a law for Financial SEZ

If the IFC has not been passed as law, then a more limited strategy consists of enacting a 'Finance SEZ Act', which is a subset of of the IFC, which is only applicable within Finance SEZs. The components out of the overall IFC which are relevant are: Micro-prudential regulation, Resolution and Trading. This will require implementation work by the Ministry of Finance in setting up a specialised regulator for Finance SEZs which will enforce the Finance SEZ Act, setting up a bench of the Financial Sector Appellate Tribunal (FSAT) and setting up operations of the Financial Data Management Centre (FDMC).[a]

[a]On 30 September 2014, the Ministry of Finance has begun implementation of the FSAT and FDMC through task forces. These implementation projects would need to be modified to have a special element of operations of these new institutions in Finance SEZs.

The Indian work on Finance SEZs will need to think on a similar scale, for a comprehensive rewrite of financial law, for the institutional capacity to enforce the improved law, and sharp improvements in the working of courts.

A comprehensive framework for a world class financial system is found in the draft *Indian Financial Code* (IFC), that was drafted by Justice Srikrishna's 'Financial Sector Legislative Reforms Commission'. If this is enacted as law, and properly enforced with special attention to the requirements of financial services exports, it would address this problem. However, till such law is passed a specialised law for the Financial SEZ could be passed (See box 4).

A Finance SEZ Act, may be more feasible when compared with enacting the Indian Financial Code. This would also call for commensurate institution building to enforce this law. This suggests three alternative strategies which could be adopted:

1. Use section 18 *SEZ Act*, to notify new guidelines applicable to the Finance SEZ which may also include a new authority
2. Enact a 'Finance SEZ Act' now, and in the future this is repealed when the IFC is enacted, or
3. Enact the IFC now.

3.2 Contract Enforcement and Dispute Resolution

For a Finance SEZ to succeed, it has to provide a high degree of *predictability about enforcement of contracts*. This arises from the nature of financial services and transactions. In manufacturing the nature of contracts between a manufacturer and the buyer are relatively simple and short. Simplicity arises from fact that, most of the time, the performance of the contract can verified, by the buyer, by inspecting the goods. The length of the contractual relationship is also relatively short. Once the buyer has accepted the goods there is usually no relationship between the buyer and the seller.

Financial contracts, especially those carried out in financial centers, are different. They usually have relatively complicated contracts and require long term relationships between buyers and sellers. For example, a long term credit-default-swap (which may extend up to a decade or even longer) requires the seller to maintain adequate resources to protect against the credit-default. The terms of a credit-event or default are complicated and usually involves using more judgment than the quality of a manufactured product. Similar features are present in contracts involving equity, long term foreign exchange transactions, interest rate swaps, etc. that are commonly traded in financial centers.

The length and complexity of contracts means that disputes arising out of such contracts require:

1. The contract law to be detailed with clear outcomes for a large number of possible scenarios.
2. The legal system must have expertise to solve such contractual disputes.
3. The legal system and the law must operate with a high level of predictability and certainty.

Predictability involves the ability of parties to predict, within a high degree of accuracy; the time within which a legal dispute will be settled. Certainty involves the ability of parties to depend that the legal system will operate in a predictable way and up-hold terms of the contract as per commercial practice.

Currently, on enforcing contracts, India ranks 186 out of 189 as per the Ease of Doing Business report of the World Bank. GIFT will not function as a financial centre with such low level of enforceability of contracts. To correct this two important features have to be reformed:

1. The resolution of a contract dispute.
2. The enforcement of such resolutions.

Contract disputes can be resolved through two ways:

1. The civil court system
2. The arbitration system

An arbitration mechanism would bypass the problems of civil courts to a large extent in *resolution of disputes*. However, even an arbitration system requires an efficient judicial system, appointing arbitrators and upholding arbitration proceedings. Therefore two steps have to be taken:

1. A chamber of arbitration with professional arbitrators is set up in the Finance SEZ.
2. The High Court the state would need to be strengthened to ensure arbitrators are appointed quickly and that arbitration proceedings are protected from undue delay.

Arbitration can only resolve a dispute. If the losing party refuses to cooperate, an enforcement mechanism has to be set up to allow the winning party to enforce the arbitration award. This requires an efficient civil court system operating over the area of the Finance SEZ for enforcing awards. To implement this solution two approaches are possible:

1. Modernise the courts with territorial jurisdiction over the Finance SEZ (magistrate's court and district court).
2. Set up new magistrate's court and district court with jurisdiction over the Finance SEZ with modern facilities.

The Ministry of Finance presently has a Task Force in motion for construction of the Financial Sector Appellate Tribunal. This will develop the systems and procedures for a world class court, within the narrow objective of hearing appeals against orders of a financial regulator.

This building block is directly required for Finance SEZs. In addition, this modern court needs to be extended to perform the aditional services described above : the magistrate's court and the district court.

This can be implemented by extending the terms of reference of the Ministry of Finance 'Task Force on Establishment of FSAT'.

3.3 Capital control issues

A fully articulated mechanism is required through which firms operating within Finance SEZs can have full capital account convertibility.

As an example, Company A or parent company is a broker registered under SEBI Brokerage Regulations. It wants to establish a brokerage company in a Finance SEZ. Since Finance SEZs will be a different jurisdiction than India, investment to and fro shall be treated as cross-border transactions under FEMA. The clients of this broker may be Indian or even foreigners. If its an Indian client, the capital controls restrictions of FEMA applies to the client. Therefore, the Indian client can only invest up to the prescribed limit subject to the conditions imposed under FEMA. However, for investing in foreign securities on a foreign exchange, the Indian broker has to have a dollar account to initiate and close trades. Moreover, the Indian broker has to have permission to act as broker on the foreign exchange.

Box 5 provides a blueprint of how a Financial SEZ will functions.

4 Strategy for policy

We have established the rationale, the objectives, and the key requirements for achieving these objectives. This requires four elements of work:

1. Full capital account convertibility within Finance SEZs. This is analogous to the arrangements for export processing zones like Kandla or SEEPZ: Even though India had many restrictions on imports and exports, these were all removed within the SEZ.

2. Preferential access for India-related finance in the Finance SEZ, exactly as has been done by China for Hong Kong. Specifically, we should replicate the policies that China has setup for Hong Kong as the policies between India and Finance SEZs.

3. Establishment a modern financial regulatory framework either through enacting and enforcing a 'Finance SEZ Act', or by enacting and enforcing the IFC.

4. Residence-based taxation through which non-resident activities are exempted from taxation. This is analogous to the exemption from taxation of production-related activities in Export Processing Zone. Personal income tax would be paid by individuals working in the Finance SEZ, and corporation tax would

Box 5: Blueprint of how Financial SEZ will functions

Step 1: Company A incorporates a subsidiary in a Finance SEZ. The parent company infuses capital into the subsidiary. The initial capital will be in INR. This initial fund will be used for (a) preliminary and administrative expenses in setting-up the subsidiary; (b) seed money for conducting its business. All non-financial transactions such as payment of salaries will be in INR.

***Legal Restrictions*:** Currently, the FEMA ODI Regulations puts a cap on the total amount that parent can infuse into its subsidiary. Also prescribes conditions for such investment. Therefore, FEMA ODI Regulations need to be amended to allow infusion of capital without restrictions or conditions.

Step 2: The subsidiary has to get a broker license. And subsidiary will open a dollar account with a foreign bank in a Finance SEZ or an offshore bank.

***Legal Restrictions*:** Under FEMA, every capital account transaction is prohibited unless specifically permitted. Currently, there is no permission to Indian brokers to open a dollar denominated account for the activities mentioned above. Therefore, a specific permission under FEMA is required such that brokers can open and operate such accounts.

Step 3: The subsidiary will undertake trades on behalf of Indian clients or foreign clients on exchanges operating in a Finance SEZ or exchanges located abroad. The subsidiary can also undertake proprietary trades.

***Legal Restrictions*:** Currently, proprietary trading is not permitted by foreign investors. Since the investment by the parent company into the subsidiary is foreign investment such subsidiary cannot engage in proprietary trading. Therefore, this restriction should be relaxed for such subsidiaries.

Step 4: The subsidiary can freely remit the profits that it books either as part of proprietary trading or service fees from clients to its dollar account in Finance SEZs.

be paid by companies which operate there, but taxes related to financial activities by non-residents would be exempted. This is identical to the taxation framework used by every international financial centres.

This is a modest and feasible strategy. It will deliver high paying jobs in Finance SEZs for India. It will improve India's engagement with financial globalisation, as has been done by China using Hong Kong. It will give a controlled experiment with the working of the IFC, and potentially yield useful lessons which can improve the work of the Ministry of Finance when this Code is being implemented on an all-India scale.

5 The road to implemention

The road to implementation of a Financial SEZ will require handling all the three issues mentioned in the previous section. This would involve:

1. Law and regulation
2. Contract enforcement and dispute resolution
3. Capital control issues

The implementation roadmap for a Financial SEZ will require multiple steps and can be broken across three phases.

5.1 Law and regulation

Unlike manufacturing, where most of the control orders have been withdrawn; financial services continues to be a heavily regulated area in India. While some regulation for the protection of investors is necessary, the current system of regulations in India prohibit many transactions which are considered *normal* in most jurisdictions and are regularly carried out in financial centres. These include derivative transactions in securities, re-insurance, commodity derivatives to hedge large exposures, currency derivatives.

This has led to a gradual export of India's financial markets to international financial centres like London, Dubai, Singapore, etc. These financial centres are now providing financial services to many Indian firms as they integrate with the global economy and compete with international firms which do not face such restraints.

Section 18(2) *SEZ Act* states:

> *The Central Government may, subject to such guidelines as may be framed by the Reserve Bank, the Securities and Exchange Board of India, the Insurance Regulatory and Development Authority and such other concerned authorities, as it deems fit, prescribe the requirements for setting up and the terms and conditions of the operation of Units in an International Financial Services Centre.*

Under Section 18(2) of the *SEZ Act*, separate regulations or guidelines for a Finance SEZ which may different from regulation applying to rest of India for setting up financial units. Under this law separate guidelines may be created by which Indian and international firms may set up units/subsidiaries inside a Financial SEZ.

Section 49 *SEZ Act* states:

> *49. (1) The Central Government may, by notification, direct that any of the provisions of this Act (other than sections 54 and 56) or any other Central Act or any rules or regulations made thereunder or any notification or order issued or direction given thereunder (other than the provisions relating to making of the rules or regulations) specified in the notification–*
> *(a) shall not apply to a Special Economic Zone or a class of Special Economic Zones or all Special Economic Zones; or*
> *(b) shall apply to a Special Economic Zone or a class of Special Economic Zones or all Special Economic Zones only with such exceptions, modifications and adaptation, as may be specified in the notification.*

Currently many businesses allowed in all financial centres and most developed jurisdictions are prohibited within the territory of India. These include OTC derivatives, commodity options, re-insurance, many types of exchange traded derivatives, contingent contracts like swaps. Many of these prohibitions arise out of regulations and notifications made by the SEBI, Reserve Bank, IRDAI and other regulators. For example, other than a limited number of transactions specified by SEBI, *no securities transactions are permissible in India.*[1] Some other restrictions are under under statutory provisions (See box 6).

As pointed out in the previous section of this paper, exemption from these regulations alone does not suffice in promoting a finance SEZ. What is needed

[1] See, Securities and Exchange Board of India, *Notification*.

Box 6: Statutory provisions prohibiting normal financial transactions

An example of this is the prohibition of options under Section 19 *Forward Contracts (Regulation) Act, 1952*, which is a very common transaction in almost all financial centres. Even within India we have removed the provision for other securities under *Securities Contracts (Regulation) Act, 1952*. This restriction prohibits the development of our commodity derivatives market, which in turn forces large Indian corporations to use international markets to hedge their commodity risks.

Similarly under Section 18A of the *Securities Contracts (Regulation) Act, 1952*, the protection of contract enforcement is provided only to derivatives traded on exchanges. In effect, making all other OTC derivatives illegal. Such prohibitions prevent the development of basic financial services required by a large and rapidly internationalising economy

is a regulatory framework based on principles of consumer protection and prudential regulation, as articulated by the Financial Sector Legislative Reforms Commission. It may also be appropriate to empower a new authority to regulate and monitor financial transactions inside the Finance SEZ which is separate from the current regulators in India. This would be in lines of the Special Economic Zone Authority for an SEZ. A Finance SEZ Authority may be vested with regulatory powers to implement specific regulations and notifications with regard to financial transactions inside the Finance SEZ.

5.2 Contract enforcement and dispute resolution

An efficient dispute resolution framework for a finance SEZ should rest on two primary pillars:

1. Efficient resolution; and
2. Efficient enforcement.

In addition, the judicial system inside the Finance SEZ must be able to ensure the correct application of non-financial laws to ensure individual safety and security.

The first requirement of efficient dispute resolution is high-quality regulation that creates clear outcomes. Contract law must be unambiguous and predictable, as far as possible. The next requirement is that of an efficient

adjudicatory mechanism. A Finance SEZ will face inevitable questions relating to the adjudication of commercial contracts that may not necessarily be adversarial in nature. Additionally, it may be necessary to bypass the civil court system in the interests of speed and efficience, subject to statutory constraints. An efficient arbitration mechanism is therefore, a key requirement of the dispute resolution framework.

Any arbitration done in a finance SEZ will be subject to the *Arbitration and Conciliation Act, 1996* ("Arbitration Act"). Under the *Arbitration Act*, parties are free to contractually agree to their choice of applicable law, as well as the seat of arbitration, and have the arbitration award enforced in India, if required. IFCs world-wide (Singapore, London, Dubai and New York) provide high quality arbitration law and mechanisms. Indian businesses, and also foreign firms doing business with Indian firms often choose foreign law (such as that of Singapore) as the law applicable to their contracts, and choose foreign seats of arbitration (Dubai, London, Singapore). In order to compete with these jurisdictions, Indian finance SEZs must also provide similar facilities. This will require the following:

1. *Creating a seat and venue for arbitration on par or better than existing IFCs*: GIFT must have a court of arbitration (or a GIFT arbitration centre) that conforms to global best practices in both infrastructure and ability to resolve financial disputes efficiently. Therefore, it must also maintain a panel of internationally reputed arbitrators[2]

2. *Writing arbitration rules and procedures that create transparent, credible, and speedy outcomes comparable to other IFCs*: As explained in section 3.1, laws and regulations are integral to the success of IFCs. As an example, the Singapore International Arbitration Centre has detailed rules that apply to any arbitration dispute submitted to it.[3]

   The GIFT arbitration centre must also devise and follow similar rules of procedure that incentivise contracting parties to choose GIFT as a centre of dispute resolution.

Creating a high-performance seat of arbitration will not however, be enough. Arbitral awards will have to be enforced by the courts. Currently, on enforcing contracts, India ranks 186 out of 189 as per the Ease of Doing Business report of the World Bank. GIFT will not function as a financial centre with such low level of enforceability of contracts.

The inadequacy of the existing court system is primarily due to two factors:

[2]See, *List of aribitrators forming the SIAC Panel of Arbitrators*.

[3]See, *SIAC Rules*.

1. Outdated or inadequate procedural law; and
2. Low administrative efficiency due to lack of adoption of modern thinking on business process engineering and court management systems.

A finance SEZ such as GIFT will have to resolve these issues in order to enforce arbitral awards efficiently. The following tasks are proposed:

1. *Requirements from the Gujarat High Court*: The Gujarat High Court will the appellate authority over most GIFT disputes. Therefore, the following issues require resolution:
   (a) expeditious handling of disputes related to GIFT;
   (b) discouragement of interim orders (injunctions, stays) relating to disputes arising in GIFT, especially on all issues related to arbitration, except for rare situations; and
   (c) consistency and clarity in upholding the regulatory framework applicable within GIFT.
2. *Establishing a world-class district court for enforcement of all decrees within GIFT*: The broad principles of the design of this court are:
   (a) Modern e-filing systems and web-based interface to minimise human interface during filing;
   (b) Modern court management systems for case filing, hearing, and disposal;
   (c) Business process engineering of the administration of the court, to minimise discretion and increase the credibility of the court process;
   (d) Modern, and automated court infrastructure.

The development and design of such a court system will also be a controlled experiment, at par with many other aspects of finance SEZs (for another example, see section 6). This may later be replicated within the existing seat of the Gujarat High Court, and other courts over a period of time.

1. Stage I: Establish GIFT arbitration centre within GIFT, with appeals to be heard by the Gujarat High Court.
2. Stage II: Resolve all issues related to the jurisdiction of the High Courts over disputes arising in GIFT.

5.3 Capital Control Issues

Capital control issues in a Financial SEZ can be broadly divided into two parts:

1. **Capital controls within the Financial SEZ:** This refers to the capital control the SEZ itself faces. There can be no capital controls for the Financial SEZ. Firms inside the Finance SEZ should be free to transfer funds to and from international financial centres. Firms and clients outside India should be able freely make payments and transfer funds to entities inside the Finance SEZ with no capital controls or foreign exchange restrictions. Transactions in the Finance SEZ will carried out in international *freely convertible* currencies.

2. **Capital controls between Finance SEZ and India:** A financial SEZ in itself would be of little use to India if there are same levels of capital controls between the Finance SEZ and the rest of India is imposed as is being imposed between Indian firms and other financial centres of the world. Financial centers/SEZ should serve the firms of the hinterland. Just like manufacturing SEZ's provide opportunities to Indian firms outside such SEZ's, the Finance SEZ should provide financial services to Indian firms. This is a crucial role played by Hong Kong for mainland China (See box 7)

Therefore, two reviews of capital controls have to be carried for a Finance SEZ. The first will involve exempting the Finance SEZ from all capital controls. Second, a review of all restrictions between the Finance SEZ and rest of India have to be carried out. Decisions have to be taken to ensure that there are only *minimum* capital control restrictions between India and a Finance SEZ to encourage Indian firms from using a Finance SEZ. At all times the capital controls between India and a Finance SEZ should be *substantially more relaxed* than India and other countries.

5.4 Taxation

Taxation inside Finance SEZ has to be rationalised. This would involve both indirect and direct taxes.

With respect to indirect taxes, just like exemption from excise duties, there has to be an exemption from Securities Transaction Tax, Commodities Transaction Tax, and the Service Tax have to be exempted inside a Financial SEZ. Most financial centres do not impose transaction taxes on financial services.

Box 7: Hong Kong serving mainland China

China has restrictive capital controls, however capital controls vis-à-vis Hong Kong is more relaxed than other nations. This makes Hong Kong the preferred route through which foreign investors can invest into China. Hong Kong has a common law system, world class courts, strong regulatory system and more importantly close enough from China to enable specialists to find more information about investment opportunities in China.

Similarly, Chinese companies face a less restrictive capital control regime when accessing financial markets in Hong Kong when compared to other financial centres. An example of this is the famous *Dim Sum* bonds.[a] These are bonds denominated in Chinese Renminbi but traded in Hong Kong (where the legal tender is the Hong Kong Dollar). Similarly, in capital markets, Chinese and Hong Kong stock exchanges operate the Shanghai-Hong Kong Stock Connect (popularly known as the *through train*) which allows participants in the Hong Kong exchanges to trade on 568 Chinese companies. This allows the investors an opportunity to invest in Chinese companies under a much stronger and tested regulatory regime of Hong Kong.[b]

[a] Wong, *Development of Dim Sum Bonds in Hong Kong's Offshore RMB Market*.

[b] See *Shanghai-Hong Kong Stock Connect*.

With respect to direct taxes a decision has to be taken on the Minimum Alternate Tax to be applied on Units/firms operating in a Finance SEZ. The rate of taxation has to be competitive with other Financial Centres competing with India.

For foreign firms transacting within a Finance SEZ, a modern residence based taxation should be used. Income tax should not be imposed on non-residents using a Finance SEZ for financial transactions. The principle of tax pass through for pooling vehicles should be implemented to encourage foreign investors using Indian financial service providers for private equity, venture capital, mutual funds, etc. This will also go a long way in reducing the use of Participatory Notes.

5.5 Implementing Finance SEZ in phases

Implementing the changes required for a fully functioning Finance SEZ is not trivial. However, in the short term incremental work should be done to start off a Finance SEZ. Substantial actions can be taken under the provisions of the present *SEZ Act*, to enable a Finance SEZ.

5.5.1 Phase I: Incremental work

The Ministry of Finance must issue a set of capital control regulations, under FEMA 1999, which give Finance SEZs the identical status vis-a-vis the Indian economy as is the case for Hong Kong vis-a-vis the Chinese economy. A large number of carefully drafted regulations under FEMA need to be issued. Going by the provisions of FEMA, the power for issuing these regulations lies with RBI, which is required to consult DEA.

The Finance Bill announced on 28 February 2015 must have a provision with residence-based taxation for all activities by non-residents in Finance SEZs.

A large number of specialised regulations need to be issued by RBI and SEBI, and to a lesser extent by other financial regulators, to enable the world class working of financial activities in finance SEZs, while operating under present Indian laws. In the area of the securities market, this involves a role for FMC (which regulates commodity markets), RBI (which regulates the Bond-Currency-Derivatives Nexus) and SEBI (which regulates the equity market).

5.5.2 Phase II: A 'Finance SEZ Act'

The Ministry of Finance must immediately build specialised regulatory institutional infrastructure for enforcing this Act. This includes modifying the work of the Task Force on the FSAT and the Task Force on FDMC, to weave a Finance SEZ dimension into their work (See box 4). From some date, when the Finance SEZ Act is enacted, this institutional infrastructure would be able to enforce it.

5.5.3 Phase III: After the Indian Financial Code is enacted

The full institutional infrastructure of the IFC will need to be enforced with a special focus upon the requirements of Finance SEZs.

5.6 Actions required

1. Drafting of regulations under FEMA, 1999, through which Finance SEZs achieve controlled capital account convertibility.
2. A detailed project to identify the capital control restrictions between a Finance SEZ and the rest of India. This would also involve formulating exceptions to normal capital control restrictions so that Indian firms can transact with units/firms inside a Finance SEZ.
3. Drafting of a chapter for the Finance Bill, for 28 February 2015, which achieves residence based taxation within Finance SEZs.
4. Drafting of a large number of regulations under present laws through which the financial activities in finance SEZs come up to world class, while working under existing laws.
5. A technical project which analyses China's mechanisms for favouring Hong Kong in its international financial engagements, and design of modifications to existing capital controls so as to favour engagement with the world through Finance SEZs.
6. Drafting of a Finance SEZ Act, which is largely a subset of the IFC.
7. The Ministry of Finance needs to establish a financial regulatory institutions for finance SEZs : (a) A unified regulator; (b) A 'Financial Data Management Centre' (FDMC) ; (c) A Financial Sector Appellate Tribunal and (d) A Resolution Corporation. These four add up to a

minimal financial regulatory institutional arrangement that is required for the working of finance SEZs.[4]

6 Finance SEZs in the context of India's economic policy strategy

Kandla EPZ in 1965 and SEEPZ in 1973 were novel projects. They represented controlled experimentation with free trade while the Indian mainland was not ready for such ideas. The success of those ideas shaped and enabled the trade liberalisation which took place on an all-India scale in the following years. Today, free trade in goods has largely been achieved and the importance of the special dispensation that was given for Kandla or SEEPZ is low.

In similar fashion, Finance SEZs would be India's first experiment with the Indian Financial Code. In some years, the Ministry of Finance will get this Code enacted and implemented. Doing this immediately at Finance SEZs, however, will be a test case where knowledge can be obtained about how this works. In the long run, once the Indian Financial Code is implemented on an all-India scale, there will be no need for this special treatment of Finance SEZs.

In the future, China and India will have full capital account convertibility. In the short run, the debate about steps towards capital account liberalisation for India is taking place. However there can, however, have no objections to removing restrictions for one physical location, as was done with trade account restrictions in Kandla in 1965 and SEEPZ in 1973. Until India achieves full convertibility, there is value in having an enclave like Hong Kong or GIFT, where high value jobs are created and the domestic economy obtains a better connection with financial globalisation.

In the future, when free capital mobility has been achieved, the importance of the special dispensation that is given for Finance SEZs will be low. Thus, in the future, Finance SEZs like GIFT will thrive or fail on their own merits, competing with New York, London and Singapore. In the short term, special

[4]The PDMA is not required as there would be no government which requires investment banking services. The RBI would not be required as there is no local currency in the finance SEZ. The FRA would not be required as there are no retail consumers in a finance SEZ. The FSDC would not be required as there is little systemic risk in a finance SEZ.

efforts are required for embarking on this journey. India cannot afford to wait for a long time before stepping into the ring in this global competition.

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