Appropriate Regulatory Structure for Development

by

C.B. Bhave

Chairman, Securities & Exchange Board of India (SEBI)

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ARDESHIR DARABSHAW SHROFF
(1899-1965)

A.D. Shroff was one of those rare gifted individuals who leave an indelible mark on their environment and an impress on the hearts and minds of those who come across them. When the history of India's industrial development, particularly industrial finance, is written, his name will figure prominently. But that was not the only area wherein he excelled. His contribution to economic thinking and public education in economic affairs was equally significant. Shroff was a champion of free enterprise and a great leader of business and industry and an economist whose predictions have proved right over the years.

After graduating from the University of Bombay and the London School of Economics, Shroff started as an apprentice at the Chase Bank, London. On return to India he joined the firm of stock brokers in Bombay, Batliwalla & Karani. In 1940 he joined the Board of Tatas and became their Financial Advisor.

In 1944, Shroff, along with seven other leading industrialists like J.R.D. Tata, G.D. Birla, Kasturbhai Lalbhai and Krishnaraj Thackersey, authored what has come to be known as the 'Bombay Plan', setting out the fifteen year perspective plan, and with "the greatest possible role for the private enterprise and reducing controls to the very minimum so that private enterprise may operate under conditions of market economy."

Shroff was one of the two non-official delegates to the Bretton Woods Conference in 1944, which led to the formation of the World Bank and IMF. He ardently put forth the case for the status of India's sterling balances. Lord Keynes, a leading protagonist of the Conference, who initially described Shroff as a "highly articulate maverick – a snake in the grass trying to catch us (Britain) out and filled with suppressed malice", later on expressed appreciation of his moderate, friendly and realistic statement of India's problem.

Shroff was Chairman and Director of numerous companies. He was Chairman of Bank of India and of the New India Assurance Company for several years. He was greatly exercised by the growing socialist ideology of the Indian Government in the early 1950s culminating in the nationalization of the Imperial Bank of India, airlines and life insurance. To educate public opinion of the serious implications of these measures, and to project the great contribution private enterprise could make to speedy development of the economy, he promoted the Forum of Free Enterprise in 1956.

Having been connected with national planning earlier, Shroff believed in planning but not to the extent that it stifled individual initiative and enterprise. He was against Soviet style of comprehensive centralized planning as adopted in India which encompassed all aspects of life. Events have proved Shroff right. The liberalization of the economy in July 1991 was a vindication of Shroff's vision and economic philosophy.

Shroff passed away on 27th October 1965. At a meeting convened by the Sheriff of Bombay to condole Shroff's death, J.R.D. Tata suggested that a Trust be established to perpetuate Shroff's memory. Therefore the A.D. Shroff Memorial Trust was set up in 1967 with Nani A. Palkhivala as the Founder-Chairman. The other Founder-Trustees were: B.M. Ghia, Jaykrishna Harivallabhdas, Sir Cowasji Jehangir Bart, Tulsidas Kilachand, J.H. Tarapore and K.M.D. Thackersey.

During Shroff's birth centenary in 1999-2000, the Government released a commemorative stamp. His biography entitled *'A.D. Shroff – Titan of Finance and Free Enterprise'* by Sucheta Dalal was also published.

INTRODUCTION

This year's Annual Public Lecture organised by the A.D. Shroff Memorial Trust was on the highly topical subject of "Appropriate Regulatory Structure for Development." This was delivered by Mr. C.B. Bhave, Chairman of SEBI, who has seen the functioning of this very important organisation from a vantage point and was thus eminently suited to deal with it. The speaker handled a very difficult brief with clarity and adroitness.

The capital market regulator dealt with the issues candidly making several salient suggestions to make SEBI's operations more effective to be able to squarely face future challenges. He rightly underlined that SEBI is only 20 years old and is in an evolutionary phase, unlike the Reserve Bank of India with a vintage of 75 years. Mr. Bhave stressed the need for autonomy, in the real sense, to avoid conflict with any other regulator where there could be a perceived overlap.

The SEBI Chairman stated that price-rigging probes by his agency and investigations by other Government Departments are cleaning up the rot in the market to protect investors. Investors should be happy that wrongdoers are caught. He also alluded to the recent line of thought that a regulatory authority should not be allowed to have its own funds and that such funds should be merged with the Consolidated Fund of India. He averred that this policy, if implemented, will severely impair the autonomy of regulatory institutions. Another disturbing feature referred to by him was the lack of protection to regulators in respect of their tenure of service – leaving their dismissal to the discretion of the executive.

He went on to the core issue whether mandatory regulations were necessary in an emerging economy or can matters be best left to self-regulation. The latter has stood the test of

time in a few salutary cases where members observe a strict Code of Conduct. But in many cases it has been found to be self-serving. Hence mandatory regulation is both necessary and expedient. However, the crucial point is how well regulators function as perceived by the stakeholders and the public at large. The system can work satisfactorily only if regulators were given full autonomy and insulation from interference by the executive. This can only be ensured by appointing at least two independent members – persons of high competence and immaculate integrity, on regulatory boards set up for the purpose.

Recent public revelations about highly unsatisfactory functioning of regulatory agencies, leading to scams and frauds, has made it imperative for the Government to have a serious review of the entire system to evolve a mechanism with checks and balances to restore credibility among the citizens, which is seriously eroded.

In cases of serious misdemeanors and frauds, an Independent Public Commission of Inquiry should be set up as done in 1958 in the case of the Mundhra episode. The Commission in that case summoned independent expert witnesses. The Finance Minister and Finance Secretary were also asked to depose. The inquiry led to both these worthies being held morally responsible and they had to resign. Nothing like this has been attempted thereafter.

Mr. Bhave's presentation was lucid and discerning. He has raised many pertinent issues which deserve serious consideration. We do trust this booklet will be read, discussed and debated by a wide section of the public as it concerns the interest of millions of investors.

Minoo R. Shroff
Chairman & Managing Trustee
The A.D. Shroff Memorial Trust

Mumbai,
28th December 2010.

Appropriate Regulatory Structure for Development

by

C.B. Bhave **

It is a great honour to be invited to deliver the A. D. Shroff Annual Public Lecture. Mr. A. D. Shroff was an outstanding financial thinker and a practitioner who took great interest in organizational and ideological issues. He was known to express his views in a candid manner and without any fear of the consequences of such expression. Regulators have a reputation of not speaking much and if they do speak then not saying much. I will try to strike a balance between Mr. Shroff's forthrightness and regulatory reticence.

The world has gone through very troubled times in the last three years. Unbridled growth and development in the financial markets is no longer an accepted article of faith. Deregulation in developed markets resulted in excessive leverage being built by large institutions and financial innovation being used more to hide risk than create real value. This inevitably led to a crisis and the cost of repair is being borne by the tax payer and the economies in general. Those who are bearing the costs are, in a substantial measure, not those who reaped the benefits of unchecked growth. In the event, there is no support for development without regulation. For orderly development, regulation is a sina-qua-non. Notwithstanding the fact that regulation is a must for orderly development, we still need to enquire and debate what

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*** The author is Chairman, Securities & Exchange Board of India (SEBI).* *The text is based on the 41st A.D. Shroff Annual Public Lecture delivered under the auspices of the A.D. Shroff Memorial Trust in Mumbai on 10th December 2010.*

constitutes an appropriate regulatory structure. We need to debate issues around this especially in the Indian context.

At the very basic level, regulation means restraint and restraint is a hindrance. Thus any business subject to regulation does pay a price whether the regulation is voluntary or imposed. The question is not whether regulation will come in the way of development but whether the price we pay by accepting regulation is worthwhile or not.

If we look at various sources of regulation one can roughly say that there are three reasons why business entities agree to regulate their behaviour even though it does make them pay a price for such regulation or restraint. The first source of regulation arises from the fact that the commercial entity interacts with the outside world, suppliers, customers, financers, shareholders and so on. There are certain norms by which the entity decides to bind itself irrespective of whether there are formal rules and regulations or deterrent punishment for deviation from norms exists or not. No trader can repeatedly violate his contract even if oral, with either his customer or with his supplier. It will simply render his business impossible. One can call this self regulation at its most basic level with the source of discipline being the market place. The market place simply does not deal with you if your behaviour is substantially out of line with basic norms and we don't need the force of law here to enforce such norms.

As a second source of demand for regulation one can look at situations where entities engaged in a particular business activity may decide to come together and conclude that certain norms of behaviour are not adequately discouraged if the entire thing is left to the individual entities. Yet, the group feels that such norms need to be in place for the overall development of their business. Since such voluntary groupings of entities do not enjoy the force of law they may

decide that any behaviour against the agreed rules of behaviour will be punished by making the concerned entity lose the membership of that group. Trade Guilds, clubs, the early form of stock exchanges are examples of this. This form of regulation is commonly known as self regulation. This self regulation is not regulation of activities by the entity by itself but is the regulation of the entity by a common interest group of which that entity has agreed to be a member. For such a grouping to succeed, individual members must be able to see the benefits of membership. The price of being expelled from membership should be high enough to ensure behaviour as per the commonly agreed norms by the group itself. Our experience in India has not been entirely satisfactory in this area. Nevertheless, we need to continue our efforts at establishing credible self-regulation.

That brings us to the third category of regulation which is regulation enforced by law. The argument in such cases appears to be that the activity of entities in a particular area of operation affects the lives of more than just the member entities. In other words the society has a stake in ensuring that the entities conduct their operation in a manner that is acceptable not just to those entities but to the society at large as well. The discontentment with financial meltdown is very aptly captured by the expression 'privatisation of gains and nationalization of losses'. This sentiment is also a reflection of the fact that there are stakeholders outside the universe of finance who suffer if finance is not regulated.

The interplay between self regulation and regulation by the authority of law has been a subject of interesting discussion not only in the area of capital markets but in other fields as well. Self regulation is generally considered desirable since it is made by the entities themselves and therefore, it is considered more business friendly. Equally there are arguments that there are not sufficient incentives in self

regulation to put the interest of other stakeholders before the interests of the participating entities. In addition self regulation lacks the ability to enforce its rules beyond depriving the member concerned the membership of the group. If a significant group decides to violate norms the self regulatory structure can become unsustainable and only the backing of law can sustain such activity. In different jurisdictions efforts have been made to make the deterrent actions of self regulatory organizations stronger by granting such organizations 'recognition'. However, difficulties arise if more than one organization wants to be recognized as a self regulatory organization for entities in the same area or business. In other words if the entities split and form multiple organizations, all of which seek recognition as self-regulatory organizations, the situation is not amenable to an easy resolution. Notwithstanding the various forms of self regulatory organizations and the different degrees of strength and their deterrent actions, it is commonly accepted around the world that self regulation alone is not sufficient and an apex regulatory body is necessary.

Regulation with the backing of legislation is administered either by the Government itself or their autonomous statutory regulatory organizations. While the model of Government being a regulator itself has been tried in the past, the modern consensus is to have independent and autonomous statutory regulatory bodies. In the wake of the reforms undertaken by the Government in 1991, SEBI legislation was passed by the Parliament in April 1992. SEBI has been created as an independent statutory body.

What are regulators expected to do? The regulators set rules for conduct of market entities, the manner of conducting business, and even the tariff to be charged in certain cases. Regulators may also lay down norms for entry as well as continuity of business for entities. It is thus apparent that

regulators can enjoy powers in the area of rule making for entry / exit regulation, conduct regulation, tariff regulation, and risk containment regulation. Regulators not only set rules but are also required to keep an eye on the compliance of these rules. They therefore, end up setting up an elaborate mechanism for ensuring compliance. If despite this, the rules are breached then the regulators are charged with the duty of carrying out necessary investigation and enforcing these rules by adjudication. The list of responsibilities is fairly onerous and since the regulators combine in themselves the roles of rule making (legislative role), administration of rules and investigation if breach of rules occur (administrative function) and adjudication (judicial function), it is necessary to pay careful attention to the governance issues of regulators. It is an accepted principle that regulators need to be autonomous in discharging the duties laid down by law. A regulator, subordinate to or dependent on the executive wing of the Government will not be in a position to do proper justice to its duties.

Autonomy is not only a matter of creating appropriate structures and legal provisions but also a matter of perception. Regulatory structures in India are in different stages of evolution and therefore the thinking on autonomy and the perception of autonomy has not yet fully crystallized. The Reserve Bank of India as a regulator has been in existence for more than 75 years and therefore, the relationship between the executive branch of the Government and the RBI is far more evolved compared to the relationship of regulators which are of more recent origin. SEBI is in its 19th year and stands somewhere in the middle of regulatory evolution – it is more evolved compared to the regulators that have been set up in this century but has lesser history when compared to the Central Bank. The first Chairman of statutory SEBI, Mr. G. V. Ramakrishna, once famously remarked in the early days that brokers of BSE should know

that the route from Dalal Street (BSE) to Mittal Court (SEBI HO then) is not via the North Block (Finance Ministry, Delhi). The brokers at that time had not got used to the idea of a regulatory body having been formed which would independently set regulations. Capital market regulation was part of the Ministry of Finance functions till the formation of SEBI. They therefore had a tendency to run to the Government for every little problem. The tension between the executive branch of the Government and the regulatory bodies is not a phenomenon only during the early stages of regulation nor is it peculiar to India alone. Both the regulators and the executive need to nurture this relationship in a manner that reinforces regulatory autonomy. It is not easy for the executive to deal with this especially when the very powers that were exercised by the executive are transferred to the regulator. It is imperative in this context to make sure that there are adequate supportive provisions in law and the rules to support the autonomous character of the institutions.

To maintain the autonomous character of the institutions and its independence from the executive one needs to start at the process of the appointment and the terms of removal of the Members of the regulatory apparatus. Interestingly, the framers of the Indian Constitution saw the importance of this aspect in institutions such as the Election Commission, the Higher Judiciary namely High Courts and Supreme Courts and the Comptroller and Auditor General of India. The Constitution makers were very careful in providing for the conditions for removal of persons at the helm of these bodies even while recognizing that the appointments will be made by the executive. These autonomous institutions have served India well. The prolonged tension between the Election Commission and the other organs of the Government is an example of how constitutional protection delivered a powerful and autonomous Election Commission which admirably served the cause of democracy. The regulators do not enjoy

protection in terms of the conditions under which their services can be dispensed with by the executive. In fact the regulators are at the other end of the spectrum in terms of provisions for their removal. In SEBI, the Members and the Chairman are appointed for a tenure of certain number of years or until further orders whichever is earlier. A tradition has been established that regulators are not removed from their jobs as easily as the functionaries in the executive itself. There is no known example of the executive having resorted to the clause 'until further orders whichever is earlier' to remove the functionaries of the regulatory organizations. Whether it is sufficient to rely on tradition or whether we need a better legal mechanism with checks and balances needs to be debated, so that this important aspect of governance is not ignored.

A vital component of autonomy is financial autonomy. In case of SEBI and some other regulators such as IRDA this autonomy was built into the legislation by way of providing that such authorities will establish a separate fund into which the fees paid by the market intermediaries will be credited. Such funds are to be used by the authorities for discharging the functions entrusted to them by law. Currently there is a line of thought – as you must have all read in the media - that the regulatory authorities should not be allowed to have funds of their own but these funds should be merged with the Consolidated Fund of India. If the Government finally accepts this line of thinking, substantial damage will be done to the autonomy of regulatory institutions. If the regulators have to depend on the executive for release of funds the question of independent behaviour by the regulators would be jeopardized. It is necessary to carefully consider the pros and cons of taking away financial autonomy from regulators.

The function of investigation in case of breach of rules is an area that hinges in a vital manner on autonomy from the

executive wing. Regulators by the definition of their responsibility have investigative wings. This function has come under increasing judicial scrutiny and the movement of the last 15 to 20 years has been to free the investigation function from the possibilities of influence by the executive. The CBI is a case in point. Under the direction of the Supreme Court the supervision of this institution is with the Chief Vigilance Commission which in itself is an independent statutory authority. I would therefore, argue that regulatory autonomy vis-à-vis the executive wing of the Government is not only necessary but is essential.

Any governance structure based on autonomy must also look into the question of accountability. Since regulators have multiple roles, part legislative, part administrative and part adjudicatory, the accountability in the three areas is handled in different ways. Regulators are creatures of law and the ultimate supervisory authority of the Parliament to assess whether the regulators are discharging the functions assigned to them is supreme. The Comptroller and Auditor General of India is empowered under the regulatory provisions to audit accounts of the regulators and submit reports to the Parliament to help the legislative in its assessment. In addition the regulators are required to prepare an annual report on their activities and lay it on the table of both Houses of Parliament.

The adjudicatory function of the regulators has been treated differently and by its nature has to be a subject matter of supervision by judicial bodies. A mechanism in the form of Securities Appellate Tribunal headed by a retired High Court Judge and an appeal provision to the Supreme Court of India forms an integral part of SEBI legislation. The rule making powers of SEBI are supervised by the Parliament in order to ensure that the rule making is confined to the powers granted by the Parliament to the regulators. If the regulators exercise

power beyond the permissible limit of legislation the rules can also be challenged in the courts of law. In the rule making function the regulators do interact with the executive branch of the Government. The executive wing of the Government will have legitimate imputs into the rule making process and a fine balance is required between the need for autonomy and the need for harmonization. This is achieved through the presence of Government representatives in the Board of SEBI.

In conclusion, it is quite clear that attempts at unregulated development not only in a particular sector but even in small sub-sections of sectors have failed. The failure is mainly because such development ultimately leads to crisis. The cost of resolving such crisis is high and the burden of the cost is borne not just by those who benefited from the development but a large portion is borne by those who were not part of the recipients of the benefits. Clearly the collateral damage is very high.

The question is, therefore, not so much as to whether development and regulation are in conflict as the quality of regulation that will enable us to find a balance between the needs of development and the need to keep the risk-reward relationship appropriate. It is necessary to carefully think and design proper regulatory structures, ensure regulatory autonomy and make sure that there are checks and balances in the system to address the concerns of accountability as well.

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