ARTICLES

Changing Role of Regulators in Fostering Innovation

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As the stock market is getting complicated and products of different complexities keep surfacing in the market, the Regulators like SEBI need to work not only on improving the financial literacy but also imparting more in depth knowledge on the sophisticated innovations so that the users know what care they should exercise while dealing with such products.

THE ROLE NEED NOT CHANGE

We must be clear about what we mean by regulator or rather who is a regulator and who is not? We all believe that SEBI is a regulator. Looking at the Preamble of the SEBI Act, one can come to know that SEBI has been established for the purpose of investor protection, market development and regulation. Are not these the standard functions of the Government? It has Executive, Judicial and Legislative powers. Are not these again the standard powers of the Government? Then, why do we call it a regulator? It has functions and powers similar to that of the Government. It is actually Government within the Government. Further, it has functions other than regulation. It is responsible for investor protection as well as for market development. It is not a standalone regulator. In fact, no entity is a regulator and regulator alone. Similarly, there is no entity which is not a regulator. What about ICSI? What about a Stock Exchange? What about a Depository? These are all regulators. Government itself is a regulator. If you look at capital market, Government, SEBI, Exchanges, SROs, depositories – all of them have some kind and amount of regulatory responsibility. Everybody does regulation. Even a broker regulates its sub-brokers. So there is nobody who is not a regulator. It is a matter of degree only. The important point to note here is that if an entity is not a full time, dedicated, exclusive or standalone regulator, what else does it do? It generally does developmental or innovative work – again it is a matter of degree. There are no standalone developers or there is nobody who is not a developer. All the entities - Government, SEBI, Exchanges, Depositories, market participants, SROs all carry on some kind of developmental work. What is developmental work? It is development of structures, products, markets, processes; these are innovations. Are not these the job of regulators? Again look at the Preamble of the SEBI Act. It says SEBI is responsible for market development and regulation. It does regulation along with innovation. Regulation and innovation are not mutually exclusive. If so, why should the role of SEBI or, for that matter, any regulator, change to foster innovation? Because we ask such question, we end up with sub-optimal outcomes. SEBI-like organizations primarily focus their energy on regulation and not so much on other responsibilities as they are judged by their performance in the regulatory arena only.

DEVELOPMENT AND REGULATION ARE NOT MUTUALLY EXCLUSIVE

Innovation is an integral part of its job. Look at what it will regulate if there is no market. Market comes from innovation or development or promotion of an environment which supports innovation or development. Development and regulation are so integrated that one does not exist independent of the other. Unless market develops, it cannot be regulated. Unless there is regulation, the market cannot develop. Regulation is necessary to develop the market and once the market develops, it needs to be regulated. For example, in India, the law was amended in 1995 to lift the ban on options in securities. But trading in derivatives did not take off, as there was no regulatory framework to govern these trades. Once the regulatory framework was developed in 2000, trading in derivatives took off. This is so because the market develops in a regulated environment, as it gets the protective shield of regulation. The same logic did not hold good when derivatives emerged for the first time in the world. The market for derivatives emerged as a few enterprising innovative participants felt a need and designed a new product to meet the need. As people found the product useful, the market developed. With development of market, the participants and regulators understood the nuances of the new market and developed

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* Adapted from the talk delivered at the 36th National Convention of ICSI at Goa on 8th November, 2008.

regulations to deal with the nuances and provide an environment, which further promoted the market. As markets developed further, a variety of derivatives emerged to meet the demand of each niche segment and instances of market abuse were also noticed. This made the regulator fine-tune the regulatory framework to deal with the possible abuses. This facilitated the proliferation of the market. Thus development and regulation fed onto each other in a virtuous circle for an orderly growth of the market. As other jurisdictions noticed the new product, they imported the regulatory framework and fine-tuned it to suit to their environment so that market could develop in their jurisdiction also. Thus, if there is market for a product elsewhere, the regulation comes first at a different place. If there is no market at all anywhere, the development comes first and regulation follows.

FOCUS ON THE PPP MODEL OF GOVERNANCE

There can be situations where the regulatory and developmental initiatives may not be in harmony with each other. This disharmony arises from the fact that development is predominantly an initiative of the market participants, while regulation is generally the initiative of the regulator. The disharmony can be reduced if the market participants and the regulator undertake these initiatives jointly. The participants, while developing the market, should look at the regulatory concerns, while the regulator, while framing regulations, should keep in mind the developmental aspects. The regulator and the participants must have due respect for each other and involve each other in developing and implementing their initiatives. Otherwise we get into a blame game. To cite an example; the author had the dubious distinction of working with the Government, the Regulator and a stock exchange. The brokers privately express their discomfort with the functioning of the Exchanges. The brokers feel that the Exchanges do not fully understand the market and, hence, bring in regulations, which at times hinder the growth of the market. The exchanges similarly in private express their discomfort with the functioning of SEBI. This also applies to SEBI and Government. This blame game is essentially because the participants on one side do not have appreciation of the constraints and opportunities on the other side. Further, while the development of the market is the long term common objective of all concerned, they pursue different, and at times conflicting, short-term objectives to maximize their private interests. This happens because all the participants in the market are not on the same wavelength and they try to achieve their objectives in isolation. The regulator has to, therefore, bring all the participants to the same wavelength so that the regulations framed are appreciated and implemented smoothly. Some times what actually happens is the other way round. The participants bring the regulators to their wavelength!

While regulators do not need to change their role, they need to focus more on the participatory approach to regulation so that they carry participants with them and frame regulations which foster innovation. In securities market, this has been in vogue. This market believes that the market is for the participants, of the participants and by the participants. Accordingly, it adopted the PPP model of governance, two centuries before we talked of PPP model for development of infrastructure. The brokers assembled together and framed rules for their participation in the market. They formed, in course of time, self regulatory organizations to exercise oversight on them. In course of time, regulation became complex and vast and specialized. Then, the regulatory responsibility was shared among different agencies in the regulatory hierarchy. SEBI now evolves regulation in consultation with the regulated, shares the regulatory responsibility among the agencies in the hierarchy and implements through them. This helps SEBI to know the changes happening in the market, to learn the nuances associated with the changes, and accordingly develop regulation to deal with the changes. Then, it assigns the responsibility with accountability to stock exchanges, depositories, etc., who act as the frontline regulators. It has, therefore, been endeavouring to develop SROs to share regulatory responsibility. The SROs would have their own rules and bye-laws governing the admission of members, standard of conduct, certification, resolution of disputes, initiation of disciplinary action, internal control standards, etc.

LIMITS TO THE PPP MODEL – ILLUSTRATION FROM FINANCIAL TURMOIL

There is a limit to PPP model. It is ideal where both the Ps have roughly 50% responsibility and accountability. If one P dominates the other, the system is not efficient. Let us now take a peep at the recent global financial turmoil, to illustrate how the private P took precedence over the public P, that is, regulation did not understand the innovation. We suddenly have a new 'planetary crisis'. The financial 'tsunami' struck the world with a force never seen in the history of mankind; the pace of the *Great Depression* of the 1930s was less dramatic, thanks to the geographical and technological limitations of those times. The financial *over-innovations*, some of which *Warren Buffet* has termed as weapons of mass destruction, *have* achieved a scale of global destruction in hours what the real sector over-ambitions could not even dream of in centuries!

Interestingly, we have identified the culprit, the NINJA loans! A handsome $1.4 trillion worth of housing loans to the 'bottom of the pyramid' became NPAs. If it was only $1.4 trillion, the answer to the crisis would have been so easy- a write off of a maximum $1.4 trillion plus the accrued interest (in any case all the loans would not be NPAs), like the farm loan waiver of India. It is a different matter that the neo-liberals criticised this Indian size waiver of $10bn *ad nauseam*, but do not mind US size bail out of trillions of dollars. But these loans camouflaged in footnotes the many an *unknown* trillion worth of securitization in the form of CDOs and many other exotic three-letter pet names that have overnight became four-letter nightmares.

So, it is not the original home loans to the poor that were toxic, but the complex products that were mounted over them through greed-based financial engineering models: through over-securitization and complex product innovations, which converted the loans to the poor into AAA rated instruments to be lapped up by the high-flying finance agents everywhere.

But why and how the 'greed merchants' could take the world with them for a flight of fancy. This is episode #2 of the story- the

(in)action of the many empowered, autonomous regulators. Free from the democratic compulsions of the elected Governments- they seek behaviour modification through appropriate incentive structures and identify stress points in time and take remedial action without fear or favour. But probably they did not do that, or they got intimidated by the beauty and complexity of the products churned out by the Wall Street.

George Stigler talked of 'regulatory capture' four decades ago when the regulators were not even independent in the modern sense. He warned that the regulators would gradually come to champion the cause of the regulated rather than the consumers, whom they are supposed to protect. It is regulatory capture of a greater magnitude that happened which led to the great financial turmoil. The regulators not only supported the conflict-of-interest-ridden organisational structures and product over-innovations of the high street but also lightened the regulation and oversight of these entities and their activities. When one puts so much emphasis on "Know Your Client (KYC)", doesn't the regulator have to know the entity and its business as well?

FOCUS MORE ON LEARNING AND UNDERSTANDING THE INNOVATIONS

Regulators need to know the product churned out by the market. It is not that all the financial innovations, like that in real science, are economically and socially productive. Financial entities seeking greater profits will build new structures that would boost their bottomlines. No harm. But it is for the regulators to put them through the prism of economic and social value addition before allowing them entry into the market. Any sign of toxicity, potential systemic concern, should be nipped in the bud like 'terror futures' mooted by the Pentagon in the aftermath of 9/11. If there are knowledge gaps, clear only those products you understand-nothing will happen to the world if some of the financial innovations with unknown implications are prevented, but the opposite can be quite disastrous. There is nothing wrong in admitting that we do not understand many things. As the recent events unfold, even a high finance professional looks financially illiterate!

Look at the size of the moral hazard, bigger than some of the big economies! Ultimately the State, even in the freest of the markets, cannot fail its people and systems. The regulators should take note of this. Like a chess master who sees many a moves in advance, regulators must know the implications of organisational structures, products and practices of market participants and 'front-run' the financial Frankensteins.

FOCUS ON DISCLOSURE BASED REGULATION

Understanding of the innovations by the regulators is not enough. The users must also understand the innovations. The regulators need to make the users aware of this. The regulators achieve this by increasing reliance on DBR. Instead of deciding merits of a product or transaction on their own, they leave it to the participants and ensure availability of adequate information to enable informed decision. They ensure availability of information by casting a duty on the suppliers to disclose certain information about themselves/ their products. At times, they supplement by conferring a right on the users to demand and obtain the information from the suppliers.

In the context of the securities market, it means disclosure of information about the products, namely, the securities and the services of the intermediaries, and their suppliers, namely, the issuers of securities and the intermediaries. Such information enables an investor to decide, if at all, to undertake transactions in the securities market, and, if so, in which securities and at what prices and through which intermediary. Similarly it enables an issuer to decide, if at all, to raise resources through the securities market and, if so, through what instruments and which intermediary.

India followed merit based regulation till 1992, when the Capital Issues (Control) Act was repealed. However, this approach has severe limitations in the securities market which suffers from moral hazard and adverse selection associated with information asymmetry. In contrast, the disclosure based regulation assumes that the market rather than the regulator is best equipped to determine the merits of a transaction. Under this approach, the regulator ensures disclosure of full and accurate information, based on which investors / issuers take informed decisions and also assume responsibility for their own decisions. It believes that the regulator cannot take decisions for investors / issuers, but it can protect them by arming them with the information they need to take decisions. The investors / issuers like it because it gives them the freedom to take their own decisions. The regulators like it because they are reluctant to be accountable for the decisions they take for or on behalf of issuers / investors. The issuers / intermediaries like it because it is not as ideologically threatening or as costly to comply with, particularly with the availability of technology, as substantive mandates.

The regulators need to focus on two things to make DBR succeed. There are costs and benefits of disclosure to the discloser and the user of disclosed information. The discloser wishes to disclose something, but does not have incentive to disclose everything. Disclosure involves cost, particularly when the competitors use the disclosure to their advantage and there is a cost of responding to the behaviour of the users toward the discloser based on disclosure. He is willing to disclose upto a point and, beyond that, it adds to his cost rather than to his benefit. Similarly, the user needs certain minimum disclosure to benefit from disclosure. He has similar costs and benefits from disclosure. If the maximum disclosed by the discloser falls short of the minimum wanted by the users, the DBR breaks down. The regulator has to step in to play around the variables behind cost and benefit functions of the users and disclosers, either to push up the maximum from the perspective of discloser or to bring down the minimum from the perspective of the user.

The market is getting complicated. Products of different complexities keep surfacing in the market. Financial pundits fail to understand these products. The success of DBR requires a group of users who understand the sophistication of the innovations. The Regulators need to work not only on improving financial literacy, but also imparting more in-depth knowledge on the sophisticated innovations so that the users know what care they should exercise while dealing with such products.

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REGULATION HAS BUILT-IN FLEXIBILITY FOR INNOVATION

We need to make a distinction between control and regulation. Control means: the authority determines who will produce, what will be produced, what quantity will be produced and at what price it will be sold. Regulation means: the authority lays down broad rules of the game and lets market participants decide what to produce and let the market determine the price and the quantity. Regulation allows people to design products, structures and processes in any manner subject to meeting the standards. Thus regulations have built-in flexibility to promote innovations. In fact, this is the precise reason why we shifted from the controlled regime to the regulatory regime because we wanted to promote innovation.

Coming back to the securities market, it is the place where investors, issuers and intermediaries try to make the most. In pursuit of this, they have made the market very complicated. It has a layered - pre-primary, primary, secondary, tertiary - structure. The participants acquire essentially the same property in this market by undertaking transactions in the different segments of the market, namely, mutual funds market, pre-IPO market, new issues market, stock market, derivatives market, etc. They undertake generally back-to-back leveraged transactions to maximize their returns and hedge positions. What has supported these innovations? It is the regulation. The failure of a participant to honour a particular transaction can have domino effect. But regulations have ruled out this. Because regulations promote innovations, we have adopted regulation based governance for markets. The role of regulators does not have to change to foster innovation. We need to slightly refocus its strategies.

FOCUS MORE ON INCOMPLETE LAW WITH MORE OF PRINCIPLE BASED REGULATION

There are two basic forms of law, namely, the 'almost complete' law and 'almost incomplete' law. The almost complete form endeavours to enact the law with perfection, which can deal with all possible circumstances for a long time. An example of such 'complete law' is the Indian Penal Code enacted in 1860. Take the definition of 'theft' given therein, which has not been amended yet. It is a complete definition - Whoever intending to take dishonestly any movable property out of the possession of any person without that person's consent, moves that property in order to such taking. Any activity satisfying the ingredients specified in the definition is construed as theft. Once the Legislature lays down the definition of theft and prescribes the penalty for it, it is for the Executive to administer the law. In case of any violation, the Executive or any affected party brings it before the court which penalizes the guilty if it is satisfied that it was a case of theft and there is sufficient evidence to the effect that the guilty has committed it beyond all reasonable doubts.

The almost incomplete form believes that it is not possible to visualize all the circumstances and, hence, provide for the same in the legislations. In this form, the legislations tend to be skeletal. An example is the Securities and Exchange Board of India Act, 1992. It empowers SEBI to register and regulate intermediaries listed in the Act and also such other intermediary who may be associated with the securities market in any manner. This allows SEBI to regulate the intermediaries who are not listed in the Act, should the need arise in future and also the new intermediaries that may emerge in future, without amending the law. At the time of the enactment, the Legislature could not visualize all such intermediaries who may need to be regulated in the future. Similarly, the law did not visualize all instruments which can be considered securities. It listed a few and granted discretion to the authorities to declare any such instrument to be securities. The instruments listed do not have anything common among them. Unlike the definition of theft, we cannot consider an instrument as security because it has certain ingredients which a security ought to have. Only feature common to all the instruments, which are considered securities, is the insecurity. In fact, all the securities are the most unsecured instruments. The Act also confers substantial powers of delegated legislation on SEBI to make regulations to fill up the gaps in the laws and deal with the matters in detail, which keep changing rapidly with time. This enables it to strike at the right time and keep the laws in tune with the time. All these are examples of incompleteness and the regulator has been mandated to complete these taking into account the changing market environment, which emanate from market innovations. While incomplete law provides the scope for innovation, principle based regulation enhances the scope further.

FOCUS MORE ON ENFORCEMENT MECHANISM

As stated earlier, the market grows in a protected environment. The innovation succeeds if there is protection. A new product in its infancy requires more protection. This requires a feeling among market participants that nobody can sabotage innovations as there is a vigilant and objective enforcement mechanism in place. There is fear of the regulators. In the almost complete form of law, there is almost complete separation of powers among the governmental agencies - the Legislature frames the laws; the Executive administers and the Judiciary enforces them. However, under the incomplete regime, the regulator has all these powers simultaneously. The separation of powers is completely blurred – the same entity is vested with legislative, executive and judicial functions to enable it to enforce the laws proactively and preferably before the harm has been done. The regulators enjoy tremendous powers arising from fusion of these three powers. *Mens rea* is not an essential ingredient for attracting penalty for contraventions of market laws. If anybody has violated the law, penalty will visit him irrespective of the motive or circumstance in which the violation took place. The violation need not be proved beyond reasonable doubt. Preponderance of probability is adequate to levy penalty. Further, such laws allow the regulators to resort to a number of enforcement actions simultaneously. For example, if an intermediary in the securities market is found guilty, its registration can be cancelled or suspended. The people behind the intermediary can be debarred from dealing in the securities market. The violation can be adjudged and monetary penalty imposed. Further, all of them can be prosecuted. All these have created fear of the regulator among the participants. The regulators only need to be fair and objective and expeditious in the disposal of enforcement actions. ❑

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