Unit linked insurance products (ULIP) and Regulatory Tangle

The recent dispute between the Securities and Exchange Board of India (SEBI) and the Insurance Regulatory Authority of India has taken new dimensions with the intervention of the Finance Ministry cutting into call a draw. The main point of dispute was whether the ULIPs are insurance products or "collective investment scheme" as defined in Section 2(ba)1 read with Section 11-AA2 of the Securities and Exchange Board of India Act, 1992 (the SEBI Act). This has led to a regulatory row hitherto unknown in the centralised regulatory regime as prevalent in India.

The row brings out a need for discussion into the following issues:

(a) Nature of regulatory scheme in India
(b) Nature of regulation-entity centric or product centric
(c) Role of various regulatory agencies in regulation of collective investment schemes
(d) Nature of ULIP products
(e) Definition of "contract of insurance" as exempt from the purview of collective investment schemes under Section 11-AA of the SEBI Act.

Nature of regulatory regime in India
Regulation in India is an oft discussed topic. However, the exact nature of regulatory regime has seldom been examined. The Indian Constitution provides for the framework on which regulatory agencies work in the country. Part XI read with the Seventh Schedule of the Constitution provides the guidelines of legislative process. According to this constitutional scheme, Parliament of India and the State Legislatures shall have exclusive any matter which comes within List I and List III respectively and both Parliament of India and the State Legislatures have exclusive power to make laws regarding the matters enumerated in List II of the Constitution of India. Articles 249 to 255 provide guidelines in case of conflict between the legislative powers. These provisions have been responsible for non-overlapping of the regulatory powers in India. Further, unlike many other countries, regulation through specialised agencies is a relatively new phenomenon in India. Till very recently regulation was mainly done through the various departments of the Government itself. This is also one good reason why regulatory overlapping was not very frequent in India.

However, even during the time regulation was handled by the various departments of the Government, there were disputes as to the jurisdiction and powers of various departments. In most of these cases resolution was possible without going for a legal battle since the matter involved the same branch of the Government. However since the evolution of regulation through self sustaining corporate bodies, the dispute resolution has become more difficult especially since jurisdiction means power and no regulatory body would be willing to forgo the power that comes along with the jurisdiction.

Very recently the Raghuram Rajan Committee on Financial Sector Reforms has proposed establishment of a Financial Stability and Development Council which the Planning Commission has said would solve most of the issues relating to regulatory competition. The Deputy Chairman of the Planning Commission Mr Montek Singh Ahluwalia has reportedly3 favoured fast-tracking the process of setting up an FSDC which he thinks would solve issues where two or more regulators are involved.

Nature of regulation entity centric or product centric
As already stated the legislative scheme outlined by Article 246 of the Constitution of India states that the appropriate legislative body has power to regulate the "matters enumerated in" the relevant List of the Seventh Schedule. A reading of various entries in the Seventh Schedule would make it clear that the entries cover both entities and areas. In the case of IRDA and SEBI, Entry 43 of List I of Schedule VII of the Constitution of India reads as follows:

43. Incorporation, regulation and winding up of trading corporations, including banking, insurance and financial corporations but not including cooperative societies.

Entry 47 mentions insurance whereas Entry 48 mentions stock exchanges and future markets.

A perusal of the legislative scheme under which SEBI and IRDA work would make it clear that these bodies are established to regulate the "securities market" and "insurance business" and re-insurance business. The term "securities market" is not defined in the SEBI Act, but sub-clause (2)(a) of Section 11 of the SEBI Act gives an indication that it means any marketplace dealing in securities similar to stock exchanges. 4

The other provisions of Section 11 also give an indication that the SEBI Act deals with entities and not the business of securities, though SEBI can regulate the market through regulation of entities which play in the market. Similarly, the IRDA Act also provides for regulation of entities playing in the insurance market. While it is true that these regulatory bodies also get the power to regulate specific products through the entities floating the products, the thrust of regulation...
is always on the activities of the bodies which are regulated by these bodies. Thus it is clear that the role of agencies like SEBI and IRDA are more generic in nature viz. to control the marketplace rather than the specific products.

Further, the SEBI Act mentions certain specific type of entities5 that are coming within the purview of the regulatory regime of SEBI. Only those entities venturing into any of the activities mentioned in the SEBI Act could be regulated by SEBI. Similar is the case of IRDA. As such it should be seen that those entities carrying on a business or activity that comes within the purview and already regulated by one of such authority should not normally come within the regulatory regime of the other.

It is also pertinent to note that these entities like SEBI and IRDA are products of a liberalisation regime which did away with license raj; and any attempt by these agencies to prohibit entities from dealing with any product solely on the ground that these entities are not registered with them.

Role of various regulatory agencies in regulation of collective investment schemes  Collective investment schemes as defined in Section 2(ba) read with Section 11 AA of the SEBI Act have the following features:

1. These are schemes or arrangements by a company other than schemes exempt under Section 11 AA(3).
2. Under these schemes, the contributions, or payments made by the investors are pooled and utilised solely for the purposes of the scheme or arrangement;
3. Such contributions or payments are made by the investors with a view to receive profits, income, produce or property, whether movable or immovable from such scheme or arrangement;
4. The property, contribution or investment forming part of scheme or arrangement, whether identifiable or not, is managed on behalf of the investors;
5. The investors do not have day-to-day control over the management and operation of the scheme or arrangement.

As can be seen from this definition, this is a very wide definition, with the obvious intention to bring any collective investment scheme where investors do not have day-to-day control over management or operation of the scheme with the regulatory umbrella.

However, it has to be noted that Section 11 AA(3) excludes certain schemes from within the purview of collective investment schemes even though they are having the very same basic characteristics identified under Section 11 AA(2). The question is why? To answer this question we need to examine the exempted items, which are:

Exempted schemes/arrangementsRegulatory agency Any scheme or arrangement offered by a cooperative society registered under the Cooperative Societies Act, 1912 (2 of 1912) or a society being a society registered or deemed to be registered under any law relating to cooperative societies for the time being in force in any State;Regulatory body formed under the Cooperative Societies Act including the Registrar of the cooperative society Any scheme or arrangement under which deposits are accepted by non-banking financial companies as defined in clause (f) of Section 45-I of the Reserve Bank of India Act, 1934 (2 of 1934);Reserve Bank of India A contract of insurance to which the Insurance Act, 1938 appliesInsurance Regulatory and Development Authority of India Any pension, insurance or other scheme under the Employees€™™ Provident Funds and Miscellaneous Provisions Act, 1952Employees Provident Fund Organisation Scheme of acceptance of deposits under Section 58 A of the Companies Act, 1956Registrar of Companies Scheme of deposits by a company declared as Nidhi or Mutual Benefit Society under Section 620 A of the Companies Act, 1956Registrar of Companies Chit business as defined under Section 2 of the Chit Funds Act, 1982Officer appointed by the respective State Government Contributions in the nature of subscription to a mutual fundSEBI It is pertinent to note that each of these exempted schemes are governed by a special statute, different from the SEBI Act and the mode of regulation of these schemes is provided under the relevant statute, and is regulated by another regulator (except mutual funds).

An argument that can be advanced is that since mutual funds, which are also exempted from the definition of collective investment schemes, are regulated by SEBI itself, it would not be correct to look at the exempted products in this manner. However, it is pertinent to note that in Section 12(1 B) of the Act which provides for registration of entities carrying on collective investment scheme mentions collective investment scheme including mutual funds, thereby making it clear that the definition of collective investment scheme in Section 11 AA(2) was intended to exempt all those schemes and arrangements otherwise regulated. It is also pertinent to note that the definition of collective investment scheme and the provisions related to registration of persons carrying on such scheme were brought in through the SEBI (Amendment) Act, 2002, Section 7 (w.e.f. 29 10-2002) and on that date SEBI had in place a separate set of regulations for mutual funds called the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996.

If we see the exclusion of mutual funds from the definition of collective investment schemes, the legislative intention in exempting schemes or arrangements already regulated by various bodies from further regulation by SEBI would become crystal clear. This deduction would be further strengthened by the argument that the statutes we are discussing viz. the SEBI Act and the IRDA Act are products of liberalisation which is a philosophy antithetic to over-regulation, including regulation by multiple bodies. Viewing the scheme of the SEBI Act from this angle, it would be clear that a contract of insurance, which is regulated by the Insurance Act and IRDA would not come within the purview of the SEBI Regulations.
Nature of ULIP products One of the main issues that was raised by the order of learned Prasanth Sharan, Whole Time Member, SEBI dated 9-4-2010 was regarding the nature of ULIP products. To quote from the impugned order:

24. I conclude that ULIPs offered by the said entities are a combination of investment and insurance and, therefore, the investment components are in the nature of mutual funds which can only be offered/launched after obtaining registration from SEBI under Section 12(1 B) of the SEBI Act.7

To understand this further, we need to first look into the definition of the term â€“mutual fundâ€“. The SEBI (Mutual Funds) Regulations, 1996 define â€“mutual fundâ€“ as follows:

2. (q) â€“mutual fundâ€“TMâ€“TM means a fund established in the form of a trust to raise monies through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments or gold or gold related instruments or real estate assets; 8

The Mutual Funds Act of British Virgin Islands gives a better definition as follows:

an entity which collects and pools investor funds for the purpose of collective investment and which issues shares that entitle the holder to receive on demand, or within a specified period after demand, an amount computed by reference to the value of a proportionate interest in the whole or in a part of the net assets of the entity.

The essential features of mutual funds as per the SEBI definition are:

(a) A fund has to be established in the form of a trust,
(b) The purpose of the trust is to raise money,
(c) Money is raised through sale of units to public or a section of public under one or more schemes of investing in securities.

It is pertinent to note the following regarding this definition:
(a) The definition precedes the definition of collective investment scheme in time.
(b) Except the requirement that mutual funds are to be established in the form of a trust, the other two conditions are similar to the definition of collective investment scheme under Section 11 AA of the SEBI Act.
(c) The definition is silent as to what the holder is entitled to. It is in this light the definition of mutual funds under the Mutual Funds Act of British Virgin Islands turns out to be better than the Indian definition. In the definition of mutual funds under the Mutual Funds Act, the holder of units of mutual fund is entitled to receive on demand, or within a specified period after demand an amount computed by reference to the value of proportionate interest in the whole or in part of the net assets of the entity. This appears to be a proper definition for mutual funds.

Now let us examine the nature of ULIP products:

(a) The unit linked insurance product has two components insurance and investment.
(b) The customers are given option to choose from various funds maintained by the company as per IRDA guidelines for the purpose of investment.
(c) The customer gets the option to move from one fund to another fund, and enhance, balance or secure the returns at specified points of time.
(d) The insurance part of the product should always be active for the product to give any returns. Some of the insurance companies permit partial withdrawal of funds before maturity, in which case the funds required for insurance are parked with the insurance company. However it does not appear that any insurance company is giving a scheme where the insurance part can be totally withdrawn by the customer, keeping his funds with the insurance company only for the investment purposes.
(e) Going to the rationale of the order of SEBI dated 9-4-2010, some of the grounds taken by SEBI for coming to the conclusion that ULIPs are similar to mutual funds and the correct position regarding each of them is given in the table below: Arguments by SEBICorrect position/counter argument The attributes of the investment component of ULIPs launched by these entities are akin to the characteristics of mutual funds which issue units to the investors and provide exit at net asset value of the underlying portfolio. The definition of collective investment scheme under Section 11 AA of the SEBI Act recognises that there could be collective investment schemes outside the SEBI Regulations, including insurance products and company deposits. The investment component of ULIPs is subject to investment risks associated with securities markets which are entirely borne by the investors. There are two components of ULIPs an insurance component where the risk on the life insurance portion vests with the insurer and the investment component where the risk lies with the investor. This establishes conclusively that ULIPs are a combination product and the investment component need to be registered with and regulated by SEBI.True but it needs to be also kept in mind that the guidelines issued by the competing regulator IRDA is sufficient to hedge the investment risks. Further, it has been said that ULIPs have a mandatory insurance cover which forms a vital and inseparable part of every ULIP. In this regard I note from one of the products offered by one of the entities that for a sum assured of 15,00,000 an annual premium of 1,50,000 is collected for 10 years. The premium allocated for insurance out of this is 7500 in the first year and 3000 in subsequent years. (The annual premium for a term plan for 10 years for an identical sum assured for an identical life assured by the same company is 3342.) Here, the insurance component is 2% of the premium paid. The products offered by other
entities also follow a broadly similar pattern. Thus, the argument that insurance is both predominant and inseparable in a ULIP fails. Here instead of going into the issue whether insurance component is the vital and inseparable element, the learned Member has instead gone into the issue whether ULIP is predominant, and after coming to the conclusion that the insurance is not a predominant element, on the basis of the conclusion that the value of insurance component in case of some products is much less compared to investment component. It must be borne in mind that the issue is not whether which component is predominant, but whether the components are inseparable, since if the components are inseparable, the insurance companies would go out of the purview of the SEBI Regulations by virtue of Section 11 AA(3)(iii) of the SEBI Act. Hence it can be concluded that it is unreasonable to hold ULIPs as mutual fund products simply because the requirements under the SEBI guidelines are fulfilled, since the definition of a mutual funds in the SEBI guidelines have not been updated since the introduction of Section 11 AA in 2002 and further the legislative intention is clear in the language of Section 12(1 B), which says that, a person shall sponsor or cause to be sponsored or carry on or cause to be carried on any venture capital funds or collective investment scheme including mutual fund9, unless he obtains a certificate of registration from the Board in accordance with the regulations. (emphasis supplied) Since mutual funds are also in the exempted category in Section 11 AA(3) of the SEBI Act, the purposive inclusion of mutual funds alone within the registration requirement under Section 12(1 B) of the said Act clearly shows the intention of the legislature to exempt all other collective investment schemes, which may have some of the features of mutual funds, but are regulated by a different regulator. Now in the light of the above discussion, it can be understood that the most critical test is whether the ULIP is an insurance product.

Definition of a contract of insurance Neither the SEBI Act nor the IRDA Act defines what is a contract of insurance, though indication under both these statutes is that the contract of insurance is defined in the Insurance Act, 1938. However a perusal of the Insurance Act, 1938 would reveal that the term a contract of insurance though used in the Insurance Act, 1938 is not defined therein. However, the Insurance Act defines different types of life insurance business and also frequently refers to a contract of insurance. Hence we need to look into case laws for a proper definition of a contract of insurance.

In Prudential Insurance Co. v. IRC10 the Kings Bench defined a contract of insurance as a contract whereby one party (insurer) promises in return for a money consideration (premium), to pay to the other party (insured) money or moneyâ€™s worth on the happening of an uncertain event more or less adverse to the interest of the insured. In Gould v. Curtis11 the Kings Bench held that in case of life insurance policies, it is not necessary to have a character more or less adverse to the interest of the insured in the case of life insurance since life insurance has an investment aspect as well, such as one providing for the uncertainty of life.

From the above decisions it is apparent that insurance, especially life insurance has an integrated investment aspect as well. Even the traditional life insurance products, have the investment aspect and the payout on maturity happens by liquidating the value of the collective investment, through a complex actuarial calculation, and if the logic adopted by SEBI in its order dated 9-4-2010 is applied, all life insurance products would come within the purview of Section 11 AA(2) and this was clearly not the legislative intention as can be seen from exemption given to contracts of insurance under Section 11 AA(3)(iii) of the SEBI Act.

The question now posed is whether ULIPs specifically have the features of contract of insurance as defined in Prudential Insurance Co.12 and Gould13. In fact this issue was examined in Fuji Finance Inc. v. Aetna Life Insurance Co. Ltd. where the Court of Appeal in UK held a capital investment bonds having features identical to ULIPs, to be contracts of insurance. The arguments raised against such reckoning by the court below was that a policy is not a contract of insurance unless quantum of the payment made unless triggered by death or a contingency on life (and not same as what the insured would get on surrender of the policy), similar to the argument raised by SEBI in its order dated 9-4-2010. The Court of Appeal rejected this argument and held that since the policy came to an end on the death of the insured and the right to surrender was related to the continuance of life for it could not be exercised after the death of the insured, there was an uncertainty involved. While it accepted that a contract offering merely a surrender value would not have been an insurance policy, it held that there should be no reason why a contract that offers both death benefits and surrender benefits should not be considered as a contract of insurance. There seems to be no reason why this logic as applied to capital investment bonds is not equally applicable to ULIPs in India and hence ULIPs are contracts of insurance exempt from the regulatory purview of SEBI under Section 11 AA(3)(iii) of the SEBI Act.

Final analysis In the light of the above discussions, the following conclusions can be drawn:

(a) Regulatory regime in India, post liberalisation can bring in a scenario of regulatory competition which was hitherto unknown, and there is requirement of a dispute resolution mechanism between regulators to avoid such conflicts. Such mechanism should also ensure that before any orders which may affect the matters within the jurisdiction of another regulator, the matter has to be referred to the affected regulator and the dispute resolution mechanism and on post resolution of the dispute and/or approval of the order through the dispute resolution mechanism, such orders should be made public. This is required both for good governance, to avoid regulatory conflicts and to ensure smooth functioning and healthy growth of the financial sector.

(b) Collective investment scheme is a generic term and the essential requirements to constitute any scheme or
arrangement as provided in Section 11 AA(2) of the SEBI Act would also cover the entities exempted under Section 11 AA(3) of the said Act. The purpose of the exemption therefore is to avoid regulatory conflicts and an understanding of the exemption in this sense is missing from the SEBI order dated 9-4-2010.

(c) It is undisputed that ULIPs are combined insurance and investment products. But it should also be understood that both the insurance and investment parts are currently regulated by IRDA, and hence further regulation by SEBI is both unnecessary and contrary to the spirit of Section 11 AA(3) of the SEBI Act. Further such regulation is also not in sync with the purposes of liberalisation which gave birth to agencies like SEBI and IRDA.

(d) ULIPs which offer a combination of insurance and investment are contracts of insurance drawing the logic of Fuji Finance Inc. v. Aetna Life Insurance Co. Ltd.15 and hence are exempt from the regulatory purview of SEBI.

In the light of the discussion above, it is proper to conclude that regulatory competition at least in the case of ULIPs was perfectly unavoidable had SEBI took into account all aspects of law and regulation. However, it should not go unseen that existence of multiple regulatory bodies will create such scenes in future, since regulation means control and control means power. Hence it is pertinent to create an appropriate dispute resolution mechanism, which would pre-empt regulatory issues and resolve them before those issues go ugly. The most appropriate mechanism should be a higher body, with legal experts in Board, which would judiciously decide on issues of regulatory competition taking all the parties into confidence and which has powers to withhold the orders before they are issued. It would be only appropriate that such issues are resolved before it goes public since the impact of such regulatory issues would be much higher on individual investors than any of the regulators can imagine.

- 2. (ba) â¢œcollective investment schemeâ¢• means any scheme or arrangement which satisfies the conditions specified in Section 11-AA.
- 11-AA. (2) Any scheme or arrangement made or offered by any company under which,â€”
  (i) the contributions, or payments made by the investors, by whatever name called, are pooled and utilised for the purposes of the scheme or arrangement;
  (ii) the contributions or payments are made to such scheme or arrangement by the investors with a view to receive profits, income, produce or property, whether movable or immovable, from such scheme or arrangement;
  (iii) the property, contribution or investment forming part of such scheme or arrangement, whether identifiable or not, is managed on behalf of the investors;
  (iv) the investors do not have day-to-day control over the management and operation of the scheme or arrangement.
- (3) Notwithstanding anything contained in sub-section (2), any scheme or arrangementâ€”
  (i) made or offered by a cooperative society registered under the Cooperative Societies Act, 1912 (2 of 1912) or a society being a society registered or deemed to be registered under any law relating to cooperative societies for the time being in force in any State;
  (ii) under which deposits are accepted by non-banking financial companies as defined in clause (f) of Section 45-I of the Reserve Bank of India Act, 1934 (2 of 1934);
  (iii) being a contract of insurance to which the Insurance Act, 1938 (4 of 1938), applies;
  (iv) providing for any scheme, pension scheme or the insurance scheme framed under the Employeesâ€™ Provident Funds and Miscellaneous Provisions Act, 1952 (19 of 1952);
  (v) under which deposits are accepted under Section 58-A of the Companies Act, 1956 (1 of 1956);
  (vi) under which deposits are accepted by a company declared as a Nidhi or a Mutual Benefit Society under Section 620-A of the Companies Act, 1956 (1 of 1956);
  (vii) falling within the meaning of chit business as defined in clause (e) of Section 2 of the Chit Funds Act, 1982 (40 of 1982);
  (viii) under which contributions made are in the nature of subscription to a mutual fund, shall not be a collective investment scheme.
- Section 11(2)(a) of the SEBI Act provides that the measures mentioned in Section 11(1) deals inter alia with â¢œ(a) regulating the business in stock exchanges and any other securities markets;â¢•. (emphasis supplied)
- Section 11(2)(b) of the SEBI Act reads:
  11. (2)(b) registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with securities markets in any manner;
  (ba) registering and regulating the working of the depositories, participants, custodians of securities, foreign institutional investors, credit rating agencies and such other intermediaries as the Board may, by notification, specify in this behalf;
  (c) registering and regulating the working of venture capital funds and collective investment schemes, including mutual funds.
- Section 12(1-B):
  12. (1-B) No person shall sponsor or cause to be sponsored or carry on or cause to be carried on any venture capital
funds or collective investment scheme including mutual funds, unless he obtains a certificate of registration from the Board in accordance with the regulations.
- See, Para 24 of the order dated 9-4-2010, available in SEBI website.
- Regulation 2(q) of the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996.
- Emphasis supplied.
- (1913) 3 KB 84 at p. 95 (CA).
- Supra, n. 10.
- Supra, n. 11.
- Ibid.