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Expert Expressions
Corporate Governance Demystified

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REGULATORY PHILOSOPHY – REFORMIST OR PUNITIVE?

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Regulatory interventions vary from the equivalent of capital punishment to a slap on the wrists. Is there any hope that regulatory philosophies will converge?

One of the sharpest exchanges reported in economic history was between Ricardo and Malthus. When Ricardo mocked Malthus' economic thought, and referred to it as the philosophy of poverty, Malthus shot back by saying that Ricardo's thoughts reflected the poverty of his philosophy.

Regulatory philosophy of organisations, as well as those that lead them, often influences conduct and behaviour in the regulated universe. In the context of action taken regarding a big player in the financial system, Uday Kotak is reported to have observed that Regulators should not be too conservative and cautious, but should respond fast to accidents in the financial sector. He added that a zero accident policy was dangerous.

With a number of high-profile cases inviting regulatory attention, it is useful to ask ourselves whether regulation should be strict or lenient. In other words, will "light touch regulation" be adequate for transgressions in the financial sector? Is a slap on the wrist sufficient disincentive or deterrent for those inclined to take liberties with laws and regulations? At the other end of the spectrum, should a large number of activities lend themselves to criminal action in the case of abuse, misuse or omissions?

The philosophy of regulation is a material determinant influencing whether business can be carried out smoothly, or will be subject to repeated disruptive interventions by the persons blowing the whistle. Will the absence of strict regulation be interpreted as the Regulator turning a blind eye to misconduct that has systemic implications?

For years, the central questions was whether regulations should be rule-based or principles-based. Those that were directly dealing with compliance matters felt that rule-based regulation was easier to understand and implement, and did not leave room for interpretation. On the other hand, persons at the highest levels in the organisation sought comfort in the nebulous arrangement called "principles-based regulation". It was their concerned view that if strict rules were in place, we could end up throwing out the baby with the bathwater, and dealing a death blow to entities that had resorted to minor transgressions. Taxation laws, all over the world, are subject to strict interpretation, leaving little room for discretion in decision-making. Will a similar approach in financial sector regulations lead to extinguishing initiative, and obstructing the smooth conduct of business?

Administrative law contemplates the exercise of discretionary powers. However, they are subject to guidelines to prevent uneven treatment of similar cases, and to curb irrational decision-making, unconnected with the specifics of the situation. Is it worthwhile importing into financial sector regulations, the exercise of discretionary powers, with guardrails and guidelines?

Should regulation aim for dealing with a large number of instances of misconduct or should it focus on cases with systemic implications? Securities regulations contemplate a settlement or consent system in which the relatively minor cases are settled by discussions with the alleged offenders, resulting in the payment of an agreed amount as settlement consideration, but not as a penalty, since settlement proceedings do not contemplate a plea of guilty or not guilty. This approach has made it easier for those in charge of enforcement in regulatory organisations to focus on cases with systemic implications, so that an effective message is sent out to the regulated universe that misconduct will not be tolerated. This approach also leads to faster determination of the more significant cases.

Regulators who decide to deal with almost every case that falls within their ambit, run the risk of biting more than they can chew. Often times, it is impossible to even think of dealing with all matters that prima facie need to be looked into. The surveillance system at the securities Regulator's office throws up, every minute, a large number of suspicious movements in market prices. Would it be the correct regulatory philosophy to go into each of these, recognising that there are bandwidth issues in terms of number and skillsets in most regulatory organisations?

Should regulatory philosophy be conditioned by the right temperament, that in a non-disruptive manner, brings order to the regulated universe? Is there a requirement of assessing what the fallout of the outcome of regulatory action might be, before setting forth on writing orders of indictment?

A study of the regulatory ecosystem might be in order to get a better understanding of how regulatory philosophy impacts the conduct of business. In the securities market, the Stock Exchanges are the first level Regulators when it comes to listed entities. SEBI, which is viewed as the securities markets Regulator, is positioned above the Stock Exchanges. As far as mutual funds are concerned, the Trustees are the first level Regulators. It is for the first level Regulators to look at breaches and misconduct, and to take appropriate actions. In the case of Stock Exchanges, there is a fundamental problem that needs to be resolved. Stock Exchanges are business entities that have a focus on their own toplines and bottomlines. Would it be realistic to expect such entities to suspend companies that are listed on them, and in the process suffer a revenue loss? Is the Chinese Wall separating the business function and the regulatory function a myth or a reality? History has shown that Stock Exchanges very rarely initiate action against listed entities, especially the bigger entities, fearing revenue loss. As for the Trustees of mutual funds, their domain knowledge, and their ability to constructively challenge the functionaries of the Asset Management Companies, is in serious doubt. Therefore, even with two first level Regulators, the securities market Regulator often has to look at the totality of non-compliance in their regulatory domain. The RBI has a different problem. When it comes to public sector banks, the RBI has been known to take the position that these being majority Government owned, the RBI is handicapped in carrying out some aspects of its regulatory function. As far as cooperative banks are concerned, the RBI has often claimed that a dual regulatory system can be exploited by the regulated entities. Both these explanations do not seem to hold water. As far as public sector banks are concerned, the Government, as the majority shareholder, cannot get in the way of regulatory action taken by the RBI under the Banking Regulation Act or any other statute falling within RBI's remit. As far as cooperative banks are concerned, the State Government/ Registrar of Cooperative Societies is the entity Regulator, and the RBI is the function Regulator that should look at how banking business is being conducted. Here again, there is adequate room for the RBI to enforce its directions, and in the event of non-compliance, nothing would prevent the RBI from suspending the business of the cooperative bank, even if such action seems to be disruptive. What is most important is for Regulators at these multiple levels to share the philosophy of quick and effective enforcement, while allowing the business to be carried on with minimal disruption.

At the end of the day, do regulatory organisations exist to punish or to reform? Which is the philosophy that best serves public interest in the long run by ensuring orderly conduct in the regulated universe in a non-disruptive manner?