ILLUSTRATION: BINAY SINHA

Conflict management: Thy name is governance

In the realm of market regulation, managing conflict is the key to effective governance

Once, a Securities and Exchange Board of India (Sebi) chairperson was mocked for never having "seen a share certificate", casting doubts on his ability to regulate the securities markets. Today, the tables have turned, as another chairperson has drawn attention for having "seen share certificates". What was once considered a qualification is now perceived as a potential liability, bringing conflicts of interest to the forefront of governance. In between, a different chairperson with modest holdings chose to divest them before assuming office, reinforcing the need for regulators to, like Caesar's wife, remain beyond reproach, free from even the appearance of conflict.

In a market economy, conflict of interest is inherent and often unavoidable in any professional or organisational setting, as individuals and entities juggle multiple roles and responsibilities often with competing interests. However, the problem arises when an individual in a regulatory position allows personal interests to influence his/ her official decisions. While excluding individuals with potential conflicts from regulatory roles might seem a straightforward solution, it risks narrowing the pool of qualified candidates. The key is not having conflicts, but ensuring they don't cloud judgement.

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In the United States, it is common for individuals to move between regulatory agencies and the private sector. Individuals with market experience often join agencies like the Securities and Exchange Commission (SEC), bringing valuable insights into industry practices. At the same time, SEC officials frequently transition to senior roles in financial firms, leveraging their regulatory experience. This "revolving door" fosters a deeper understanding between regulators and industry, enhancing oversight and compliance. However, a host of safeguards — disclosure, recusals, cooling-off periods, and more— are in place to mitigate conflicts while ensuring that the exchange of expertise is beneficial.

Historically, the government played a dual role — running businesses through entities like BSNL and MTNL in telecom, and GIC and LIC in insurance — while also making rules to regulate these sectors. This created a perception that the government, being both a player and a regulator, would favour its own enterprises. Businesses were wary of a system where their competitor also set the rules, issued licences, conducted investigations, and imposed penalties. To address this inherent conflict of interest, independent regulators, such as the Central Electricity Regulatory Commission for electricity, Petroleum and Natural Gas Regulatory Board for fossil fuels, and Sebi for securities markets, were established to regulate businesses. The withdrawal of government nominees from the governing boards of self-regulatory organisations like stock exchanges further mitigated the conflict.

In the case of securities markets, this shifted the conflict, along with the responsibility, to Sebi. Initially, the Sebi Act, 1992, sought to address this by prohibiting directors of companies from serving on Sebi Board. The rules mandated that Sebi members avoid financial or other interests that could prejudice their functions. However, the Sebi Act was amended in 1995 to allow company directors to join the board, with mechanisms to manage potential conflicts. The amendment aimed to "allow directors of companies to be appointed as members of the Board so that the Board benefits from the expertise of people familiar with the capital market."

This brought in a few high-profile company directors as part-time members of Sebi's board, but they were not available on a full-time basis. Sebi typically attracts talent from two streams for full-time board positions: Public sector (government included) professionals, who usually do not own shares and thus face fewer conflicts, and private sector professionals, who may own securities and thus have potential conflicts. To effectively utilise both streams of talent, Sebi voluntarily implemented the Code on Conflict of Interest for Board Members in 2008, establishing a framework for managing and mitigating conflicts.

Sebi recognised early on that effective governance of the market hinges on managing conflicts. It set out to eliminate conflicts among frontline regulators, who are essential for maintaining market integrity. Historically, stock exchanges regulated brokers and markets, with brokers owning and governing the exchanges while trading on them. This setup led to repeated misconduct, as brokers' private interests sometimes overshadowed public interests. To address this, stock exchanges were demutualised and corporatised in 2005, limiting brokers' influence.

Over time, regulations were tightened: Brokers can no longer sit on the governing board. They may hold up to 50 per cent of shares, while the managing director is prohibited from holding any shares in a broking entity. Demutualisation introduced new conflicts between the commercial aspirations and regulatory responsibilities of stock exchanges. Sebi addressed them by regulating securities transactions by directors, requiring the majority of the board to be public interest directors, and creating separate verticals for regulatory and commercial functions. Similar provisions broadly apply to the other frontline regulators like depositories and clearing corporations.

Sebi employs conflict management as a key tool to enhance the governance of markets, asset management, product distribution, and companies. It prohibits insiders from using confidential information for personal gain and prevents intermediaries from front-running trades for their own benefit. Key executives in asset management companies are required to invest a minimum amount in the schemes they manage or oversee, aligning their interests with those of investors, while employees are restricted from trading in securities of investee companies. Investment advisers and research analysts must avoid promoting financial products where they have a personal interest, with mandatory disclosure of conflicts. Related parties are barred from voting on related-party transactions, while independent directors are denied stock options to ensure impartial decision-making.

As the securities market is growing in complexity and sophistication, its regulator must have the flexibility to attract talent from diverse sources. Even the government, traditionally reliant on career public servants, is increasingly seeking talent from the private sector on contractual terms. Just as Sebi prescribes and enforces governance norms for frontline regulators, markets, and listed entities, the government must implement a comprehensive conflict management framework to effectively address all types of conflicts involving all members, including nominee members, of every regulator across regulatory functions — quasi-legislative, executive, and quasi-judicial. This framework should draw from the governance norms of frontline regulators, market and corporate governance practices, and international standards, ensuring that individuals in regulatory roles remain beyond reproach, preventing any collateral damage to the regulator.

The authors are legal practitioners. Both worked for Sebi previously