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PRESCRIPTIVE, DESCRIPTIVE, RESTRICTIVE

Regulation is always work in progress. The continuing search for improvement and alignment finds expression in more and more circulars. Comply, don't complain.

At the recent Corporate Governance Summit, Gatekeepers of Governance, hosted by Excellence Enablers, a Whole Time Member of SEBI referred, in passing, to the large number of consultation papers that had been put out, especially in the recent past, by that organisation. He was inviting attention to the consultative approach that Regulators follow in finalising regulations which have a significant impact on the markets and the market participants. Viewed through another lens, it might be possible to arrive at the conclusion that the rapid pace at which consultation papers are coming out, and the limited time available for public response, is striking at the root of effective and constructive consultation.

Be that as it may, our focus in the present newsletter is on a few draft Regulations that have been put out in the recent past for public consultation. The first of them that we choose to focus on is the "Draft Insurance Regulatory and Development Authority of India (Regulatory Sandbox) (Amendment) Regulations, 2024". Even before getting into the specifics, it is hard to resist the conclusion that this is one of the best consultation papers that has come out in the recent past. In structure and in content, the draft regulations do not leave much to be desired.

The Exposure Note identifies 4 elements that have gone into the proposed regulations. These are (1) adoption of principle-based approach over rule-based approach, (2) no hard-coding of values, numbers, etc in the regulations, (3) operational issues to be covered in the master circular, and (4) regulations to facilitate introduction of innovative ideas/ new concepts across the insurance value chain. The clarity with which these fundamental issues have been identified and approached, is deserving of praise.

The first of the elements is the primacy that will be accorded to a principle-based approach over a rule-based approach. While this is theoretically sound, it does leave the door open for confusion in the minds of practitioners, when the principles, as stated, give rise to doubts or difficulties. The second element, taking out values/ numbers out of the regulations, and housing them in the master circular, is a very welcome move. Regulations are in the nature of Subordinate legislation, and should not be frequently tinkered with. It is easier to make changes when items, that could merit change at reasonable periodicity, are included in the circular. Equally welcome is the proposed coverage of operational issues in the master circular, rather than in the regulations. The icing on the cake is however the proposed introduction of regulations to facilitate innovative ideas and new concepts across the insurance value chain. The clarity with which these elements have been identified and approached is what sets this consultation paper apart from several others.

Regulation 1(3) provides for review once in 3 years from the date of publication, unless a review, repeal or amendment is warranted earlier. This sunset clause approach to regulation is long overdue, and the more it is seen in other regulations, the better it would be for practitioners and Regulators. A periodic review will ensure that regulations that have become contextually irrelevant, are either amended or removed. This is the only way that regulations can keep pace with the rapid changes in the regulated universe.

To ensure that innovation in the insurance sector is consistent with the perceived needs of the industry, a procedure has been put in place for those with innovative ideas, to get them validated by a Regulator, and then to give effect to them. This will ensure that adventurous persons, with hairbrained ideas, do not disrupt the sector in the name of innovation. The single point of contact (SPOC) to review the progress of the proposal is also a welcome move. No longer will those that have filed their applications have to knock on the doors of different departments to ascertain the fate of their proposals.

The draft regulations also contemplate the possibility of inter-regulatory sandbox proposals, which is a clear recognition that far reaching proposals cannot often be confined within the remit of a single regulatory authority.

Some notifications relating to various subjects have been appended to the draft regulations. While all of them are important, the focus in this newsletter is on the “Insurance Regulatory and Development Authority (Meetings) (Amendment) Regulations, 2024”. While some of the proposed features are routine in nature, what attracts notice is the flexibility in conducting number of meetings, and considering the financial year instead of the calendar year for reckoning the number of meetings. This is a long overdue move.

There is one matter that perhaps needs clarification. In the various attached regulations, the heading does not include the words “of India”, whereas the headings of all notifications do. If this difference is on account of the name of the principal Act/ Rules, uniformity in the name must be introduced.

The second consultation paper that this newsletter addresses is on “Process for appointment of specific KMPs of an MII; and cooling-off period for KMPs and Directors on an MII joining a competing MII”. What this paper attempts, whether intentionally or otherwise, is to reduce the power of the Boards of the Market Infrastructure Institutions (MIIs), and to reduce their influence in a manner not consistent with the expectations from a Board.

The stated objective is to strengthen the governance framework of the MII. The proposal envisages that MIIs should be staffed by Key Managerial Personnel (KMPs) “of appropriate stature and independence” in “identified crucial” areas. While stature and independence are important, what has been missed out is the requirement of “competence” in the persons being considered. The philosophy seems to be that MIIs should deliver on the core public interest mandate of giving primacy to technological resilience, market integrity and compliance, over commercial considerations. The paper goes on to state that while serving as first line Regulators, they should also operate as efficient, innovative and competitive commercial profit-making entities. If commercial considerations, as pointed out hereinabove, are to be treated as stepchildren, it is difficult to conceive that the institutions would be competitive, commercial, profit-making entities. The paper goes on to state that MIIs should give higher priority to critical operations, coming under vertical 1 which covers operations and technology, and vertical 2, covering regulatory, compliance, risk management and investor grievances, over other functions, including business development (vertical 3). It is not necessary to treat business development as a secondary responsibility in order to promote compliance and risk management. This, in some sense, resonates with the thought that while Corporate Governance is an essential condition for good performance, it cannot be a sufficient condition.

Having treated vertical 1 and vertical 2 as more important than vertical 3, the consultation paper goes on to recommend changes in the procedure for appointment of KMPs in-charge of verticals 1 and 2. To begin with, the MII is required to engage an independent external agency to recognise and recommend suitable candidates for heading verticals 1 and 2. The agency, so appointed, shall submit its recommendations to the Nomination and Remuneration Committee (NRC). The NRC, after evaluating the recommendations, would submit its own recommendations simultaneously to the Governing Board and SEBI. SEBI will then review NRC’s recommendations and provide comments, if any, for the consideration of the Governing Board, which shall make the final decision, after considering NRC’s recommendations and SEBI’s comments, if any.

It is time to revisit and reinforce some of the basic tenets of the powers, functions and responsibilities of the Board. In any corporate entity, the Board, by whatever name called, is at the highest level of decision-making. There is no case for outsourcing, either a part, or the whole, of its decision-making process to any outside authority. Such outsourcing will introduce a disconnect between the powers of the Board, and the legitimate expectations from the Board. It is somewhat unusual for the Regulator to offer comments on the recommendations of the NRC, which is a committee of the Board. The suitability of the candidate has to be, as per the consultation paper, decided on the basis of “appropriate stature and independence”. It is difficult to contemplate how a regulatory organisation will contribute to decision-making on these parameters, when they have no direct knowledge of the functioning of these candidates. More importantly, the position of the CEO will get diluted since he/she has no role in identifying any of the KMPs. If the intention is to separate the responsibilities of regulation and business development in a first level Regulator, better structural arrangements should be put in place, rather than the convoluted procedure suggested in the consultation paper.

The entire proposal is based on the premise that the Board by itself might not do a good job of identifying the KMPs. The Public Interest Directors (PIDs), including the Chairperson, constitute the majority on the Board. The MD & CEO is appointed with the approval of SEBI. Should a Board, having a majority of SEBI appointed/ approved persons, not be trusted to select KMPs for the organisation? To signal that all is not lost for the Board, SEBI has indicated that it will no longer prescribe a cooling off period for PIDs of an MII joining a competing MII. The Governing Board is expected to put in place a policy prescribing the minimum cooling off period. PIDs are Public Interest Directors. Why should their cooling off period occupy mind space?

Facilitating the ease of doing business is one of the stated expectations from a regulatory body. Getting involved in a process that belongs entirely to the Board of the MII is a step in the wrong direction. The Regulator should come into the picture only when the CEO is appointed.

The third paper tackles a hardy perennial of securities regulations, namely the “definition of Unpublished Price Sensitive Information (UPSI) under the SEBI (Prohibition of Insider Trading) Regulations, 2015”. The proposed review of the definition is to bring regulatory clarity, certainty, and uniformity of compliance in the ecosystem.

The origin of this proposal can be traced to a behavioural aspect which should have been anticipated. A study, conducted by SEBI on material events disclosed to the Stock Exchanges, and events classified as UPSI by listed entities, revealed that companies were categorising only the items explicitly mentioned in the regulations. It would not have taken much to assume that if there is an explicit mention of some items, companies will not bend backwards to categorise anything more.

In order to expand the number and nature of items that need to be disclosed, SEBI went into the usual process of appointing a Working Group to identify the steps to be taken. The Working Group identified a number of items which would need to be disclosed. While listing all of them in the consultation paper, there is the haunting refrain that the need to ensure the ease of doing business should be kept in mind. Without getting into the specifics of the proposal, it is possible to conclude that significant management bandwidth would go into identifying and disclosing all these items in real time.

Even with this strenuous exercise being undertaken, there is no guarantee that all material and price sensitive information would be identified and disclosed. Would it not be better to pass on the responsibility to the concerned Board, and if any instance of non-disclosure of material information is noticed, to hold that Board to account? This would also reduce the information asymmetry between those that regularly look at the websites of the Stock Exchanges to take note of disclosures, and those that, having invested in companies, do not keep track of such developments because of their inability to do so.

Instead of getting a Working Group to look at these issues, it might be preferable for an industry body, which already exists, to recommend, based on their experience, what ought to be included as material, and what ought not to be treated as material. Merely expanding the list would lead to giving the impression, by implication, that everything outside the list is not material.

Tailpiece

Many years ago, the Chief Minister of a State received a late night call from the then Union Home Minister, stating that a certain person was being appointed as the Governor of the State. The Chief Minister then telephoned me, the Principal Civil Servant, to state that the proposed appointment should be opposed. I responded by saying that he was only being consulted, and that consultation is not concurrence.