Law Economics Policy Conference

High Performance Regulators

Conference Material

India Habitat Centre
4-6th December 2017
New Delhi, India

NIPFP

Institute for New Economic Thinking

Rule of law and fundamental financial reform in India

December 1, 2017

Shubho Roy

Ajay Shah

National Institute of Public Finance and Policy, New Delhi
ajay.shah@nipfp.org.in

Debates about financial reform are generally couched in the language of financial economics. In this paper, we show six examples of the failures of financial regulation in India, which feature violations of the rule of law. We trace these failures to poorly drafted laws that establish financial agencies. These problems have been solved as part of India's attempts at fundamental financial reform, which consists of the draft Indian Financial Code, a proposed law which replaces all existing financial law. The rule of law is important as political philosophy, and also as a means to achieving State capacity in financial regulation.

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1 Introduction

In the international discourse, financial reform is primarily about financial economics. The discourse on financial reform is conducted in terms of the issues of consumer protection, micro-prudential regulation, resolution, systemic risk regulation, monetary policy, capital controls, etc. The legal foundations for the sound working of State agencies are treated as a given.

In this paper, we document an array of problems in the Indian financial regulatory apparatus. There are extensive violations of the rule of law. We should six examples in some detail, spanning multiple different financial regulatory agencies, where there are documented actions in recent years which are inconsistent with the concept of the rule of law. In each of these examples, arbitrary power is placed with the officials who work in financial agencies.

When we investigate the sources of these problems, they are all traced to infirmities of the legal foundations of the working of financial agencies. There is no horizontal law, akin to the U.S. Federal Administrative Procedures Act, which establishes the foundations of the working of all State agencies in India. Each agency is governed by its own law. The drafting of these laws embeds provisions which confer arbitrary power to the officials of the agencies. Through this, officials of the agencies can violate the rule of law while obeying the law.

We engage in a comparative law analysis, where each of these six maladies is analysed in terms of the US and UK legal systems, and identify the specific legal mechanisms through which these maladies would not arise in these legal systems.

We turn to the process of fundamental financial reform, which began in India in 2011 with the establishment of the Financial Sector Legislative Reforms Commission (FSLRC). FSLRC has drafted a single modern law, the Indian Financial Code, which replaces 61 existing laws. The work of FSLRC can be classified into two pillars: The substantive content of financial regulation, which involves addressing market failures in the field of finance, and administrative law that establishes sound financial agencies.

We engage in counter-factual analysis of the six examples in a hypothetical world where the Indian Financial Code were enacted. We find that all the six examples are suitably addressed. These violations of the rule of law would be addressed by enacting the Indian Financial Code.

In many settings, financial economists have been disappointed at the working of financial agencies. This paper suggests that sometimes, the sources of institutional failure may lie in the legal foundations of the working of financial agencies. A systematic focus on curtailing the discretion of financial agencies, and upholding the principles of the rule of law, is required for achieving State capacity in financial regulation.

2 Traditional motivations for financial reform

Large-scale financial reform has taken place in numerous countries. In advanced economies, the trigger for large-scale financial reform has generally been a major failure of the erstwhile arrangement. The difficulties of the British Pound in 1992 led up to the reforms of 1997, and the global crisis of 2007/2008 led to large scale financial reform in the UK and the US.

Large-scale financial reform has generally taken place in transition economies and emerging markets for a different set of reasons. In countries emerging from socialism, establishing the broad contours of a modern market-based financial system is seen as an essential ingredient of building a market economy.

Many emerging markets have not experienced the clarity of purpose of a post-socialist transition. In this case, the impetus for large-scale financial reform has come from a different direction. Economic growth, the emergence of sophisticated private firms, and the increased internationalisation of the economy tend to create difficulties for the erstwhile financial system and its regulatory apparatus. Finance often becomes a bottleneck for the rest of the economy, which creates an impetus for financial reform. Financial reform is advocated on the grounds that it will foster the next stage of sophistication of the economy. As an example, when countries seek to build physical infrastructure, policy makers desire a well functioning bond market.

When political economy constraints do not permit financial reform ahead of time, matters often come to a head with a financial crises such as a banking crisis or a currency crisis. These events can help foster financial reform.

Episodes of fundamental financial reform may thus be classified into three categories:

- In the aftermath of a crisis, where the status quo has visibly failed and policy makers want to make sure the problems do not recur;
- The clarity of purpose in the post-socialist transition, where there is an aspiration to build a market economy, and finance is seen as an essential component of this; and

- Addressing the increasing mismatch between a growing modern economy and an inadequate financial system.

In all three cases, the discourse is largely conducted in terms of financial economics. The debate tends to revolve around issues such as inflation targeting, capital account openness, establishing financial markets and the role for derivatives trading, sound regulation for banks and insurance companies, consumer protection, arrangements for public debt management, systemic risk regulation, and financial regulatory architecture. These are the issues that generally occupy policy-oriented financial economists worldwide. Most of the literature in policy-oriented financial economics is engaged in designing sound arrangements on these issues.

Financial reform in India also began by engaging with these kinds of issues. From the early 1990s onwards, in numerous areas, financial reforms were implemented that appeared fairly sound in terms of financial economics. The outcomes were often disappointing. Financial agencies, such as regulators, were not effective in discharging the objectives articulated in laws.

This led to an examination of the problem of State capacity. Why do reasonable men, set in motion towards reasonably sound financial regulatory objectives, deliver poor outcomes? Rule of law considerations were identified as an important source of the chronic under-performance of financial agencies. When the process of fundamental financial reform began in 2011, this was a key element that was pursued.

3 The rule of law in financial regulation in India: Six examples

While mimicking the external structures of a modern financial system, India's financial laws, placed in the context of the underlying legal system, grant wide powers to financial agencies. This leads to surprising outcomes when compared with the working of financial agencies in advanced economies. In this section, we show a series of examples of powers and actions which are *legal* in India but do not conform with the rule of law.

The first is an example of *excessive delegation*, where the entire regulation of the securities market has been left the to discretion of the regulator including how to exercise its powers. Instead of the regulator implementing the securities law, the regulator is empowered to do exercise *measure it thinks fit*. This has been extended to empower the regulator to even confiscate/freeze assets of a person *ad infinitum*.

The second example deals with a recent example arbitrary entry-barriers into a growing and innovating sector of financial services: payments. The Reserve Bank of India (RBI), India's central bank and payments regulator, *temporarily* suspended giving permissions to set up payment service providers. This was done without issuing any legal instrument, but by just issuing a *press-release*. The law governing payments in India does not envisage any such suspensions or system. However, due to lack of procedure governing how licenses should be granted there has been no challenge to such arbitrary measures.

The third example deals with the arbitrary methods that regulators follow when the *do grant* licenses. This is an example of arbitrary and non-transparent methods of granting licenses for a special type of banks, *payments bank*.

The fourth example is about unstated legal requirements. The RBI as the regulator for capital controls placed legal requirements on foreign investments *indirectly* which were never stated in an legal instrument.

The fifth example is about the use of the coercive power of the State without equal treatment or transparency: the rules of the game are unequal between any two private persons, and are kept secret.

The sixth example about artificial distinctions which are a product of unguided discretion responding to political pressures and exigencies. This undermines the concept of equality before law.

These six examples are only illustrations of the larger problem. Difficulties of this nature suffuse the present Indian financial regulatory landscape. Financial agencies have arbitrary power, which does not conform with the rule of law.

3.1 Excessive powers at SEBI

Legal theorists have long emphasised the distinction between *rule of law* and *rule by law*. The fact that parliamentary law governing a regulator exists, and is followed, does not mean that there is *rule of law*. Parliamentary legislation can violate the principles of the rule of law. This can happen if it grants excessive powers to a regulator. The establishment of a financial markets regulator requires clear legislative thinking about the powers, functions and accountability measures. A law which does not clearly articulate the powers of a regulator and provides checks for the exercise of the powers may be *rule by law* but not *rule of law*.

The law that establishes the Indian financial markets regulator, SEBI, has infirmities. An example of this is the vague drafting in subsection (1) of section 11 of the *SEBI Act*, which reads:

> *Subject to the provisions of this Act, it shall be the duty of the Board to protect the interests of investors in securities and to promote the development of, and to regulate the securities market,* ***by such measures as it thinks fit.***

(emphasis added)

By statutory law, the Indian Parliament seems to violate the basic principle of rule of law, i.e. making the entire securities market regulated not by law, but by the *thoughts* of a group of persons i.e. the Securities and Exchange Board of India (SEBI). This is excessive delegation of powers. In a rule of law system, a regulator must *regulate* based on *law* and not its *thoughts*.

For a counter-example, laws governing the police are very clear on how the police can maintain law and order, or how it should keep the peace, or how crimes are investigated. The police are not allowed to maintain law and order on how they *think fit*. A system like that would give arbitrary powers to the police to detain anyone without reasonable suspicion, use force without proportionality, extend detention without producing the suspect before a court. For each of these functions of the police, the law has formulated checks and balances, the law speaks clearly, and does not give opportunity for the police to determine its own conduct based on its thoughts.

In 1995, the law governing SEBI was amended to include another provision which allowed the Board to make *directions* to any intermediary, any person *associated with the securities market* or any listed company, any direction that *may be appropriate in the interests of investors in securities and the securities market.*[1] There is full discretion in the hands of SEBI on what kind of directions is can make.

In 2002, the law was further amended to allow the securities regulator to suspend trading of any security, restrain persons from dealing in securities, suspend any officer of an exchange or Self Regulatory Organisation (SRO), attach bank accounts, and prevent sale of securities by any intermediary. This power allows the securities regulator to ban a person or freeze his assets without collecting evidence and convincing and independent judicial officer of the merits of the case. The interesting part of this power is that there is no time limit to the order. While there may be a genuine need to freeze assets in case the suspect is at flight risk, such determination should be made in a court of law. A regulator which carries

[1]See Section 6 of the *Securities Laws (Amendment) Act*.

out the investigation, then prosecutes the suspect and tries the suspect should not have this power. It violates the principle of *nemo judex in re sua*: being a judge in one's own case. The mixing of roles of the prosecutor and judge usually leads to the judge favouring the prosecutor.

3.2 Arbitrary suspension of licensing in payments

Rule of law requires faithful execution of the mandate of the written law. If the executive or regulator acts in a way that portions of the law become ineffective, and violates protections and procedures in the parliamentary legislature, this is inconsistent with the rule of law. When a right is granted to persons by a law, the regulator has to make due efforts to ensure that the right can in practice be exercised. The regulator cannot simply decide to suspend provisions of parliamentary legislation.

The Indian Parliament enacted a law governing the payments system.[2] It created a new class of financial service providers called 'payment systems'. An person who wants to start a payment system has to apply to the RBI for a license. In the application process, the law embeds two protections for the applicant: (i) RBI must give the applicant a hearing if it proposes to refuse the application, and (ii) applications must be processed within six months of the date of filing such application.[3]

A remarkable event unfolded in September 2016. A *press release* was issued, announcing that the RBI would not be accepting applications.[4] The press release said that the RBI had created a *vision document* for payments. This document had suggested that the RBI should review pending regulations. RBI was carrying out this review, and till the review was completed, the RBI would not accept any more applications. On 20th March, 2017, RBI extended this temporary ban till 30th April, 2017, again with a press release.[5] Overall, this has added up to a long hiatus in licensing.

This action of the RBI was a violation of the rule of law. The underlying law has no mention of a vision document, the possibility of suspending the licensing process, or the use of a press release as a legal instrument.

[2] *Payments and Settlement Systems Act, 2007*.

[3] See subsections 3 and 4 of Section 7 of the *Payments and Settlement Systems Act, 2007*.

[4] See *Temporary suspension in grant of Authorisations for Pre-paid Payment Instrument (PPI) issuance*.

[5] *RBI seeks comments on draft circular on Master Directions on Issuance and Operation of Pre-paid Payment Instruments (PPIs) in India*.

The legal instrument that RBI used to suspend statutory rights, a press release, is a violation of the rule of law. The Parliament, under the law, provided two instruments for processing applications: (i) the provisions of the Parliamentary law and (ii) the regulations made by RBI:[6]

> *The Reserve Bank may, if satisfied, after any inquiry under section 6 or otherwise, that the application is complete in all respects and that it conforms to the provisions of this Act and the regulations issue an authorisation for operating the payment system under this Act...*

Every regulation has to be laid before Parliament and published in the official gazette. Press releases have no such checks on them. By making this press release the RBI bypassed both these checks and suspended new licenses. There is nothing in the law which empowers the RBI to suspend the licensing process, or to do this using the legal instrument of a press release.

The press release takes away rights and protections provided under law. Since the RBI would not even accept applications, there is no way a person would get a hearing before his application was rejected. Similarly, the six month deadline for processing applications becomes meaningless if applications are not accepted. Through this press release, the RBI effectively wiped out the protections that an applicant was entitled to under the Parliamentary law.

With the benefit of hindsight, we see that this arbitrary suspension of new permissions had important anti-competitive consequences. In November 2016, the government went through an unexpected 'demonetisation' exercise by withdrawing the two highest denomination notes in India, 500 and 1000 Rupees (USD 7.64 and USD 15.27).[7] The temporary licensing suspension ended up benefiting existing players. The demonetisation exercise created a shortage of physical cash and forced many citizens to adopt electronic payments. The market for electronic payments grew sharply, and incumbent players started obtaining network effects. These benefits was cornered by payment systems licensed before the press-release, and substantial harm was imposed upon persons who failed to submit their application before 2 September 2016.

3.3 Arbitrary process in bank licensing

The rule of law requires that the public should know the standards to which they are being judged. Standards are not only substantive, but also procedural. An

[6]See subsection (1) of Section 7 of the *Payments and Settlement Systems Act, 2007*.

[7]See *Notification for demonetisation of high value notes*.

applicant should know what standards are expected, and the process by which she will be judged. For example, laws governing driving licenses not only state what the applicant must know, but also lay down in detail *how* a person will be tested. In a rule of law system, these provisions must be stated *before* the application process begins. These design elements are required in order to avoid arbitrary power in the hands of the persons who perform the licensing function.

In India, a new category of banking licenses were granted in 2015. The RBI created a new sub-category of bank licenses called *payments banks*.[8] Without changing any provisions of the parliamentary legislation, the *Banking Regulation Act*, the RBI made this category and set up a completely *new* procedure for giving licenses. The licensing process was developed *after* applications for payment bank licenses were submitted. The process developed by RBI did not provide any criteria by which any external party could evaluate the process.[9]

There were 41 applications. *After* the licensing process was completed, RBI came out with a press release describing the process that was followed.[10]. This says that the short-listing was done by a committee. The press release states that the committee *set up its own procedures for screening the applications*. The procedure followed was not released to the public.

All that has been stated is that applications were screened on the basis of: Financial soundness; fit and proper criteria; physical outreach; business model innovation; capability of volumes of transactions and money; and their proposed business plan. There was no information how these high level concepts were translated into an operational licensing procedure. As an example, it is hard to compare a parameter like *business model innovation* across 41 entities. No score sheets were provided, no reasons were given about why some made it and others did not.[11] The RBI had published guidelines for applicants (which was completely silent on how the applications would be adjudged) but that did not provide any cut-offs, or any decision about granting only 11 licenses.

In fact, the press release suggests the RBI may have rejected some applications without any justification and had doubts about the fairness and legality of its own

[8]This was done based on the recommendations of a committee constituted by RBI. See Chapter 3.6 at pg. 74 of the *Committee on Comprehensive Financial Services for Small and Low Income Households: Report*.

[9]For a more detailed analysis of the events, see Roy and Shah, "Payment bank entry process considered inconsistent with the rule of law".

[10]For the press release, see *RBI grants "in-principle" approval to 11 Applicants for Payments Banks The Reserve Bank of India has today decided to grant "in-principle" approval*.

[11]From informal enquiries, we found out that the unsuccessful applicants were not informed about the reasons for rejection.

process. The press release says:

> *The Reserve Bank believes that some of the entities who did not qualify in this round, could well be successful in future rounds.*

Any licensing process driven by rule of law can have only two outcomes: (i) the applicant meets the criteria and is entitled to a license, or (ii) the applicant does not meet the criteria, and therefore, is not entitled. A legal process of licensing cannot reject participants in one *round* and console them with likely success in future rounds.

For a counter-example within the Indian legal system, a similar procedure for allocation of coal blocks in India had been over-turned by the Supreme Court as ad-hoc and casual, with no fair and transparent procedure.[12]

The RBI was able to use such an ad-hoc process because of the silence in the law governing bank licenses. Section 22 of the *Banking Regulation Act*, governs licensing of banks in India. This provision has no procedure for how licenses should be given. Unlike Section 7 of the *Payments and Settlement Systems Act, 2007*, which gives the applicant a right to be heard before their application is rejectedThe *Banking Regulation Act*, has no provision for hearing the applicant. Section 22 is silent on the licensing procedure. This allowed the RBI to formulate its own procedure and reject applications without due process. The law was obeyed and yielded an outcome which violates the rule of law.

3.4 Hidden legal obligations for foreign venture capital

Another dimension of ad-hoc legal procedure is a procedure which does not disclose, up front, all obligations upon private persons. We summarise an example of this that is found in an official government report,[13] which shows the imposition of conditions which are not provided in any legal document.

India has a complex administrative system of capital controls. Within this, one category of foreign investors is called Foreign Venture Capital Investors (FVCI). FVCIs have to comply with two sets of regulations. There are capital controls regulations governed by RBI.[14] In addition, there are investment regulations

[12]See, Supreme Court of India, *Coal Block Allocation Judgment*.

[13]See Para 5.1.2 of the Working Group on Foreign Investment, *Report of the Working Group on Foreign Investment*, at pp. 71–72.

[14]See, Schedule 6 Reserve Bank of India, *FEMA 20*, up to 2012. After this a new framework for regulating foreign investment was developed.

governed by SEBI.[15]

Under the capital control regulations each foreign investor is required to open a special type of bank account through which investments would have to be routed. Each bank account opening had to be approved by RBI. This power was used to create a new mechanism for capital controls. From March 2007 onwards, RBI stopped approving the opening of bank accounts[16] (necessary for routing investment) unless the aspiring FVCI gave an undertaking that it would invest only in ten industries:

1. Information technology;
2. Seed research and development;
3. Bio-technology;
4. Research and development of new chemical entities in the pharmaceutical sector;
5. Production of bio-fuels;
6. Building and operating composite hotel-cum-convention centre with seating capacity of more than three thousand;
7. Developing or operating and maintaining or developing, operation and maintaining any infrastructure facility;
8. Nanotechnology;
9. Dairy, or
10. Poultry.

If the applicant did not give the undertaking, their application to open bank accounts would not be processed. The interesting feature was this was not provided in any documents. The applicant would wait for an approval from RBI, which would be delayed. After some time the applicant would call up RBI to find out why his application was delayed. Only then would the applicant be informed that he/she had to make this undertaking. A new dimension of capital controls – industrial policy in controlling the targets of foreign venture capital investment – was created through the requirement that FVCIs require approval in order to open a bank account.

This is only an example; regulators in India often create practices and legal obligations which are not codified in the official gazette and sometimes not even stated in other forms of public documents. Such *hidden legal requirements* create opportunities for corruption and rent-extraction. This has led to the creation of a group of lawyers, advisers and consultants who *collect* such *knowledge*

[15] See, *Securities and Exchange Board of India (Foreign Venture Capital Investors) Regulations*, . Note that these regulations were replaced in 2012.

[16] Shah, "Rule of law and foreign venture capital funds".

from prior transactions or connections with the regulators.[17] New investors find it almost impossible to get regulatory approvals for transactions without approaching this group of individuals/firms and paying substantial advisory or legal fees. This group is able to maintain a monopoly position through access to such *historical* material. New entrants in the field of law, consultancy or advisory cannot effectively compete with such persons/firms. No amount of research or proper documentation of laws will ever provide such entrants with information about these *hidden* legal obligations.

3.5 Customised legal obligations

A founding principle of the rule of law is the generality of law. Law is not written with one person it mind, it is expected to set up a general principle which all persons/entities meeting a pre-determined criteria. This is essential for fairness. Laws should be made publicly and applied equally. However, for a class of financial firms in India, the Non-Banking Financial Companies (NBFCs), this does not apply. The law provides delegated legislation making powers to the RBI without the normal checks and balances expected in delegated legislation.

Delegated legislation in India ordinarily has two channels for checks. First, the legislation has to be published in the *official gazette*.[18] This makes it available to the public. All law published in the official gazette goes through legal vetting in the government's law offices for constitutionality and validity within the empowering parliamentary legislation. Second, all such subordinate legislation is laid before Parliament, is examined by the Parliamentary Committee on Subordinate Legislation, and and may be annulled or modified by Parliament within a limited time.[19]

These checks and balances are absent for NBFCs. NBFCs is considered as a residual basket of financial sector firms which are regulated by the RBI. The parent law governing NBFCs allows the RBI to issue customised regulations for individual firms. These customised legal obligations are called *directions*. The source of the problem is the legislative provision governing regulation of NBFCs: Section 45JA of the *RBI Act, 1934*. This provision was inserted in the 1934 law by an amendment

[17] Staff retiring from regulators, especially those involved in regulation making, are appointed as consultants to law firms and such consultancies.

[18] This is analogous to the *Federal Register* in the U.S.

[19] For example, See Sections 30 and 31 of the *SEBI Act*; sections 26 and 27 of the *IRDAI Act, 1999*; and Sections 52 and 53 *PFRDA Act*, and almost all powers to make subordinate/delegated legislation in Indian law is governed by similar checks.

in 1997.[20] The provision is an exception because it does not incorporate the normal checks and balances found in most other regulatory governance laws in India. Section 45JA creates a new class of subordinate legislation called *directions* which do not have any such checks. Moreover, Section 45JA states that the RBI:

> *... may give directions to non-banking financial companies generally or to a class of non-banking financial companies or to any nonbanking financial company in particular..*

These directions are not published in the official gazette. Some of them are uploaded on the web-site of RBI, but it is not clear if they are exhaustive. Moreover, the specific directions are not published at all. These directions can control major financial functions like:

> *... income recognition, accounting standards, making of proper provision for bad and doubtful debts, capital adequacy based on risk weights for assets and credit conversion factors for off-balancesheet items and also relating to deployment of funds*

(sic)

This creates a situation where *different* directions on accounting standards may be given to different NBFCs, and there is no method to find out if such directions have been provided. The entire regulatory framework for NBFCs works on these *directions*, making it non-transparent and undermining the requirement that laws should be generalised and publicly available. As with the problem of *hidden legal obligations*, it has spawned an entire compliance industry which privately obtains the text of such directions from clients and keeps them secret. New NBFCs have to approach such consultants to find out what legal obligations will apply to them. There is no independent way of finding out what the law is.

3.6 Arbitrary distinctions

Equal treatment is a core concept of rule of law. In India, this is provided under Article 14 of the Constitution. Article 14:[21]

> *...combines the English doctrine of the rule of law and the equal protection clause of the 14th Amendment to the American Federal Constitution...*

Equal parties should be treated equally. If parties are treated differently two tests must be met:[22]

[20] See Section 4 of the *Reserve Bank of India (Amendment) Act*.
[21] See *Basheshar Nath v. Commissioner of Income Tax*.
[22] See Sirca, "The Old and New Doctrines of Equality".

> *(i) that the classification must be founded on an intelligible differentia which distinguishes those that are grouped together from others left out of the group, and (ii) that the differentia must have a rational relation to the objects sought to be achieved by the Act*

However, in the field of regulation for borrowing from foreign sources, this has been violated by the central bank. An official government committee notes that the system of regulation of borrowing from foreigners (commonly called External Commercial Borrowing (ECB)) is:[23]

> *antithetical to the rule of law and adds hugely to administrative workload and enforcement of law without addressing any market failure*

The RBI operates a complicated set of capital controls governing ECB under the *fema*. Broadly two features are used to classify restrictions:(i) by the *nature of the borrower* (this is based on sectors of the economy, like aviation, real-estate, infrastructure, services, financial services, hospitality, power generation, etc.); and (ii) by the *purpose* for which foreign currency being borrowed (for example if the money is being borrowed to buy capital goods, or finance export or for general working capital). Based on this classification two *routes* are permisisible: (i) the *automatic route* (where specific permission is not required from RBI), and (ii) the *approval route* (where each loan has to be approved by the RBI).[24]

The committee finds how from just two categories of borrowers in 2004, in one decade, it grew to a total of 16 categories. There are inconsistent restrictions under the capital control laws. ECB is not allowed for the *purpose* of funding working capital. However, in the aviation sector it can be used for working capital if borrowed through the approval route. Infrastructure firms are allowed to use 25% of their ECB to refinance borrowing in domestic currency. However, if you are a *power sector* firm you can use 40% of your borrowing to refinance borrowing in domestic currency.[25] There is no *intelligible differentia* which guides these classification. A political process of lobbying by the industry appears to result in favours being granted to certain persons. This is inconsistent with the rule of law.

There is little evidence that this approach to capital controls has delivered useful outcomes in macroeconomic policy.[26] However, without any legal requirement to

[23] See para 2.3.2 of the *Report of the Committee to Review the Framework of Access to Domestic and Overseas Capital Markets*, at pg. 21.

[24] For details, see *Master Direction – External Commercial Borrowings, Trade Credit, Borrowing and Lending in Foreign Currency by Authorised Dealers and Persons other than Authorised Dealers*.

[25] See para 2.3.2 of the *Report of the Committee to Review the Framework of Access to Domestic and Overseas Capital Markets*, at pg. 21.

[26] See Shah, "Futility of capital controls?"; Patnaik and Shah, "Did the Indian capital controls work as a tool of macroeconomic policy".

carry out a *post facto* cost-benefit analysis, the failure or success of the regulatory mechanism is never judged. This undermines the rule of law and leads to political economy problems. The committee points out that:

> *The prospective borrowers are tempted to lobby for their inclusion in the list under the automatic route or, at least their requests to be considered under the approval route.*

3.7 Concerns about the rule of law

These six examples suggest that there are concerns about the extent to which financial regulation in India is imbued with the rule of law. These examples suggest that officials in financial agencies wield arbitrary power. We now turn to a comparative law perspective which will help understand the root cause of these violations.

4 Root cause analysis

The source of these violations of rule of law is the legislative framework which governs the financial sector. Some of the problems arise from *acts of commission* in legislation where legislature has granted powers which are not in conformity with rule of law. Examples of this include the power to regulate based on what the regulator *thinks fit* or creating exceptions to the system of making regulations with a new statutory instrument called *directions*. Most of them arise from *acts of omission* where the legislature has omitted to put in appropriate checks and balances on the regulator to establish rule of law in financial regulation. In other jurisdictions like the US and the UK, such violations of rule of law is not possible due to extant legal provisions governing regulators.

4.1 Excessive Powers at SEBI

The *US APA*, identifies and provides appropriate process requirements for all regulators under it. Similarly the *FSMA 2000*, has detailed provisions governing rule making, authorisations, information gathering and investigations and the way disciplinary measures are carried out. For example, neither of the laws have language analogous to the *SEBI Act*, which allows the regulator to act as it *thinks fit* for the entire set of regulatory functions. The UK legislation gives this discretion to regulators, but only in cases of publication or where a quasi-judicial order is made. Neither US or UK laws governing the securities market allow officials of the regulators to seize or freeze assets. They must approach the appropriate courts to make such orders.

Abuse is further protected by creating separate adjudicatory bodies with the regulator which determine violations of law. The *US APA*, creates a separate office of administrative law judges who impose penalty. While the *FSMA 2000*, does not have strict separation of functions, the regulator has created *chinese walls* through rules. The financial sector regulator (U.K. Financial Conduct Authority (FCA)) has a Regulatory Decisions Committee (RDC), which imposes penalties. The rule-book states:[27]

> *The RDC is separate from the FCA's executive management structure...*

It also mandates that:[28]

> *The RDC has its own legal advisers and support staff. The RDC staff are separate from the FCA staff involved in conducting investigations and making recommendations to the RDC.*

The absence of these protections in the laws governing SEBI has led to excessive powers at SEBI.

4.2 Arbitrary suspension of licensing in payments

The rule of law in licensing is a well understood problem. Unlike the Indian laws, Section 558 of the *US APA*, regulates the way application for licenses have to be dealt with which states:[29]

> *When application is made for a license required by law, the agency, with due regard for the rights and privileges of all the interested parties or adversely affected persons and within a reasonable time, shall set and complete proceedings required to be conducted in accordance with sections 556 and 557 of this title...*

This mandates the regulator to provide a hearing to applicants. The law obliges the regulator to give due regard to the rights and privileges of interested parties (in this case the applicant). This language gives private persons the right to have a license. This is different from the Indian approach where licenses are usually seen as privileges granted by the regulator.

[27] DEPP 3.1.2 (1) of *FCA Handbook*.
[28] DEPP 3.1.3 of the *FCA Handbook*.
[29] Clause (c) of Section 558 *US APA*.

The other important feature available in the UK and the USA are appeals to tribunals or dedicated courts. In these countries, if a regulator arbitrarily suspended licensing, the applicant can easily approach courts. The *US APA*, creates the administrative law judge, a separate adjudicatory body with a regulator/agency. All hearings have to be conducted before this administrative law judge. After that, there can be formal appeals to the federal courts. While the *FSMA 2000*, does not provide a system similar to the dedicated administrative law judge, it creates a dedicated tribunal to review the decisions of the regulator. For example, if an application for a license (permission to carry out a regulated activity is rejected) the applicant has a statutory right to appeal to the tribunal.[30]

In India there is no specialised tribunal to hear appeals against the RBI (unlike SEBI, Insurance Regulatory and Development Authority of India (IRDAI) and Pension Fund Regulatory and Development Authority (PFRDA)).[31] Approaching constitutional courts (High Courts and the Supreme Court) is expensive and time consuming. This lack of judicial review emboldens the staff of RBI.

The absence of these protections in the law governing payments regulation by RBI is the root cause of the breakdown of rule of law in payments licensing.

4.3 Arbitrary process in bank licensing

Arbitrary processes in licensing are not possible in the UK or the US because of the detailed procedural requirements around licensing. As discussed in section 4.2, Clause (c) of Section 558 of the *US APA*, prevents the regulator from rejecting licenses without providing a hearing. In addition, clause (b) of Section 558 of the *US APA*, states:

> *A sanction may not be imposed or a substantive rule or order issued except within jurisdiction delegated to the agency and as authorized by law.*

Since rejection of license applications has to be done through orders (for which there has to be a hearing), the regulator cannot arbitrarily reject an application. When a hearing is made under the law, the affected party has the right to receive a notice which has to contain (among other information):[32]

> *the matters of fact and law asserted.*

[30] Section 55 of the *FSMA 2000*.

[31] See Roy, "Rule of law: A pair of stories".

[32] Section 554(b)(3) of the *US APA*.

This enables the party to gain access to the reasons why an application is proposed to be rejected *and* the provisions of law which make these reasons relevant for rejecting the license. No such process is required under Indian law.

Similarly under the *FSMA 2000*, there are detailed provisions governing how authorisations are granted to carry out regulated financial services.[33] This requires the authority/regulator to conduct quasi-judicial hearings if it proposes to reject an application. All applications have to be disposed within 6 months. Even if an incomplete application is submitted to the regulator, the regulator has an obligation to decide the application within twelve months.[34] If the regulator proposes to add conditions to a license, it must notify/warn the applicant that it proposes to do so.[35] The warnings under the law follow a standardised procedure with hearing the applicant and providing other *due process* protections.[36]

The absence of these protections in laws that govern the RBI is the source of the breakdown of the rule of law in bank licensing.

4.4 Hidden legal obligations for venture capital firms

Due to the standardisation of statutory instruments and the requirement that they be published, hidden legal obligations are not possible under the U.S. and U.K. law. Regulators impose general legal obligations through subordinate legislation. Under the *US APA*, only one type of instrument can create legal obligations: rules. Similarly under the *FSMA 2000*, there is an exhaustive list of legislative instruments may be made a regulator.[37]. While the UK law does not require the publication of rules in the official gazette, it requires the regulator to write and publish them. The law embeds an incentive for the regulator to clearly publish rules: it states that if a rule was not available to a person, such person cannot be considered to have contravened the rule and therefore cannot be penalised for it.[38]

The notice and comment procedure under the *US APA*, makes all legal obligations public, even before they are implemented. Similarly, the *FSMA 2000*, reproduces

[33] See sections 51 to 54 of the *FSMA 2000*.

[34] See subsections (1) and (2) of Section 52 of the *FSMA 2000*.

[35] See subsection (6) of Section 52 of the *FSMA 2000*.

[36] Warning notices under the law are required to me made following a set procedure, See section 126 of the *FSMA 2000*, to understand how warning notices lead to *due process* protections.

[37] See Paragraph 1.(2) of Schedule 1 *FSMA 2000*, other statutory instruments may be made by the government and not the regulator.

[38] See subsection (6) of Section 163 of the *FSMA 2000*.

the notice and comment systems under different Sections.[39] Both the jurisdictions ensure that all statutory instruments which can impose obligations are regulated through procedure designed to ensure transparency. This prevents the regulators from creating hidden or customised legal obligations.

The absence of these protections in the Indian capital controls law is the source of the breakdown of the rule of law in the working of capital controls for venturecapital firms.

4.5 Customised legal obligations

Customised regulations through *directions*, as seen the case of NBFCs in India, is not possible in the other jurisdictions. This is because of the formality in creating subordinate legislation. As discussed in section 4.4, the clarity of regulatory functions under the laws have completely blanketed the regulator in *due process* requirements for *every type* of action a regulator can undertake. The system of published legal obligations, whether in the *Federal Register* or the Web-site of the regulator makes regulatory mandates public. Because there is no such obligation to publish regulations it is possible to make customised legal obligations. This problem is further exacerbated by the problem of judicial deference as discussed in section 4.7.

4.6 Arbitrary distinctions

Arbitrary distinctions are not easily checked by statutory laws governing regulators. Regulators require certain amount of discretion to make effective regulations and the tests of equality are more subjective than procedural checks like publication and requirement to provide hearing. However, three requirements of making regulations can provide a check against arbitrary restrictions: (i)Requirement to publish supporting documents for making regulations, (ii) cost-benefit analysis, (iii)notice and comment *with* the obligation to respond to submissions.

The requirement to publish background information with a proposed regulation is usually contains the requirement to publish the *objective* of the regulations. This usually lays down the problem the regulator seeks to solve. For example, if the regulator identifies that borrowing in foreign exchange for working capital is a problem, but then exempts aviation from the requirement, it has to explain why

[39]For example, See sections 155 (for rules), 65 (for codes on takeover), Section 119 (for codes on market abuse) of the *FSMA 2000*.

it is doing so in its objective clause. Second, it has to do a cost-benefit analysis of such exemptions. Third, when the public/regulated entities points out the contradiction in the proposed regulation the regulator has to respond to such criticism.

These three requirements are laid down in the UK and US law. The US law requirements arise from two sources:Section 553 of the *US APA*; and The famous *Executive Order 12866*. The former requires the regulator to publish: (i) The legal authority under which the regulations are proposed; and (ii) the substance of the regulation. The latter (which has now survived both Democratic and Republican Presidents) has three components: (i) Regulatory philosophy and principles; (ii) Regulatory planning process; and (iii) Centralized review of agency rulemaking by the U.S. Office of Information and Regulatory Affairs (OIRA)

Under regulatory philosophy and principles there are a number of requirements which ensure that the regulator has to do cost-benefit analysis, use market failures as the main motivation for regulation, consider alternative methods of regulations to determine the least burden on the regulated. The provision of the review by the OIRA creates a review by a disinterested party. This acts as an independent third-party review about the quality of regulations and its compliance with the principles laid down in the executive order.

Under the *FSMA 2000*, similar obligations are placed on the regulator. For example Section 115 of the *FSMA 2000*, puts obligations on the regulator which are similar to the requirements under U.S. law. For each regulation the regulator has to publish a proposed draft with four documents: (i) Cost-benefit analysis; an explanation of the purpose of the rules; (iii) why the regulator thinks that the proposed rules further the statutory objectives of the regulator; (iv) how to public can respond to the draft rules.[40] With the final rules the regulator has to publish: (i) the representations received by it; and (ii) the regulator's response to them.

Such provisions are missing in India law. While regulator claim to carry out public consultation as a good practice (as opposed to a legal requirement), a closer look shows that they rarely carry them out in any meaningful manner.[41]

Any system of checks and balances on a regulator requires a forum to enforce such checks and balance. This is missing in parts of the Indian financial regulatory system. Recently, there Supreme Court has identified this as a weakness in the Indian financial system. In a recent judgement where it overturned a regulation on call-drops by the telecommunications regulator, the Supreme Court noted that

[40] *FSMA 2000*, Subsection 2 of Section 155 of the.

[41] See Burman and Zaveri, "Regulatory responsiveness in India: A normative and empirical framework for assessment".

while there was no law in India, the regulator should follow the principles of the *US APA*, as the represent best practices in regulation.[42]

4.7 Additional issues

In addition to these missing components governing regulatory behaviour, the weakness in rule of law in financial regulation in India can be attributed to three reasons: (i) The absence of an efficacious appellate mechanism for RBI; (ii) The problem of judicial deference; and (iii) the lack of provisions in the *Constitution of India*, establishing rule of law with the same clarity as done in the U.S..

In India, there is no separate adjudicatory forum or dedicated tribunal for the banking regulator: the RBI. There is a separate adjudicatory forum for all the other regulators: Securities Appellate Tribunal (SAT).[43] This may also explain why many issues with licensing and rule of law arise with the RBI. Private persons do have right to appeal to constitutional courts: the High Courts and the Supreme Court. In a non-rule of law situation, however, regulated entities are afraid of filing appeals against the regulator. Even if the regulated entity is successful in one case, the wide and arbitrary powers that the regulator enjoys, allows the regulator to find innovative ways to penalise the litigant. One common method is artificially delaying all further applications made by the regulated entity. However, when there is a dedicated appellate tribunal where it is acceptable to litigate issues, parties feel more confident to assert their rights. For example, while 591 appeals were filed against the decisions of SEBI in the SAT in the year 2015-16:[44] There are no records of appeals filed against the decisions of the RBI.[45]

Even when one is able to approach the constitutional courts in India, the appellant can expect only a very low level review of the actions of the regulator. In the U.S. there has been some criticism of the *Chevron Deference*.[46]. In India, the Supreme Court sets an even lower standard of judicial review for administrative

[42]See paragraphs 73 and 74 of Supreme Court of India, *Cellular Operators Association of India v. Telecom Regulatory Authority of India*.

[43]The SAT was originally created as a dedicated appellate tribunal for SEBI. However, in the last two years, the insurance regulator (IRDAI) and the pensions regulator (PFRDA) have been brought under its jurisdiction, but the name has not been changed to reflect its enlarged duties.

[44]See table 3.55 at pg. 148 of the *Annual Report*.

[45]It is difficult to collect information about an appeal against the decision of RBI, as an appeal can be filed in any one of the 24 High Courts. However, conversations with practitioners and regulated businesses show that this is rarely done. For example, when 30 payments bank applicants were rejected, without assigning any reason, none of them approached the judiciary

[46]For example, See May, "Defining Deference Down: Independent Agencies and Chevron Deference".

action. This limits most review to a mere procedural test. As long as the process was not arbitrary the judiciary will defer to the expertise of the administrative body/regulator. Some of the relevant features of the test as laid down by the Supreme Court in *Tata Cellular vs Union of India*, are:

> *(1) The modem trend points to judicial restraint in administrative action.*
> *(2) The court does not sit as a court of appeal but merely reviews the manner in which the decision was made. (3) The court does not have the expertise to correct the administrative decision. If a review of the administrative decision is permitted it will be substituting its own decision, without the necessary expertise which itself may be fallible.*
> *(4) ...More often than not, such decisions are made qualitatively by experts.*
> *(5) ....In other words, a fair play in the joints is a necessary concomitant for an administrative body functioning in an administrative sphere or quasi-administrative sphere. However, the decision must not only be tested by the application of Wednesbury principle of reasonableness (including its other facts pointed out above) but must be free from arbitrariness not affected by bias or actuated by mala fides.*
> *(6) Quashing decisions may impose heavy administrative burden on the administration and lead to increased and unbudgeted expenditure.*

Another cause of the different regulatory outcomes is the subtle difference between the Constitutions of the United States and India. A commonly cited source of rule of law in the US is the Fifth Amendment which prohibits the taking of life, liberty *or property*:

> *...without due process of law ...*

However, the *Constitution of India*, uses a slightly different language which prohibits taking of life or liberty:

> *...except according to procedure established by law...*

One of the reasons for the excessive deference by the courts is that the Indian constitution does not establish *due process* as a constitutional right. It leaves this to the Parliament. In effect, if Parliament does not establish due process, there is none. This is different from the U.S. position, where even if the legislature grants wide discretion to the regulator, the constitution acts as a check. In India, there are some other provisions which may bring in some aspects of rule of law.[47]

[47] For example Article 14 of the *Constitution of India*, establishes right to equality and equal treatment before the law.

5 Fundamental financial reform

As noted above, the legislative reforms in the 1990s and the first decade of the new millennium were additions to the already existing set of laws. Almost no law from the previous eras were repealed, or substantially modified. The reforms in the 1990s and 2000's, in line with *international best practices*, concentrated on setting up independent regulators. There was little reform in the content of *substantive* laws governing the financial market.[48] These regulators however would implement *substantive* laws from a previous economic era. For example while the securities regulator was set up in 1992, it implemented a law made in 1956.[49] Similarly the insurance regulator was set up in 1999, the substantive law governing insurance is from 1938.[50]

This created a complex mosaic of uncoordinated pieces of legislation which have to be regularly amended for minor changes. For example, between the creation of SEBI in 1992 and 2014 (20 years), the securities laws were amended at least 10 times.[51] This is unusual for the Indian legislature where one subject matter is dealt by the Parliament once every two years. In contrast, the *Indian Contract Act*, has been amended just twice in 145 years (in 1930 and 1996) One of the reasons for these frequent amendments was the fact that while India had moved to a more open economic model, the laws governing securities market still followed a closed economy and socialist model. The Parliamentary laws encoded broad prohibitions on generally accepted financial transactions. For example, the *SCRA, 1956*, prohibited all options trading in the Parliamentary law.[52] After creating modern exchanges, it was impossible to introduce even plain vanilla derivatives. The government had to approach the Parliament and pass an amendment to allow option trading.[53]

The process of fundamental financial reform in India began in the early 2000s. A series of expert groups came out with criticism of the working of the financial regulatory system. This led up to the creation of the FSLRC on 24th March, 2011,

[48] We distinguish *substantive* laws as the laws which actually govern the financial transactions as opposed to the laws incorporating and governing the financial market regulators which have their own independent statutes.

[49] SEBI was set up by the *SEBI Act*; while the substantive law governing the trading of public securities and licensing stock exchanges is the *SCRA, 1956*.

[50] When IRDAI was set up under the *IRDAI Act, 1999*; the law governing insurance is the *Insurance Act*.

[51] Calculated by counting the "Securities Laws (Amendment) Acts" passed by the Indian Parliament and the amendment to *SEBI Act*

[52] See section 20 of the *SCRA, 1956*, which placed a blanked ban on all options contracts, before it was amended in 1995.

[53] See section 22 of the *Securities Laws (Amendment) Act*, which repealed the Prohibition.

to review the legal and institutional structures of the financial sector in India. It was headed by a retired Judge of the Supreme Court of India, B.N. Srikrishna and had nine other members drawn from the regulators, academia and government. The main objective of the setting up FSLRC was:

> *...re-writing and cleaning up the financial sector laws to bring them in tune with current requirements*

The mandate of FSLRC was wide and it was given a 9 point terms of reference which covered most of the issues in the Indian financial sector.[54] FSLRC took two years to review the legal system governing financial sector. The commission held a number of meetings, interacted with the regulators and the government, studied best practices in multiple jurisdictions. It completed the work with a two volume report. Volume I is "Analysis and Recommendations"[55] and Volume II is the "Draft Indian Financial Code"[56] a model law for regulation of the financial sector. For the substantive law, it divided the entire financial sector into nine thematic areas: (i) consumer protection; (ii) micro-prudential regulation; (iii) resolution; (iv) systemic risk regulation; (v) capital controls; (vi) monetary policy; (vii) public debt management; (viii) development and redistribution; and (ix) contracts, trading, and market abuse.[57] The code covers all the important parts of the financial sector and has 19 parts with 414 clauses/sections. Interestingly, the draft code dedicates 137 provisions/sections to regulatory processes rather than substantive rights of parties in a financial contract. This includes 36 provisions governing a dedicated appellate tribunal and a full 101 provisions governing the functioning of the regulator. Roughly one-third of the model code has nothing to do with finance. It deals with the setting up, management and processes of the regulator.

While the Commission did carry out its mandate of harmonising the laws, the largest single component of the *Code*, deals with "Rule of Law". The reason for this emphasis is found in the Indian experience with regulatory reform since the 1990s. Today, the regulatory structure of the Indian financial markets mimics most developed jurisdictions. It also reflects the recommendations of economists for financial development. There are independent regulators, they have been given wide powers to make subordinate legislation, carry out investigations and impose penalties. A separate specialised court has been set up to hear appeals

[54]For the complete terms of reference, see *Resolution for setting up the Financial Sector Legislative Reforms Commission*.

[55]Financial Sector Legislative Reforms Commission, *FSLRC Report: Vol. I*.

[56]The commission prepared a draft code which was then further edited by the government based on input from stake-holders *Code*.

[57]See Patnaik and Shah, "Reforming India's Financial System".

from these regulators. One would expect the system to work like the financial systems of other developed countries. However, even with the same regulatory structure as developed nations, the financial system in India does not work like them. There are large scale regulatory failures in India. Even after 25 years of financial reform, a large proportion of the population is without bank accounts. Informal sources of credit predominate amongst small businesses and the poor. Attempts to mainstream the informal lending sector has failed.[58]

There is little literature explaining the cause of this failure. Pritchett, Woolcock, and Andrews, have talked about this from the general development failures in India. They propose the concept of *isomorphic mimicry*: *the adoption of the forms of other functional states and organizations which camouflages a persistent lack of function.*[59] This is where the external appearance of institutions are copied by a nation but not the detailed systems and processes which should drive such institutions. The Pritchett, Woolcock, and Andrews, argue that it may be strategy for: *avoiding needed reform or innovation while at the same time maintaining the appearance of legitimate engagement with developmental discourses.* So, India has a securities regulator, like many other countries, modelled on the U.S. U.S. Securities and Exchange Commission (SEC): the SEBI. However, the way in which SEBI acts or the powers it wields over the intermediaries in the securities market is completely different. There may be laws governing *payments* as a separate financial service, as it is found in many developed jurisdictions, but again the content of laws and the way the regulator exercises its power under the laws is completely different.

Regulators in India see this differently. Exposure to the possibility of judicial review by a tribunal is not palatable for a regulator which, for decades, has been able to operate in a non-rule of law environment. As an example, the previous RBI Governor, raised the issue that implementing the reforms which provide an appellate mechanism over the regulator risks *halting necessary government actions.*[60] In effect, the Governor is arguing that since it is difficult to distinguish necessary government function from excess, there should be no judicial oversight. It seems that a functioning regulator is only possible if its functioning cannot be challenged it courts. The other reason offered for not creating appellate mechanism is the *the government or regulator is less effective in preparing its case*

[58] Many authors have recorded the persistent failure of formalising the Indian financial system, for example Tsai, "Imperfect substitutes: The local political economy of informal finance and microfinance in rural China and India", notes how after many years of trying to get formal credit markets to take off, they have failed for the poor and small businesses in India.

[59] Pritchett, Woolcock, and Andrews, "Capability Traps? The Mechanisms of Persistent Implementation Failure".

[60] Rajan, "Democracy, Inclusion, and Prosperity".

than private parties. This creates a circular argument the since the regulator does not have to capacity to prepare cases, it should not be held accountable in a court, in turn the regulator does not develop capacity to prepare cases.[61].

5.1 Two pillars of financial law

The work of FSLRC is divided into two parts. One part is the financial economics thinking about market failures and the interventions required to address them. This includes the issues of consumer protection, micro-prudential regulation, resolution and systemic risk.

The second pillar of FSLRC is the working of financial agencies. The law establishes sound foundations for the efficient and accountable working of financial agencies, taking into the account the lack of a horizontal law in India that is akin to the US Federal Administrative Procedures Act. This covers the issues of the board and governance, the legislative process, the executive process, the quasi-judicial process, reporting and the framework for penalties. The thorough drafting work in this second pillar creates a rule of law environment.

5.2 How would the examples of Section 3 work out under the proposed law?

The *Code*, provides detailed legal processes to establish rule of law in the functioning of regulators. We now visualise how the maladies shown in Section section 3 would play out under the proposed law. We show the provisions in the proposed law which would have prevented or mitigated the examples of violation of the rule of law.

5.2.1 Excessive Powers at SEBI

Due to an exhaustive enumeration of functions of a regulator, there is no need for the *Code*, to provide for wide powers. It envisages the role of the regulator as: Writing regulations after proper consultation and cost-benefit analysis; inspecting and investigating for violations of the parliamentary law or its regulations; and, through an independent judicial process, penalising the violation of parliamentary

[61]For a detailed response to such arguments, see Rai and Shah, "Going from strong as in scary to strong as in capable".

law or regulations. There is no ambiguous function like *regulate the securities market.* The *Code*, does not use the term *think* in any form in any of its provisions.

Every investigation procedure requires some preventive action, pending the completion of the investigation. However, instead of providing *carte-blanche* powers to the regulator, the *Code*, provides a detailed procedure governing such cases.[62] The proposed law protects the rights of the suspect through a series of checks and balances. The first step is the creation of a separate adjudicatory wing within the regulator, called the *administrative law wing*, headed by an *administrative law member.*[63]. For any action to freeze assets or bank accounts, there has to be a pending investigation in which an investigator. Only this investigator can apply for freezing the assets of a suspect, only if the investigator has reasons to believe that delay would frustrate any eventual remedy. The administrative law member can order the suspect to keep records or funds for a period of ninety days, but must give a hearing to the suspect at the *earliest possible opportunity*, if not provided before the order. This freezing may be extended by ninety days, but no more. If the investigator proposes so seize any other assets (freeze them) the investigator must approach the normal criminal courts and apply to a magistrate under the normal criminal law which has in-built protections.[64]

The proposed system differs from the present system in the following ways: Creates an independent adjudicator, dependent on investigation, time bound freezing, based on principles of natural justice, guided discretion, no exception from criminal law. In the present system the same person is responsible for the administration of the regulator and passing quasi-judicial orders for officers in the same organisation. In the proposed law creates an independent judicial wing which is separate from the investigation functions. The proposed code also creates a clear ground for freezing assets. No longer can assets be frozen to *regulate the securities market.* For freezing assets a person has to be under investigation. Investigations can only be launched if a violation of laws is suspected and formally recorded.[65] Unlike the present system where assets may be frozen without any limit, in the present case only records and funds collected from the public may be frozen for a maximum of 180 days. However, the person has to be heard before the order, or after the order if it was not possible to hear the person, before the order. For the investigator applying for such order and the administrative law member, the proposed law provides the grounds under which records or public funds may be frozen. The present law has no grounds to guide the discretion of the regulator. For freezing other assets, the code requires the regulator to follow

[62]See, Section 83 of the *Code*.
[63]See Section 87–90 of the *Code*.
[64]See Section 81 of the *Code*.
[65]See Section 77 of the *Code*, for the detailed procedure to launch investigation.

the general criminal law and does not create exceptions from general procedural law for the regulator.[66]

5.2.2 Arbitrary suspension of licensing in payments

In the proposed legal structure regulators will not have the discretion to stop granting permissions. Under the *Code*, licensing of financial businesses is controlled through the legal process governing *applications*.[67]. Applications are used to gain *authorisation* to carry out financial business including payments.[68]. Unlike the present system every application must be acknowledged by the Regulator within seven days from receiving such application.[69]. Further there is a clear prohibition of developing new procedure for dealing with applications which is not provided in the legislation.[70] Most importantly the proposed law states:[71]

> *A Regulator must not reject an application seeking authorisation merely on the ground that no regulation governing the subject matter of the application is in effect*

If the regulator does not respond to an application within 180 days, the application is deemed to be granted and the entity will have the authorisation to carry out the business.[72]. The present system where the regulator can suspend accepting applications is expressly prohibited under law. If the regulator does not respond to an application then the authorisation is automatically granted.

5.2.3 Arbitrary process in bank licensing

Instead of being silent about the process of making regulations the *Code*, lays down a detailed process for granting licenses. In addition to the requirements mentioned in section 5.2.2 the regulator is required to make regulations governing how applications are accepted and processed.[73] The proposed law also requires that an application can be rejected only after: (i) a notice providing the reasons for rejecting the application is given the applicant (show cause notice); (ii) the

[66]This is especially important for India because the India Constitution does not have a *due process clause* like the U.S. Constitution, and all due process protections are provided in the law governing criminal procedure

[67]See Section 71 of the *Code*.

[68]See Section 154 of the *Code*.

[69]See subsection (2) of Section 71 of the *Code*.

[70]See sub-section (2) of Section 73 of the *Code*.

[71]See sub-section (3) of Section 154 of the *Code*.

[72]See sub-section (5) of Section 71 of the *Code*.

[73]See subsection (1) of Section 71 of the *Code*.

applicant is heard by a administrative law officer of the regulator; and (iii) a formal written order with the reasons for rejecting the application is given to the applicant.

The process by which the notice and hearing will be provided is also detailed in a general provision which is then applied to all functions of the regulator where notice and hearing is appropriate.[74] If the regulator wants to reject an application, it has to issue a *show cause notice*. A show cause notice must:(i) Be in writing; (ii) state the action the regulator proposes to take; (iii) state the causes which requires the regulator to take the action; (iv) state the proposed effect of the notice; (v) state the material the regulator has to support the show cause notice.

The applicant also has a statutory right to appeal against this order in the Financial Sector Appellate Tribunal (FSAT).[75]

5.2.4 Hidden legal obligations for venture capital firms

The proposed law will make it difficult for the regulator to have unstated/hidden legal obligations. Since applications are approved unless the regulator provides notice and hearing for rejection with a reasoned order; the applicant has no need to communicate with the regulator.[76] If the regulator considers the form to be incomplete, the regulator must inform the applicant. If the applicant is confident about his application, he/she does not have to communicate with the regulator at all. This denies the opportunity to the regulator to deny applications.

5.2.5 Customised legal obligations

Customised legal obligations are the consequence of not completing the regulatory loop. Under the present law regulators can make *regulations* which have some due process requirements of laying before Parliament. However, in addition to regulations, regulators are allowed to make multiple types of subordinate legislation like: circulars, directions, master directions, guidelines, notifications, letters, etc.[77] However, the other subordinate instruments have no checks on them.

[74] See Chapter 25 of the *Code*.

[75] A single appellate tribunal for *all* financial sector regulators under the proposed law.

[76] See section 5.2.2

[77] These are the ones mentioned on the web-site of SEBI at www.sebi.gov.in, under the heading *Legal Framework*. However, they find no mention in the law governing SEBI. Since they are not mentioned in the parliamentary legislation, there is no way of knowing if this is an exhaustive list, or there are other instruments which are *truly hidden*.

Naturally, regulators tend to veer towards making directions, master directions, guidelines, etc.

Under the *Code*, there are only three types of legislative instruments that the regulator can make: regulations, guidance and emergency regulation making.[78] For each type of instrument there is a detailed legal process that the regulator must follow. The clear flow of regulatory processes mandates that a person can only be penalised for violating the parliamentary law, or the regulations. Statements in a *guidance* may provide the clarity to the law, but explicitly cannot be used to penalise a person.[79] This takes out any incentive for a regulator to make hidden laws, since no one can be penalised for violating them.

5.2.6 Arbitrary distinctions

While arbitrary distinctions may be difficult to eliminate completely. The *Code*, incorporates the best practices of regulation making. The law requires the regulator to publish draft regulations with nine supporting documents: (i) the objectives of the proposed regulation; (ii) the problem that the proposed regulation seeks to address; (iii) how solving this problem is consistent with the objectives given to the regulator under this law; (iv) the manner in which the proposed regulation will address this problem; (v) the manner in which the proposed regulation complies with the provision of law under which the regulation is made; (vi) an analysis of costs and an analysis of benefits of the proposed regulation; (vii) the process by which any person may make a representation in relation to the proposed regulation; (viii) how the proposed regulation is in accordance with the principles the regulation has to comply (each part of the proposed law mandates a set of principles the regulator must follow); and (ix) if the principles are in conflict, the reasons why the regulator preferred one principle over the other.[80]

The regulator must provide the public at least 21 days to comment on the regulations. After comments have been received by the regulator, the regulator has to publish all the comments and a reasoned response to the comments received.[81]. If there is an emergency where there is no time for a full notice and comment period, the regulator may make regulations without this process, but such regulations expire on 180 days.

One important feature to prevent arbitrary distinctions in the law is the *problem*

[78]See Chapter 17 of the *Code*.
[79]See sub-section (5) of Section 61 *Code*.
[80]Subsection (1) of Section 58 of the *Code*.
[81]Subsection (3) of Section 58 of the *Code*.

statement. Since the regulator has to state the problem it seeks to achieve, if it arbitrarily leaves out a class of actions which contributes to the problem but is not regulated, the public/regulated entities can point it out in their submissions. The regulator will have to then provide a reasoned order for such arbitrary distinctions.

This will designed to reduced ad-hoc regulation making in response to political exigencies. In turn, reducing arbitrary distinctions in law.

5.3 The journey of the Indian Financial Code

While the government has not proceeded with introducing a bill on the lines of *Code*, it has started to motivate changes in many laws. The present trend seems to be implementing parts of the law to reform the existing laws incrementally, rather than a whole rewriting of the laws. Three important reforms which have been motivated by the FSLRC recommendations are: (i) merger of the commodity derivatives regulator with securities regulator; (ii) expanding the role of the SAT to cover pensions and insurance; and (iii) creating an executive Monetary Policy Committee (MPC).

India, like the U.S. had two separate regulators for commodity and security derivatives, the Forward Markets Commission (FMC) and SEBI respectively. This led to multiple issues of overlapping jurisdiction and gaps in regulation. One example of this was the case of a derivative trading platform which was able to avoid regulatory oversight and eventually collapsed to the fraud perpetrated on the platform, in 2013.[82] This led to legislative changes and the commodities regulatory (FMC) was merged with SEBI in September 2015.[83] By implication, this brought the commodity derivatives market regulation under the jurisdiction of SAT.

When new statutory regulator for pensions was created in 2013 the Parliament provided for appeals to the SAT.[84] The jurisdiction of SAT was increased when the Parliament amended the insurance law to bring the insurance regulator under the jurisdiction of SAT.[85]. Today apart from the banking regulator, all other financial sector regulators have a standardised appellate mechanism to the SAT.

In June 2016, India underwent a major reform in monetary policy regulation. It finally brought some *rule of law* in the setting of monetary policy. Prior to this the Governor of the RBI had the sole authority to set monetary policy. There was

[82]See Ukey, "The Swindlers of Corporate World".
[83]See Chapter VIII, Part I of the *Finance Act*.
[84]See Section 36 of the *PFRDA Act*.
[85]See various provisions of the *Insurance Laws (Amendment) Act*.

a committee to advise the Governor, but he could choose to reject such advise. Economists have debated the different rules of monetary policy setting. However, at its heart it is actually a rule of law problem involving how decisions are taken in a committee, what information is provided to the committee and the transparency with which the monetary policy decision and deliberations are communicated to the public. It is one area where the principles of *rule of law* like transparency and due process in decision making have direct impact on finance. The *Finance Act*, set up an executive monetary policy for India and set up detailed procedure governing the meetings and publication of the deliberations of the MPC.

The government has started task forces in the area of reforming payments law, consumer protection and debt management. The primary driver of these reforms have been the FSLRC. In the coming years, these areas of financial regulation will probably see some incorporation of principles of rule of law.

6 Conclusion

The substantial content of financial law keeps growing over the years. It seems to the natural progression as a response to failings of the financial system. The Great Depression highlighted the need for central banking, Savings and Loans Crisis highlighted the need for strong resolution mechanism, the latest crisis highlighted the need for system risk management. These get reproduced in the U.S. substantive financial law. Legislatures across the world have realised that the content of financial law, i.e. substantive financial law is too complex and have created agencies with delegated powers. However, the experience of FSLRC that can be inferred from its report and the proposed law point to importance of rule of law.

The experience of FSLRC provides insights for both developing and developed nations. The success of the SEC and the modern central banks of western European countries have spurred many countries to adopt similar models. For developing jurisdictions which seek to modernise and import "modern legal systems" like independent regulators, India may be a cautionary tale about isomorphic mimicry. When countries try to import the highly successful U.S. system it is important to look at the larger legal landscape in which financial regulators operate. One law singularly stands out amongst them, the *US APA*. All financial agencies in the U.S. function under this law. However, when developing countries import the concept of financial sector regulators, or more generally, any independent regulators, some form this law should be imported with it. Another approach for developing nations, following the common law tradition, can be the *FSMA 2000*, of the U.K. Since the U.K. does not have a generalised administrative procedure law, the *FSMA 2000* incorporates all the due process a financial sector regulator needs to follow. These include provisions like notice and comment for regulations, mandated cost-benefit analysis, formalised systems for granting permissions, and a detailed system of quasi-judicial hearings.

For developed nations the financial crisis has prompted changes in the structure of financial regulation. This has opened a new area of financial regulation, systemic risk regulation. Some of these new processes have been tested in court. The *Metlife v. FSOC*, judgement highlights the need for better understanding of *due process* in systemic risk regulations.[86] The courts, regulated firms and financial regulators are exploring what constitutes due process in these regulations. While the substantive content of individual decisions may be debatable, it is important to look at these cases as setting up a new area of jurisprudence and administrative law. Interference of courts in these issues should not be seen as a purely negative outcome. In common law countries these judgements will form the basis of administrative law in these new areas of regulation.

[86] *Metlife v. FSOC*.

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The accountability framework of UIDAI: Concerns and solutions

ajayshahblog.blogspot.in/2017/08/the-accountability-framework-of-uidai.html

by Vrinda Bhandari and Renuka Sane and Bhargavi Zaveri.

The public discourse on Aadhaar has largely focused on concerns about the privacy issues associated with the collection of personal information, and the constitutionality of the Aadhaar (Targeted Delivery of Financial and Other Subsidies, Benefits and Services) Act, 2016 ("the Act"). Regardless of the outcome of the case at the Supreme Court, most residents will likely have to interact with the UIDAI, which is the body empowered to roll out an enrollment and authentication program for beneficiaries of welfare programs.

The UIDAI is an Agent established by the Principal (Parliament), with three powers. The law allows the State to *compel an individual seeking a state-sponsored subsidy to undergo the enrollment and authentication processes* designed by the UIDAI (although Aadhaar has now been made mandatory for certain non-welfare schemes as well, which goes beyond the conception in the law). The UIDAI is empowered to *license and regulate Registrars and enrolling agencies to collect the demographic and biometric information of individuals*, and enroll them under the Act. Finally, the UIDAI has *quasi-judicial powers*, such as the power to suspend the licenses of such enrolling agencies and Registrars.

In this article, we examine the foundations required to make UIDAI work properly: the performance and accountability standards. Under the present law, UIDAI is neither performance oriented nor is there accountability for failure. The problem of accountability at UIDAI is a little explored issue, other than occasional media reporting which expresses angst about data breaches and authentication failures (see here, here, and here). There is considerable knowledge from the global and Indian literature on public administration on how to achieve performance of such an Agent. Drawing on this body of knowledge, we propose that the UIDAI should be held to appropriate accountability standards, so as to create an environment where it will perform well.

Agencification and its associated challenges

Since the 1980s, governments have established specialised organisations which perform certain functions. These Agents have diverse mandates such as regulating a specific sector (SEBI and TRAI); administration of social welfare schemes (the erstwhile Benefits Agency in the UK); and running prisons (such as the HM Prison Service (HMPS) in the UK or the Dienst Justitiële Inrichtingen - National Agency for Correctional Institutions (DJI) in the Netherlands).

The Agent performs its mandate through the exercise of three kinds of powers, namely, quasi-legislative powers, quasi-executive powers, and quasi-judicial powers (FSLRC, 2013). While some agencies have all three kinds of powers at their disposal, others have some of them. For instance, while SEBI has all three powers, agencies which are tasked with administrative functions such as the UK Benefits Agency or the HMPS have limited quasi-legislative powers and no quasi-judicial powers. Whatever may be the scope of powers of these agencies, two features cut across all such agencies: (a) they perform functions that the sovereign would have otherwise performed; and (b) they wield the power of the State in being able to coerce certain private persons in certain ways.

Broadly speaking, agencification has worked well in improving State capacity. However, this has come from establishing an array of mechanisms to deal with a few important concerns:

1. *Weaker links between the people and agencies*: When a sovereign delegates functions to agencies, this reduces accountability through elections (Maggetti, 2010). The persons manning such agencies are one more step away from the people, as they are autonomous from the government and are not politically accountable to the people. Power in the hands of unelected officials also creates concerns about democratic legitimacy (Majone 1998). For instance, agencies which have been tasked with the

administration of social welfare have been accused of opacity (Pollitt et al, 2004).

2. *Unfettered discretion*: When agencies have the power to write subordinate legislation (i.e. regulations), this power is often not accompanied by checks and balances. In liberal democracies, there are elaborate checks and balances that are placed upon Parliamentary law. These checks and balances can, and often are, diluted in the context of the "regulatory state". For example, in all these years of SEBI's establishment, only one of its quasi-legislative instruments has been challenged. Compare and contrast this to the constitutional challenge that virtually every significant parliamentary law faces in India. Similarly, in the last 30 years, no order issued by RBI has been challenged by the person penalised. This leads to the possibility of abuse of power (Cochrane, 2015).

3. *Size and ever-growing footprint in administration of public affairs*: Autonomous bodies, especially those entrusted with the administration of social security benefits, end up assuming significant proportions, both in terms of their size and budget allocations. For instance, in 2000, the Benefits Agency which was responsible for the administration of social welfare schemes in the UK employed a staff of 70,642 and accounted for 30% of the overall state budget (Pollitt et al, 2004). Similarly, the Social Security Administration in the United States now has a staff strength of 60,000. In the Indian context, the annual expenditure of the RBI is larger than that of the States such as Goa.

An accountability framework for agencies of the State

The power to coerce or the power to spend, that is conferred upon the Agent, must be associated with commensurate accountability mechanisms (Stone and Thatcher, 2002). Accountability mechanisms are *ex-ante* and *ex-post*. Examples of both are enumerated below:

Ex-ante accountability mechanisms:

1. Having an adequate strength of independent directors on the board of the agency
2. Regular internal audits to review the performance of the agency and ensuring that it complies with the law in exercising the discretion vested in it
3. Setting out the objectives of the agency and the instruments to be used to achieve them, clearly in the law
4. Setting out performance oriented goals and metrics for measurement of performance, in advance
5. Defining formal processes for the exercise of the powers vested in the agency
6. Mechanisms to facilitate transparent decision making, such as public consultations before making delegated legislation, maintaining a website, publishing a clear rationale for each decision of the agency

Ex-post accountability mechanisms:

1. Laying all quasi-legislative instruments before the Parliament
2. Reports showing the goals set out at the beginning of the year, the extent to which they are achieved at the end of the year and a statement of reasons for failure
3. Resource allocation towards different goals and year-end utilisation
4. Performance and audit by external independent agencies and publishing the reports of such audits

How do other social security administrators account for their performance?

Since the Aadhaar number is so often compared to the social security number issued by the Social Security Administration (SSA) in the United States, we can usefully draw a comparison with the annual performance and financial report published by the US SSA. The report sets out the strategic goals of the SSA that were determined at the beginning of the year. It divides the strategic goal into multiple objectives, specifies measurable performance metrics to ascertain the extent to which the objectives have been met, and the extent to which the goal was achieved. An example of how the performance reporting for the SSA works, is given below.

1. For FY 2012, a pre-determined strategic goal of the SSA was to deliver "quality disability decisions and services".

2. This strategic goal was divided into three objectives. One of the objectives was to "Reduce the wait time for hearing decisions and eliminate the hearing backlog". The metrics used to measure the performance of the SSA on this objective was to complete "the budgeted number of hearing requests" and "reduce waiting time between hearings and decisions". SSA reported its performance on these two metrics as under:

Example of performance reporting by the SSA

Objective: Reduce the wait time for hearing decisions and eliminate the hearing backlog			
Performance Measure	FY 2012 target	FY 2012 Actual	Whether target achieved
Complete the budgeted number of hearing requests	875,000	820,484	No
Minimize average wait time from hearing request to decisions	321 days	362 days	No

The SSA's performance report also shows the funds allocated to each objective and a statement of reasons where the performance metric is not met.

The current accountability framework of the UIDAI

A reading of the objectives and functions assigned to the UIDAI under the Act would suggest that the UIDAI must, at the very least, be held accountable for:

1. The enrollment and authentication of persons [sections 11 and 23(1)]
2. The regulation of enrollment agencies and other service providers licensed by it [section 23(2)(i)]
3. The security and confidentiality of the data shared by persons who have enrolled with the UIDAI [section 23(2)(j) and (k)].

The Act and the accompanying Regulations specify a limited accountability framework, which is not oriented towards performance or service delivery to the citizen. Three accountability measures are present under the Aadhaar Act and Regulations:

1. An annual CAG audit, and requiring these certified accounts of the UIDAI to be laid before each House of Parliament [Section 26 of the Act]; and
2. Requiring an annual report in a prescribed form describing UIDAI's past activities, accounts, and future programmes of work, to be laid before each House of Parliament [Section 27 of the Act]. However, no such manner and form for the publication of the report has been laid down in the Aadhaar Regulations, nor does such a Report seem to be available in the public domain.
3. Requiring certain processes to be followed by the CEO in transacting business at the UIDAI (Transaction of Business at Meetings of the Authority) Regulations, 2016, although these only relate to the number of meetings, quorum, voting procedure etc.

Apart from an annual *financial* audit, the law lacks any performance accountability mechanisms for the UIDAI. For instance, there is nothing in the law requiring the UIDAI to set performance standards for itself or account for core responsibilities such as number of people enrolled and not enrolled, number of authentication failures or number of data and security breaches. The law is similarly completely silent on ex-post accountability mechanisms. It neither requires a performance audit nor demands a justification for failures on its part.

Weak law will deliver weak performance

The conduct of an agency is largely shaped by the law governing it. For instance, Burman and Zaveri (2016) find that there is a correlation between the laws which mandate transparency of a regulator and the responsiveness of such regulators to citizens' preferences. Similarly, the detailed performance reporting by the SSA is underpinned by a law called the Government Performance and Results Act, 1993, a law that set up a performance-oriented framework of reporting for the US federal agencies to show the progress they make towards achieving their goals.

In the absence of such statutorily mandated accountability standards, measuring the performance of the UIDAI is difficult. Stories of security breaches and authentication failures for availing benefits abound. For instance, Scroll.in queried the UIDAI about the authentication requests received between September 2010 (when the first Aadhaar number was issued) till October 2016, and how many failed or succeeded. The query was aimed at assessing the efficacy of biometric authentication. The UIDAI replied that it had not maintained any records between September 2010 and September 2012 and that it did not maintain authentication data state-wise. More importantly, the UIDAI revealed that data about the success or failure of the over 331 crore authentication requests was "not readily available", nor was the breakup of the negative reply to the requesting authority on each of the five modes of authentication "readily available".

Similarly, cases of fake Aadhaar cards have also been reported. Pertinently, in response to an RTI filed by PTI, seeking details related to all cases of duplicate and fake Aadhaar cards and the action taken on them, the UIDAI refused the request on the grounds that the disclosure might affect national security, or lead to incitement of an offence. The UIDAI also informed PTI that its CIDR facilities, information assets, logistics and infrastructure and dependencies, are all classified as "protected system" under the IT Act, and are thus, exempt from RTI. It further stated that the format in which it held the information contained identity details, which may be prone to identity theft, if divulged. The practical reality thus is that cases of unauthorised leaks/disclosures of identity information are being dealt with on a case to case basis, with zero clarity in the law on who is to be held accountable for such lapses in the future.

Conclusion

In previous decades, when we first set up state agencies in India, we were driven by concerns of efficiency and expertise that such agencies would bring to public administration. We now have sufficient experience about the endemic failure of State capacity in that approach. If one more new agency is built, on the lines of existing agencies, there is a high chance that it will reproduce the failures of existing agencies.

The climate of thinking on these questions in India is shifting. The FSLRC report, which proposes a new financial regulatory architecture, made extensive recommendations on the accountability framework for financial sector regulators. These recommendations were codified in the Indian Financial Code (IFC), a draft law that accompanied the FSLRC report. For example, the IFC contains provisions that mandate (a) regulators to build a system of periodical internal audits and publish the reports of such audits, (b) performance audits by an external auditor, (c) building systems for measuring the performance and efficiency of regulators, and (d) public consultation and a cost benefit analysis before exercising quasi-legislative powers. Some of these provisions that do not require legislative amendments are being implemented by the Ministry of Finance through a Handbook on Governance enhancing recommendations of the FSLRC, adopted by the four financial sector regulators in October 2013.

The report of the Bankruptcy Law Reforms Committee (2015), drew on the regulatory governance framework recommended by the FSLRC and recommended four elements for achieving accountability of the Insolvency and Bankruptcy Board of India, India's new insolvency regulator. While some of these elements were codified in the Insolvency and Bankruptcy Code, others are sought to be implemented in the course of setting up the Insolvency and Bankruptcy Board of India. Recent events at TRAI are pushing the organisation towards sound processes.

While the subject of regulatory governance seemed remote and a second order issue in setting up institutions in India, policy thinking today has increasingly started recognising that enhancing governance standards is as important as technical soundness, when designing new frameworks. Every government agency is an Agent, and the journey to building high performance agencies lies in setting up a sound principal-agent relationship, in the law. UIDAI is an important new organisation, and it should emerge as a high performance agency. We must harness our experience and our knowledge, to build appropriate accountability standards for the UIDAI in the law.

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Vrinda Bhandari is a practicing advocate in Delhi. Renuka Sane is a researcher at the National Institute of Public Finance and Policy, Delhi. Bhargavi Zaveri is a researcher at the IGIDR Finance Research Group, Mumbai.

WP-2016-025

Regulatory responsiveness in India: A normative and empirical framework for assessment

Anirudh Burman and Bhargavi Zaveri

Indira Gandhi Institute of Development Research, Mumbai
July 2016
http://www.igidr.ac.in/pdf/publication/WP-2016-025.pdf

Regulatory responsiveness in India: A normative and empirical framework for assessment

Anirudh Burman and Bhargavi Zaveri
Indira Gandhi Institute of Development Research (IGIDR)
General Arun Kumar Vaidya Marg
Goregaon (E), Mumbai- 400065, INDIA
Email(corresponding author): bhargavizaveri@gmail.com

Abstract

This paper seeks to measure the extent to which Indian regulators are responsive in the performance of their functions. The paper focuses on one function common to all Indian statutory regulators, namely, regulation making. To measure responsiveness, the paper constructs an index of benchmarks of responsive conduct, with corresponding quantifiable outputs. It empirically measures the responsiveness of the telecom and securities markets regulators in India, on this index. The paper finds that there are significant differences among the laws governing Indian regulators in the context of the requirement to be responsive, and that the degree of responsiveness of Indian regulators is directly proportional to the legal requirement for following participatory processes.

Keywords: Regulatory performance; regulatory accountability; regulatory responsiveness; regulatory benchmarking; legal basis for responsiveness

JEL Code: K40, O17, P34, P37, P48

Acknowledgements:

Anirudh Burman is a legal consultant at the National Institute of Public Finance and Policy, New Delhi. Bhargavi Zaveri is a senior research associate at the Finance Research Group, Indira Gandhi Institute of Development and Research. The authors are grateful to Anjali Sharma and Arpita Pattanaik for the data on the consultations conducted by SEBI, and their help and inputs in developing this paper. The data has been updated for the purposes of this paper. The authors can be reached at anirudh.burman@gmail.com and bhargavizaveri@gmail.com respectively.

Regulatory Responsiveness in India: A Normative and Empirical Framework for Assessment

Anirudh Burman and Bhargavi Zaveri *

Contents

*Anirudh Burman is a legal consultant at the National Institute of Public Finance and Policy, New Delhi. Bhargavi Zaveri is a senior research associate at the Finance Research Group, Indira Gandhi Institute of Development and Research. The authors are grateful to Ms. Anjali Sharma and Ms. Arpita Pattanaik for the data on the consultations conducted by SEBI, and their help and inputs in developing this paper. The data has been updated for the purposes of this paper. The authors can be reached at anirudh.burman@gmail.com and bhargavizaveri@gmail.com respectively.

1 Introduction

The responsiveness of laws and policies to citizens' preferences and conduct has been the central theme of extensive literature focusing on political science and administrative law (Page & Shapiro, 1983). The question of responsiveness to citizens assumes greater importance in the case of unelected, or indirectly accountable agencies such as independent regulatory agencies. Such agencies are under a greater burden to ensure that they act in a fair and transparent manner to ensure that their policies are accepted by people who did not directly elect them, pre-empt regulatory capture and exhibit accountability to the principal which appointed them (See for example, Coglianese, Kilmartin, & Mendelson, 2009).

With the advent of privatisation in the late 1990s, India created several arms-length regulatory bodies. Table 1 provides a list of the major regulatory agencies in India today.[1] The Reserve Bank of India, which is also the regulator for large swathes of the financial sector in India, has been in existence since 1934. Most other regulatory agencies started being established in the early 1990s and 2000s. However, India lacks a common administrative law framework that governs the conduct of such agencies, including the extent to which they are required to be *responsive* in their conduct vis-a-vis the regulated and the beneficiaries of regulation.

Table 1: Independent regulatory agencies established under federal laws in India

S. No.	Regulator	Sector	Year
1	Reserve Bank of India	Finance	1934
2	Securities and Exchange Board of India	Finance	1992
3	Telecom Regulatory Authority of India	Infrastructure	1997
4	Tariff Authority for Major Ports	Infrastructure	1997
5	Insurance Regulatory and Development Authority	Finance	1999
6	Competition Commission of India	Competition	2002
7	Central Electricity Regulatory Commission	Infrastructure	2003
8	State Electricity Regulatory Commissions	Infrastructure	2003

[1]Regulatory agencies that perform all three functions of the state, i.e. regulation-making, monitoring and adjudication have been included. Pure standard or tariff setting bodies have not been included.

9	Pension Fund Regulatory and Development Authority	Finance	2005
10	Food Safety and Standards Authority of India	Health	2006
11	Warehousing Development and Regulatory Authority	Infrastructure	2007
12	Airport Economic Regulatory Authority	Infrastructure	2008
13	Petroleum and Natural Gas Regulatory Board	Infrastructure	2008

Each of these agencies is guided by its own statute which prescribes standards for the manner of their functioning. These standards vary vastly.[2] In the absence of common standards governing the conduct of regulatory agencies, one sees wide variance in the extent to which these agencies are responsive in the performance of their functions. Moreover, common standards for measuring the performance of regulators are absent in India [3].

What does this paper do?

We seek to measure the extent to which Indian regulators are responsive in the performance of their functions. In doing so, we focus on one function common to all Indian statutory regulators - regulation making.

We analyse the responsiveness of regulators on two axes. First we analyse their responsiveness along a rule-based axis, i.e. we study the extent to which

[2] *See* the observations of the Supreme Court of India in COAI v TRAI (yet to be reported), noting that in the absence of the specific statute requiring that a regulator must follow the principles of natural justice while making delegated legislation, the court cannot read such duty into the law, and urging the Parliament to frame a "a legislation along the lines of the U.S. Administrative Procedure Act (with certain well defined exceptions) by which all subordinate legislation is subject to a transparent process by which due consultations with all stakeholders are held, and the rule or regulation making power is exercised after due consideration of all stakeholders' submissions, together with an explanatory memorandum which broadly takes into account what they have said and the reasons for agreeing or disagreeing with them."

[3] The Financial Sector Legislative Reforms Commission, FSLRC, 2013 which contains extensive observations on the performance of the financial sector regulators in India states: "the present system of financial accounting of the regulator is focused primarily on the reporting of expenditures incurred by the regulator under various heads. This, according to the Commission, does not constitute a sufficient test of the fulfilment of regulatory objectives or the assessment of the regulators performance. Therefore, there is need to require regulators to adhere to a more comprehensive system of measuring their performance."

parliamentary legislation requires them to be responsive. Second, we study responsiveness based on outcomes, i.e. the extent to which the processes followed by statutory regulators in India are responsive while making regulations. In order to do so this paper develops a benchmark for what constitutes *adequately responsive* conduct in the context of the regulation-making functions of a regulator. The baseline is a consolidated index of benchmarks of adequately responsive conduct. We then identify a quantifiable output for each benchmark in the index and assign scores to the quantifiable outputs.

We then conduct a comparative case-study of two statutory regulators, a financial sector regulator (SEBI) and an infrastructure regulator (TRAI). We measure the extent to which each has been responsive in the performance of its quasi-legislative functions over a given period of time by using the baseline described in the immediately preceding paragraph. We measure their performance against the quantifiable outputs and assign scores to their performance.

Our analysis reveals three significant findings in relation to the responsiveness of regulatory agencies in India –

1. First, there are significant differences in requirements for responsiveness within the laws establishing independent regulatory agencies.

2. The participatory processes being followed compare generally unfavourable when measured against indices measuring outputs, but there is significant variation within this range.

3. The degree of responsiveness of regulators seems directly proportional to the legal requirement for following participatory processes.

Why is this paper relevant?

The idea of a "responsive" regulatory State was conceived in and much discourse on this subject has been limited to, developed economies (Braithwaite, 2006). Academic literature on regulators in emerging economies has largely focused on political economy and institutional location of independent regulators as technocratic agencies. For instance, Dubash, 2013 examines regulatory agencies in the infrastructure sector in the global South in the context of regulatory reform over the last two decades. Braithwaite, 2006 deals with strategies to implement "responsive" regulation in States with weak regulatory capacity.

The literature on Indian regulators has largely focused on the impact of regulatory agencies in specific sectors. For instance, Mukherji, 2006 and

Mukherji, 2009 have focused on the evolution of the private telecommunications industry and its regulator. Similarly, Dixit, Dubash, Maurer, & Nakhooda, 2007 have focused on developing the indicators for assessing the overall performance of the electricity regulator in India.

This paper departs from the political economy-oriented approach commonly taken towards studying regulators in emerging economies. We develop a framework for empirically analysing the performance of the regulatory function of regulation-making. The mere existence of a public consultation process will not automatically democratise delegated legislation-making. Hence, in this paper, we create a framework for evaluating the qualitative aspects of a consultation process. It is one of the first papers to develop a consolidated index containing indicators of a good legislative consultation process that can be used to quantify the responsiveness of Indian regulators. We also undertake a novel exercise by using these indicators to measure and develop scores measuring the responsiveness of Indian regulators. Our measures provide valuable insights on why one regulator performs better than the other. This has direct policy implications for what can be done to improve the performance of regulatory agencies.

The rest of the paper is organised as follows. Part 2 discusses the concept and features of responsiveness, in the context of law and policy-making. Drawing from this literature, we build a consolidated index of benchmarks of an adequately consultative process and devise quantifiable outputs for each of the benchmarks in the index. Part 3 measures responsivesness of Indian regulators on a rules based axis. Additionally, we measure the responsiveness of specific regulators, SEBI and TRAI on an outcomes-based axis. Part 4 concludes.

2 Concept and features of responsiveness

2.1 Meaning of responsiveness

Responsiveness in the context of regulation and governance has generally been conceived so widely that it has not yielded a specific definition. For instance, Selznick.P has conceived responsiveness as a democratic ideal responding to people's problems, environments and demands. He describes it as involving *outreach and empowerment*. On the other hand, the seminal work of Ayres and Braithwaite (1992) conceives responsiveness as responsiveness to the behaviour of regulated actors. They advocate a flexible approach of restorative strategy for self-enlightened actors and deterrent actions for "deviant" actors. This paper narrows the approach to responsiveness of a regulator in discharging its quasi-legislative functions.

Academic literature focusing on this aspect of responsiveness enumerates the features of responsiveness, instead of focusing on a definition. For instance, Stern, 1999 proposes broad measures for evaluating whether regulatory agencies are responsive to stakeholders in their decision making process (Table 2).

Table 2: Summary of best practices for regulatory consultations, Stern (1999)

S. No.	Recommendation
1	Formal consultation exercises
2	Formal or informal hearings
3	Surveys of customer views and priorities
4	Genuine chance of influencing decisions

Dixit et al., 2007 provide a more detailed list of benchmarks for measuring the degree of responsiveness of electricity regulators in India (Table 3). The benchmarks suggested by Dixit et al. include issues of internal capacity and accountability in addition to those of consumer-facing processes. For example, their benchmarks focus on whether there is clear communication to stakeholders on how their inputs will be used, and whether there is a clearly designated individual or department within the regulatory agency for processing such inputs.

Table 3: Summary of benchmarks developed by Dixit et. al. (2007)

S. No.	Benchmarks
1	Information about the public consultation process is circulated prior to the initiation of the consultation itself.
2	Documentation of consultation process
3	Broad distribution of information about process
4	Targeted distribution of information about process
5	Systematic efforts to consult more vulnerable socio-economic groups
6	More than two mechanisms of public participation to get public input into planning
7	Clear time frame for decisions
8	Clear time frame for providing inputs
9	Accountability for inputs

10	All proceedings before the regulatory body are open to the public, and the public has the right to participate.

Coglianese et al., 2009 summarise the recommendations of the Task Force on Transparency and Public Participation (2008) established in the United States on the issues of transparency, public participation and strategic management. Given the legislative mandate of public consultation contained in the "Federal Administrative Procedure Act," Coglianese et al., 2009 assumes the existence of a consultation process. The measures listed by it, therefore, largely deal with improving the existing process and ensuring its robustness in Table 4.

Table 4: Summary of processes recommended by Coglianese (2009)

S. No.	Recommendation
1	Involvement of the public in early stages of regulation-making (such as by announcing a periodic regulatory agenda in advance)
2	Adoption of pro-active processes to improve public access to agency information i.e. build and publish datasets of information
3	Ensuring that public can monitor information disclosure
4	Encouraging transparent communications with external actors i.e. Informal mechanisms for constant feedback
5	Usage of management based strategies to promote transparency and public participation i.e. Strategic management/ organisation policy for building effective participation mechanisms (policy manual, processes for evaluating performance on transparency and public participation)
6	Creation of regulatory dockets at the moment they begin the development of any new rulemaking
7	Effective management of the release of information to ensure public access e.g. e-rulemaking
8	Promotion of multidirectional flow of information in the comment process (such as providing two rounds of seeking public comments and public hearings.)

Oxford Pro Bono Publico, 2011 surveyed the practices prevailing in the European Union and five countries comprising South Africa, Canada, Switzerland, United Kingdom and the United States. The survey concluded with a recommendation to the effect that States must amend their constitutions to provide for effective and meaningful public participation in all forms of lawmaking or frame a law to that end.

Finally, OECD, 2014 has issued best practices for regulatory governance which includes a set of broad indicative benchmarks for a good consultative process (Table 5.) Again, since these are best practices, they are of a broader nature and not as granular as those listed by Coglianese et al., 2009.

Table 5: Summary of best practices for regulatory consultations, OECD (2014)

S. No.	Recommendation
1	Any proposed measures have well designed policy objectives and are written in a clear and precise manner so that stakeholders are able to provide comprehensive comments; impact assessments are an important part of the consultation process.
2	Outreach during consultation process.
3	Clear, enforceable, measureable, government-wide policy on active stakeholderengagement in developing and reviewing regulations.
4	Sufficient time is allocated for the consultation process, particularly forconsultations on major reforms.
5	Any proposed new regulations are consistent and coherent with the existing regulatory framework.
6	Stakeholders views are actually used to inform decision-making, and not just to justify a decision already taken.

2.2 Building a quantifiable index of responsiveness in regulation making

We have aggregated the features of responsiveness contained across various academic literature and best practices as listed in the preceding paragraphs, and prepared a consolidated index of eighteen benchmarks of an *adequate* consultative process. For each benchmark, we have assigned a concrete output, which we can use to quantify performance of an existing regulator and then assign scores.

This index is provided in Table 6. The benchmarks in the index have been broadly classified under two broad heads, in view of the fact that running a good consultation process warrants internal capacity building:

- Capacity building within the regulator to conduct a consultation exercise; and
- Interface between the regulator and the public during the consultation exercise.

Table 6: Consolidated list of benchmarks/ measures

S. No.	**Benchmark/ Measure/ Process**	**Quantifiable output**
	Capacity building within the regulator	
1	Early engagement with stakeholders through information dissemination	Does the regulator periodically publish an annual *regulatory agenda* in advance?
2	Regular publication of relevant information and datasets	Whether the regulator publishes datasets on the pre and post regulation effect on a market?
3	Systems for public monitoring of information disclosure practices	Whether the regulator has an internal whistle blowing mechanism for undisclosed information?
4	Mechanisms for continuous feedback (formal or informal)	Whether the regulator allows for petitioning for changes to or enactment of new regulations?
5	Internal capacity and systems (management tools and processes) for public participation	Whether the regulator has a process manual for conducting a public consultation exercise?
6	Dissemination of information regarding the participatory process	Is the information on the participatory process displayed on the website of the regulator?
7	Dissemination of information regarding the participatory process among targeted groups	Whether the regulator has awareness programmes amongst vulnerable groups and minorities?
8	Build review mechanisms for periodically assessing the quality of the public consultation process	Whether the regulator has a system for conducting periodic surveys and external audits of its consultation processes?
	Conduct of consultation exercise	

9	Publication of high quality explanatory documents and data that allow stakeholders to provide informed comments.	Does the regulator publish explanatory documents such as consultation papers/ draft regulations?
10	Effective outreach and consultation with targeted groups as part of the consultative process	Does the regulator proactively communicate with groups most likely to be affected?
11	Multidirectional flow of information between the regulator and the public and the public inter-se	Does the regulator publish comments recieved before issuing the final regulation? Does the regulator provide time for counter-comments? Does the regulator provide a response to the comments? Does the regulator provide more than one method of receiving feedback?
12	Dissemination of information about time-frame within which decisions will be made based on consultations	Does the regulator publish a statement of when the decisions will be made based on the consultative process?
13	Adequate time for submission of comments	Does the regulator give adequate time for submission of comments and counter-comments?
14	Internal processes for identifying who is accountable for running the process for the regulatory agency.	Does the regulator publish the name of the individual-in-charge of the consultation process?
15	Ensuring consistency with primary legal framework	Does the regulator publish the source of the legal power to issue the proposed regulations?

3 Measuring responsiveness of Indian regulators

3.1 Rule-based measures

Steps taken during the late 1980s to deregulate India's command and control structure did not fundamentally alter the administrative structure of the Indian state (Kochanek, 1986). This changed gradually over the 1990s, when a number of new regulatory agencies were established under specific parliamentary legislation. However, there is considerable difference in the internal processes and administrative law applicable to each regulatory agency. Work on regulatory dispersion explains why these inconsistencies arose, and continue to exist in the absence of an overall administrative law framework. As Dubash (2013, p. 103), notes, at least in India's electricity sector,

> "*The process through which electricity regulatory agencies entered India was remarkably devoid of reflection on whether and how these bodies would be able to achieve their core design objective of depoliticizing decision-making in the sector.*"

Evidence of this can also be seen in the degree of difference in the primary legislation.

Table 7: Legal requirement for independent regulatory agencies to be responsive

S. No.	Regulator	Legal requirement for consultation
1	Reserve Bank of India	No*
2	Securities and Exchange Board of India	No*
3	Telecom Regulatory Authority of India	Yes
4	Tariff Authority for Major Ports	No
5	Insurance Regulatory and Development Authority	No*
6	Competition Commission of India	No
7	Central Electricity Regulatory Commission	Yes
8	State Electricity Regulatory Commissions	Yes
9	Pension Fund Regulatory and Development Authority	No*
10	Food Safety and Standards Authority of India	No

11	Warehousing Development and Regulatory Authority	No
12	Airport Economic Regulatory Authority	Yes
13	Petroleum and Natural Gas Regulatory Board	No

* These regulators voluntarily agreed to comply with a Handbook on Governance Enhancing Measures published by the Ministry of Finance.

Table 7 highlights three important findings:

1. Not all laws governing regulators mandates them to follow a consultation process in exercise of their quasi-legislative function.
2. While none of the laws governing financial sector regulators mandate them to be 'responsive', more than half the laws governing infrastructure regulators mandate 'responsiveness' in their functioning.
3. While parliamentary laws mandate AERA and TRAI to follow consultative processes, the standard imposed by parliament in both cases is different, and it is unclear what consultative processes are sufficient for meeting the obligation established in the primary law.[4]

Given the lack of responsiveness mandates in the primary law and the wide variance in the mandate amongst primary laws that have it, we find that overall, the Indian legal framework scores low on rules-based measures of responsiveness.

3.2 Outcome-based measures: Case-study of SEBI and TRAI

To understand the extent of responsiveness of Indian regulators while performing their quasi-legislative functions, we analyse the perfomance of two Indian regulators - SEBI and TRAI - for a limited duration. This enabled us to understand the responsiveness of SEBI and TRAI individually and compare their relative responsiveness as per the benchmarks devised in section 2.

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Data for measuring responsiveness

In the absence of an administrative law in India governing regulators, Indian regulators, including TRAI and SEBI issue various instruments, all of which have a binding effect on regulators. SEBI exercises its quasi-legislative powers though different kinds of instruments such as regulations, circulars and notifications. (See Pattanaik and Sharma, 2015). While regulations made by SEBI are required to be placed before the Parliament, circulars are not so required.[6] However, all of these instruments are delegated legislation in the sense that they are issued *in rem*. TRAI similarly exercises its quasi-legislative powers through different kinds of instruments such as regulations, orders and directions. While orders are used for setting industry tariffs, regulations and directions are used for non-tariff related matters. Regulations made by TRAI are required to be placed before the Parliament. However, orders and directions are not so required. Regulations and orders are instruments *in rem*. On the other hand, directions may be issued to specific service providers or a class of them. [7]

3.2.1 How many legislative instruments underwent legislative scrutiny?

We studied the different kinds of legislative instruments issued by both SEBI and TRAI for the period beginning January 2014 and ending April 2016. Table 8 contains the details of the kinds of instruments issued by SEBI and TRAI during this period.

Table 8: Instruments issued by SEBI and TRAI (1st January 2014-30th April 2016)

Instrument	SEBI	TRAI
Regulations	51	22
Circulars	122	0
Orders[8]	0	12

[6]The "Securities and Exchange Board of India Act, 1992" requires that all regulations made by SEBI must be laid before both the House of Parliament. The "Securities and Exchange Board of India Act, 1992" additionally empowers SEBI to *to protect the interests of investors in securities and to promote the development of, and to regulate the securities market, by such measures as it thinks fit*. This wide power enables SEBI to perform some of its quasi-legislative functions through instruments such as circulars.

[7]The "Telecom Regulatory Authority of India Act, 1997" requries that all regulations made by TRAI must be laid before both the House of Parliament. The "Telecom Regulatory Authority of India Act, 1997" additionally empowers TRAI to issue orders for tariff-setting and directions for the perfomance of its functions.

[8]Orders refers to *orders in rem*.

Directions	0	24
Notifications	2	0
Total	175	58

We find that (a) both regulators use multiple instruments for regulating their respective markets, (b) both the regulators issue a larger number of legislative instruments which do not undergo legislative scrutiny. In percentage terms, while about twenty-nine (29) percent of the total number of legislative instruments issued by SEBI during the study interval underwent Parliamentary scrutiny, about thirty-seven (37) percent of the total legislative instruments issued by TRAI during the study interval underwent legislative scrutiny. Therefore, while TRAI fares relatively better than SEBI on issuing instruments which undergo legislative scrutiny, less than half of the legislative instruments issued by both regulators undergo legislative scrutiny.

3.2.2 How many legislative instruments were preceded by a consultation process?

We then studied whether each of the legislative instruments issued by SEBI and TRAI underwent a formal public consultation process of some form before their issuance. We find that SEBI held a formal public consultation process for about 10% of the legislative instruments issued by it. TRAI held a formal public consultation process for about 47% of the total number of legislative instruments issued by it. Table9 contains the details of our findings.

Table 9: Public consultation for delegated legislation issued by SEBI and TRAI (1st January 2014-30th April 2016)

Item	**SEBI**	**TRAI**
No. of instruments issued	175	58
No. of instruments preceded by public consultation	18	27
Percentage	10.28%	46.55%

3.2.3 Descriptive analysis of the consultative processes followed by SEBI and TRAI

To assess the qualitative aspects of the process and identify whether the process led to the outcomes identified in the responsiveness index contained in Table 2.2, we studied the qualitative aspects of the consultation processes followed by SEBI and TRAI.

SEBI's process involves publishing a discussion paper with a fixed time line for submission of public comments. SEBI does not engage in information dissemination exercises when the discussion paper is published or hold oral hearings for public comments. The consultation papers contain the objective of the proposed regulation and the problem being addressed. However, they generally present only one solution and do not contain a cost-benefit analyses of multiple possible solutions. The consultation paper often contains an objective worded in general terms such as "in the interest of investors" and to "promote market development".(See Pattanaik and Sharma, 2015).

During the consultation process, there is no multi-directional flow of information between the public and SEBI or amongst the public *inter se*. The comments received from the public in response to the consultation paper issued by SEBI are not published. When the final regulation is issued, it is generally accompanied with a statement that SEBI has considered the representations received. On an average, it gives about twenty (20) days for the public to comment on the consultation paper issued by it. (See Table 10) There is no information in public domain on the kind of representations that were made, the ones which are accepted or the reasons for rejecting those which are not. Zaveri (2016) notes that the discussion paper was identical to the text of the final regulations issued on at least two occasions. Pattanaik and Sharma (2015) have a similar finding on the outcome of the consultation exercise. The time-lag between the date on which the consultation exercise is completed and the date of issuance of the instrument ranges from 55 days to 645 days. The average time-lag is a staggering 250 days. (See Table 11.)

There is no data in public domain on the capacity building, if any, done by SEBI internally to strengthen the consultation exercise or place quality controls on the content of the discussion papers.

While TRAI follows a more detailed process of consultations for regulations and orders compared to SEBI, it does not generally conduct a formal consultation process before issuing directions.[9]

Often, though not always, the process begins with a high-level discussion paper which highlights the broad issues for consideration. This is then

[9] We came across a draft direction which was put up for consultation on January 20, 2016. As of the date of this writing, a direction has not been issued pursuant to the draft.

followed up with a discussion paper which dwells into the details of the proposed regulatory approach. While there is no uniformity in the quality of the consultation paper, the paper is generally structured to include the objective of the proposed intervention, industry practice, developments leading up to the consultation paper and the issues for consultation. Sometimes, the consultation paper also includes data such as global practices in respect of the issues under consideration. While some discussion papers have open-ended questions, others are more exploratory and reflect the regulator's proposed regulatory approach. The discussion papers do not propose multliple options with a cost benefit analysis of each.

There is multi-directional flow of information during the consultation process. About twenty one (21) days are given for the first round of comments. In several cases, TRAI has extended the duration for responding to the consultation paper. The comments are put up in public domain as they start flowing in. Approximately seven (7) days are then reserved for allowing the public to offer counter-comments. (See Table 10). The counter-comments are also published. The time-lag between the date of completion of the consultation process and the issuance of the legislative instrument ranges from fourteen to two hundred and forty six days (14 to 246 days). The average time-lag is eighty two (82) days. (See Table 11).

The final regulation or order is accompanied with an explanatory memorandum explaining the public consultation process followed prior to the issuance of the instrument. However, the explanatory memorandum does not give specific reasons for acceptance or rejection of some comments over the others.

There is no data in public domain on the capacity building, if any, done by TRAI internally to strengthen the consultation exercise or place quality controls on the content of the discussion papers.

Table 10: Time given for responding to consultation papers (in days)

Regulator	Minimum	Maximum	Median	Average
SEBI	7	35	21	20
TRAI	15	44	29	27.41

Table 11: Time-lag between close of consultation and issuance of instrument (in days)

Regulator	Minimum	Maximum	Median	Average

SEBI	55	645	160	250
TRAI	14	246	58	82.26

3.3 Measuring outcomes, assigning scores

On the basis of the index described in Part 2.2, we have assigned scores toSEBI and TRAI, depending on whether they have achieved the outputs indicated for each benchmark. Since information relating to the internal capacity building for each of these two regulators is not available in public domain, we have not included scores on the benchmarks relating to internal capacity building by these regulators. Where no data on any other benchmark relating to either regulator is available in public domain, we have assigned a score of 0 to both regulators.

For each output that is a 'yes', we have assigned a score of 1. Where an output has been achieved partially achieved, we have assigned a proportionate score in percentage terms out of a total score of 1. For example, if 46.55% of the legislative instruments issued by TRAI were preceded by public consultation, then on that output, we have assigned a score of 0.47 (after rounding off to the closest whole number) to TRAI. The outputs and scores for SEBI and TRAI are reflected in Table 12.

Table 12: Outputs and scores for responsiveness of SEBI and TRAI (1st January 2014-30th April 2016)

Sr.No.	Output	SEBI	SEBI's score	TRAI	TRAI's score
1.	Does the agency publish explanatory documents? [10]	10% of legislative instruments were preceded by explanatory documents.	0.10	47% of legislative instruments were preceded by explanatory documents.	0.47
2.	Does the agency pro-actively communicate with groups most likely to be affected?	No data (No).	0	No data (No).	0
3.	Does the agency publish comments received before issuing the final regulation?	No	0	Yes	1
4.	Does the agency provide time for counter-comments?	No	0	Yes	1
5.	Does the agency provide a response to the comments received?	No	0	No	0
6.	Does the agency provide more than one method of receiving feedback?	No	0	Yes	1
7.	Does the agency publish a statement of when the decisions will be made based on the consultative process?	No	0	No	0

[10] Explanatory documents refers to discussion papers and/ or draft regulations.

8.	Does the agency publish the name of the individual in charge of the consultative process?	No	0	No	0
9.	Does the agency publish the source of the legal power to issue the proposed regulation?	Yes	1	Yes	1
10.	Does the agency give adequate time for responding to the draft proposed by it? [11]	SEBI allows an average of 20 days for responding.	0	TRAI allows an average if 27.41 days for responding.	0
Total	-	1.10	-	4.47	

[11]The pre-legislative consultative policy issued by a Committee of Secretaries of the Central Government requires a minimum of 30 days for responding to a draft published by the regulator. Best practice documents issued by OECD also warrant a time of not less than 30 days. Hence, we used 30 days as a benchmark of *adequate* time.

The second column of the table refers to the concrete output. The third and fifth columns indicate whether the outputs have been achieved and where partially achieved, the extent to which they have been achieved, for SEBI and TRAI respectively. The fourth and sixth columns assign scores, depending on the entries in the third and fifth columns.

We find that on a score of 10, while TRAI achieves close to half the outputs, SEBI lags behind dismally with a score of 1.10.

The legislative frameworks governing the quasi-legislative functions of both SEBI and TRAI are similar in that they recognise the power to issue multiple categories of legislative instruments and mandate different standards of accountability for each such instrument. However, there is vast variation between the degree of responsiveness amongst both regulators in exercising their quasi-legislative functions.

4 Conclusion

By measuring the 'responsiveness' of two Indian regulators on a rules and outcomes based axis, this paper makes two specific contributions to the discourse on best practices of regulatory governance issues in emerging economies, and specifically in India.

First, it provides an empirical framework for assessing responsiveness of regulatory agencies. This framework can be scaled for assessing the responsiveness of regulatory agencies in India and elsewhere. This can feed into an initiative to measure the performance of regulatory agencies by the regulator itself, external audit agencies such as the Comptroller and Auditor General of India and the Government Audit Office in the United Kingdom, the government as the principal and the citizens themselves. Performance evaluation exercises at regular intervals on the basis of such frameworks will, in turn, incentivise regulators to be publish data which the external agencies can rely on when using such assessment frameworks. Where Parliamentary oversight mechanisms are not strong, such evaluations will act as feedback loops and information to them.

Second, the paper demonstrates variance in the responsiveness of regulatory agencies in India, in the absence of uniform standards governing the conduct of Indian regulators. There are two factors which contribute to this variance: the absence or weakness of the laws governing the conduct of regulators, and the weakness of oversight over regulatory agencies. Again, the framework developed in this paper can help plug the second contributing factor.

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Legal process in rule-making: A success story in an unexpected place

by Shubho Roy and Deepaloke Chatterjee.

Rule-making process: A critical component of the rule of law

A despotic king has absolute power. When a society matures, the rule of law emerges in two stages. First, the despotic ruler writes down a set of rules, and the main body of government implements the law. So the interface between citizen and State is now governed by law, but a despotic king has the god-given power to enact new law.

The next stage of the evolution of the rule of law is where the very law-making process is enveloped in checks and balances. It is useful to think of three levels:

1. In the worst scenario, there is only the command of a few men that purports to be the law of the land. Governments can act capriciously, violate stated laws, and courts (if they exist at all) are no help.
2. The next step up, in history, was the despotic rulers of Continental Europe who preserved the absolute right of the king to make law, but built a fairly sophisticated system of civil servants, judges and courts through which citizens faced the consistently applied rule of law. At the same time, the ruler retains unbridled power in changing laws. With the high quality judges who hear cases at the the Dubai International Financial Centre (DIFC), we may now place DIFC in this league.
3. The next step up is a liberal democracy, where legitimacy is won because the very rule making process is governed by checks and balances; is enveloped in the rule of law.

The rule-making process in independent regulators

In this post, we focus on independent regulators, which are a fascinating combination of law-making and law-enforcement. Parliament empowers them to write law. At the same time, this does not mean that a regulator is a despotic king who can issue law based on any whim and fancy. Democratic accountability requires that the very process through which an independent regulator writes law should also be enveloped in a system of checks and balances.

The Indian situation

While the above is well understood in developed countries, in India this is still very new terrain. Most finance practitioners would not be surprised if they are surprised by the newspapers with a completely new regulation issued by a financial regulator. In the field of financial regulation, the best practices in India are usually found at SEBI. However, on this issue -- the rule-making process -- SEBI remains relatively weak. At other financial regulators, rules are often issued like fatwas.

We recently came across a remarkably good arrangement in an unexpected place: the Airports Economic Regulatory Authority (AERA). In this blog post, we describe this process. While this is not yet state of the art by world standards, we think this is state of the art by Indian standards.

The rule-making process in AERA

AERA was established in 2008. As with all regulators, it has to set out regulations governing the stake-holders in its domain. The steps AERA undertakes before making regulations display a level of transparency and organization rarely seen in Indian regulators.

The AERA Act requires the regulator to maintain transparency through the following mandates:

1. Hold consultation with all stake-holders.
2. Allow all stake-holders to make submissions.
3. Document and explain all decisions.

One of the first actions of the AERA was to establish its approach and philosophy towards regulation. This was done through the method mentioned above. Let us look at the steps AERA went through:

1. A white paper was released in December 2009. It contained major issues impacting formulation of a regulatory philosophy and approach.
2. An opportunity was given to stake-holders to consider the issues highlighted and provide feedback, comments and suggestions.
3. AERA considered all the submissions and released a consultation paper in February 2010. This consultation paper contained not only the submissions received for the White Paper (the relevant paragraphs were annotated) but also *detailed responses from AERA to each submission* . Apart from the response, it also provided reasons for the approach taken (and the economic rationale where possible).
4. After the release of the consultation paper, another meeting was held where comments were received. The minutes of the meeting were uploaded on the Authority's web page.
5. AERA finalised its regulatory approach (for determination of tariffs) and issued an Order in January 2011. The order stated that the guidelines would be drafted in consonance with the consultation paper.
6. The AERA then issued the draft guidelines in February 2011. The stake-holders were again given an opportunity to comment, and another meeting was held with the stakeholders.

Analysis

This process is important for the healthy functioning of democracy. As Robert Conquest wrote in his article *Downloading Democracy* in *The National Interest* in Winter 2004-05:

> *A civic society is a society in which the various elements can express themselves politically, in which an articulation exists between those elements at a political level. A civic society is not a perfect social order - which is in any case unobtainable - but a society that hears, considers and reforms grievances. It is not necessarily democratic, but it contains the possibility of democracy.*

Most regulators in India invite comments from stake-holders. What is unique about AERA is the level of documentation and detail it provides *in response* to the comments. The entire procedure is available publicly. The parties who provided comments may not agree with the position of the regulator but they know that their comments were heard and considered. This helps create the incentive for the larger community to engage with the regulator in future consultations. A sure sign of difficulty in the rule-making process at a regulator is the event of a `consultation process' that attracts a negligible amount of comments: that tells us that the wider community has lost confidence in the regulator.

The entire process is not a one-off incident. AERA has created a detailed guideline on how it will go about inviting comments and involve stake-holders in their discussion. This creates benefits for both the regulator and the regulated as:

- The regulator can now clearly state that it is fulfilling its requirements for meeting the mandate of transparency and consultation as required under its parent legislation.
- The regulated entities/ stake-holders are clearly aware of process that goes into the drafting of regulations.

The legal process surrounding rule-making at AERA takes away arbitrary and discretionary power in the hands of the senior staff of AERA to issue rules based on whim or fancy, and thus reduces the chances of mistakes being made or of rules being hijacked through ignorance or corruption.

Economists and the Ministry of Finance are generally confident that some of the best governance in India happens on their watch (e.g. SEBI). It may come as a surprise to see sophisticated legal process in an unexpected place: AERA. As we attempt to build more sophisticated regulators in finance and infrastructure, AERA's work needs to be studied, emulated and improved.

2.5. Ownership neutrality and competition

The Indian financial system has an array of firms: co-operatives, private Indian firms, foreign firms and public sector firms. The Commission envisages a regulatory framework where governance standards for regulated entities will not depend on the form of organisation of the financial firm or its ownership structure. This will yield 'competitive neutrality'. In this framework, the regulatory treatment of companies, co-operatives and partnerships; public and private financial firms; and domestic and foreign firms, will be identical.

2.5.1. Treatment of foreign firms

Whether or not, or the extent to which, participation by foreign firms should be allowed in the financial sector is a policy matter to be determined by the Government. However, once a decision to allow foreign participation in a particular financial market has been made, there should be consistency in the regulatory treatment of foreign and domestic participants performing similar functions or undertaking similar risks in the market.

For example, if the foreign investment policy for a particular sector permits wholly owned foreign subsidiaries, the regulator must ensure that the net worth requirements, capital adequacy norms, investment limits and all other regulatory interventions should be the same for foreign subsidiaries and domestically owned firms.

Hence, the Commission recommends, under the capital controls framework of the draft Code, that subject to control restrictions as prescribed, there should be full national treatment for foreign firms.

2.5.2. Public sector financial institutions

The future of public sector financial firms is an important policy question which will shape the contours of Indian finance. In coming decades, public sector financial firms are likely to continue to be with us. The Commission has therefore identified three elements in the treatment of these firms:

1. Public sector financial firms require effective regulation and supervision. If there are problems with these firms, they impose costs upon the exchequer. Improvements in regulation and supervision will reduce the potential problems faced with public sector ownership.
2. At the same time, the draft Code emphasises the principles of equal treatment and a pro-competitive environment.
3. To the extent that competition concerns in the financial sector arise on account of existing laws that confer special privileges on state-owned enterprises, the Commission recommends amendments to the laws to create a level playing field between regulated entities, irrespective of their ownership structure.

The goal of achieving competitive neutrality in the financial sector necessarily involves a rethinking of laws such as the State Bank of India Act, 1955 and the Life Insurance Corporation Act, 1956, that were enacted to create specific financial institutions. These laws contain provisions that vary or exclude the applicability of general corporate and financial laws to the institutions created under them. They also confer special privileges as seen in the case of the explicit Government guarantee under the Life Insurance Corporation Act, 1956, for all sums assured under LIC policies. The existence of such a provision in the law despite the entry of private insurers in the market induces an unfair competitive advantage in favour of LIC as many customers would tend to choose its policies over those offered by private insurers on account of the Government guarantee.

The Commission therefore recommends the repeal or large scale amendment of all special legislations that (a) establish statutory financial institutions; or (b) lay down specific provisions to govern any aspect of the operation or functioning of public sector financial institutions (see Table 2.1). The undertakings of all statutory institutions should

Table of Recommendations 2.1 List of statutory financial institutions

The following is a list of statutes that provide for the establishment of statutory financial institutions or contain special provisions to govern the operation and functioning of public sector financial institutions:

1. The State Financial Corporations Act, 1951:
   Andhra Pradesh State Financial Corporation; Himachal Pradesh Financial Corporation; Madhya Pradesh Financial Corporation; North Eastern Development Finance Corporation; Rajasthan Finance Corporation; Tamil Nadu Industrial Investment Corporation Limited; Uttar Pradesh Financial Corporation; Delhi Financial Corporation; Gujarat State Financial Corporation; The Economic Development Corporation of Goa; Haryana Financial Corporation; Jammu & Kashmir State Financial Corporation; Karnataka State Financial Corporation; Kerala Financial Corporation; Maharashtra State Financial Corporation; Odisha State Financial Corporation; Punjab Financial Corporation; West Bengal Financial Corporation
2. The State Bank of India Act, 1955
3. The Life Insurance Corporation Act, 1956
4. The State Bank of India (Subsidiary Banks) Act, 1959:
   State Bank of Bikaner and Jaipur; State Bank of Indore; State Bank of Mysore; State Bank of Patiala; State Bank of Travancore; and State Bank of Hyderabad established under the State Bank of Hyderabad Act, 1956
5. The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970:
   Central Bank of India; Bank of India; Punjab National Bank; Bank of Baroda; UCO Bank; Canara Bank; United Bank of India; Dena Bank; Syndicate Bank; Union Bank of India; Allahabad Bank; Indian Bank; Bank of Maharashtra; and Indian Overseas Bank
6. The General Insurance Business (Nationalisation) Act, 1972:
   General Insurance Corporation of India; National Insurance Company Limited; New India Assurance Company Limited; Oriental Insurance Company Limited; and United India Insurance Company Limited
7. The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980:
   Andhra Bank; Corporation Bank; New Bank of India; Oriental Bank of Commerce; Punjab and Sind Bank; and Vijaya Bank
8. The Export-Import Bank of India Act, 1981
9. The National Bank for Agriculture and Rural Development Act, 1981
10. The National Housing Bank Act, 1987
11. The Small Industries Development Bank of India Act, 1989

be transferred to ordinary companies incorporated under the Companies Act, 1956 and their regulatory treatment should be identical as that applicable to all other financial companies. This has previously been done in case of the following institutions which were statutory corporations that were subsequently converted to companies under the Acts mentioned below:

1. IFCI Limited (previously called the Industrial Finance Corporation of India) through the Industrial Finance Corporation (Transfer of Undertaking and Repeal) Act, 1993;
2. Industrial Investment Bank of India Limited (previously called the Industrial Reconstruction Bank of India) through the Industrial Reconstruction Bank (Transfer of Undertakings and Repeal) Act, 1997;
3. Unit Trust of India through the Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002; and
4. IDBI Bank Limited (previously called the Industrial Development Bank of India) through the Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003.

The Commission recognises that the repeal or large scale amendments of the statutes identified in Table 2.1 is a long drawn process that may take some time for the Central Government to implement. However, there are certain specific provisions relating to winding up and liquidation of the concerned institutions under these laws that need to be amended immediately to give effect to the resolution framework envisaged by the Commission. This is being done in part on resolution in the draft Code.

It has also been observed that certain financial activities that are owned and managed by Government agencies tend to fall outside the sphere of financial regulation although they are functionally identical to regulated financial activities. This includes fund management services offered by the Employees' Provident Fund Organisation (EPFO), insurance services of postal life insurance and the Employees' State Insurance Corporation (ESIC) and the various small savings products issued by the Government. To the extent that these bodies are performing a social welfare function, it would not be practical or desirable to apply all areas of financial regulation to them with the same rigour that is used for private enterprises. However, the Commission recommends that there is a need for proportional regulation of these activities, particularly in the field of consumer protection so that consumers are entitled to the same rights and protections irrespective of the ownership status of the service providers.

Hence, the Commission recommends that:

1. The Government should formulate a plan for the review of the following laws and schemes, which involve the provision of financial services directly by the Government or by agencies created by it:
    - The Government Savings Bank Act, 1873
    - The Employees' State Insurance Act, 1948
    - The Coal Mines Provident Fund Act, 1948
    - The Employees' Provident Funds and Miscellaneous Provisions Act, 1952
    - The Assam Tea Plantation Provident Fund Act, 1955
    - The Jammu & Kashmir Employees' Provident Fund Act, 1961
    - The Seamens' Provident Fund Act, 1966
    - The Public Provident Fund Act, 1968
    - Post Office Life Insurance Rules, 2011
2. The laws and schemes should be examined from the perspective of assessing the changes required in order to bring them within the purview of financial regulation and to ensure compatibility with the laws drafted by the Commission.

2.5.3. Treatment of co-operatives

In understanding the wide spectrum of the financial system in India, the Commission also focused on the role of co-operative societies. The subject of co-operative societies falls under Entry 32, List II of the Seventh Schedule of the Constitution of India, which provides that the incorporation, regulation and winding up of these bodies falls within the purview of the State Governments.

In addition, when co-operative societies engage in the business of financial services, they need to be regulated and supervised by financial regulators in a manner that is commensurate with the nature of their business and the risks undertaken by them. Since financial co-operatives often cater to the needs of small households, the Commission is of the view that such institutions should carry out their business under sound prudential regulation and resolution framework, with strong protections for their consumers and appropriate safeguards to ensure that in the eventuality of their failure, the burden does not fall upon tax payers. For this to be possible, the draft Code should apply in its entirety to co-operative societies providing financial services, to the same extent as it would apply to corporate entities.

Under the current laws, co-operative banks are subject to a system of dual regulation – by the Registrars of Co-operative Societies in State Governments and the RBI, as the banking regulator. This has resulted in operational and governance challenges in the regulation of co-operative banks that have been attempted to be addressed through memorandums of understanding entered into between the RBI and State Governments. The Commission recommends that financial regulators should have statutory control over the regulation and supervision of financial co-operatives, without having to rely on contractual arrangements with State Governments. This can be achieved under Article 252 of the Constitution which allows two or more State Legislatures to pass a resolution accepting the authority of the Parliament to make laws for the State on any matter on which the Parliament otherwise does not have the capacity to legislate. Using this provision, State Governments could pass resolutions to transfer the power to make laws on the regulation and supervision of co-operative societies carrying on financial services to the Parliament.

The grant of authorisation to carry on financial services is the prerogative of the financial regulator. The draft Code provides that while laying down the criteria for carrying on a financial service, the regulator may specify the permissible forms of organisation for a proposed financial service provider. The regulator may therefore decide that co-operative societies from States that have not allowed the Central Government to legislate on the regulation and supervision of co-operative societies carrying on financial services:

1. will not be granted the authorisation to carry out certain financial services, such as banking or insurance, which require intense micro-prudential regulation; or
2. will be granted authorisation to carry on specific financial services subject to certain limitations, such as, restrictions on access to the real-time gross settlement and discount window facilities provided by the central bank and exclusion from the protection of deposit insurance provided by the resolution corporation.

The Commission therefore makes the following recommendations with respect to co-operative societies:

1. In consonance with the recommendations on competitive neutrality, co-operative societies carrying on financial services should be subject to similar prudential regulation, consumer protection and resolution frameworks as other entities carrying on similar activities.
2. Using Article 252 of the Constitution of India, State Governments should accept the authority of the Parliament to legislate on matters relating to the regulation and supervision of co-operative societies carrying on financial services.
3. The regulator may impose restrictions on the carrying on of specified financial services by co-operative societies belonging to States whose Governments have not accepted the authority of the Parliament to legislate on the regulation of co-operative societies carrying on financial services.

CHAPTER 3

Structure of the regulator

Government agencies are required to perform complex functions in eight areas in finance: consumer protection, micro-prudential regulation, resolution of failing financial firms, capital controls, systemic risk, development, monetary policy and debt management. For these functions to be appropriately performed, well structured Government agencies are required. This is sought to be achieved through a specialised and consolidated set of provisions on regulatory governance in the draft Code.

The Commission believes that the requirements of independence and accountability of financial regulators are the same across the financial system and hence it recommends a unified set of provisions on financial regulatory governance for all areas of finance. The objective of the proposed Code on regulatory governance is to create a series of obligations for the Government and for regulators. The Code will cover all functions of the regulator and lay down the principles and standards of behaviour expected from the regulator. It will also provide for a system of monitoring the functions of the regulator with a process to ensure that the regulator is fully transparent and they act in compliance with the best practices of public administration. Table 3.1 captures the recommendations of the Commission for the creation of an appropriate regulatory structure.

The Commission recommends that the structure of the regulator be standardised for all financial regulators. However, there may be exceptions required in respect of certain specific functions where the general regulatory processes may not apply. These exceptions to the general process law should be kept to the minimum and generally avoided.

3.1. Selection of the regulator's board

Regulators in India are statutory entities headed by a board. It is the responsibility of the Government to appoint the members on the board of the regulator. The Commission believes that it is necessary to create a statutory system for selecting board members in a fair and transparent manner. It is recommended that the Government should be aided in this process by a professional search and selection committee. This will help ensure that the selected members are competent persons with relevant knowledge and experience.

The Commission looked at various systems of selection committees present under Indian laws along with the practice in other common law jurisdictions. Based on this analysis, it recommends that the government should maintain a panel of experts who will serve as members of the selection committee at all times. Their expertise would be

Table of Recommendations 3.1 Basic structure of the regulator

1. The regulator will be set up as a corporate entity;
2. It will have the powers of a body corporate, including the power to enter into contracts, employ persons, acquire assets, hire agents and delegate certain functions to them; and
3. The regulatory organisation will be composed of three parts:
   (a) *Board of the regulator:* responsible for oversight and governance of the regulator;
   (b) *Chairperson:* will be the chief executive of the regulator and will chair its board; and
   (c) *Office of the regulator:* comprising of the employees, agents and assets of the regulator.

Table of Recommendations 3.2 Selection of board members

1. The responsibility for appointing board members vests with the Government. While discharging this responsibility, the Government will be guided by the recommendations of a selection committee.
2. The selection committee will shortlist at least three candidates for every position and provide the list to the Government.
3. The structure of the selection committee will be as follows:
   (a) The members will be appointed out of a list of experts maintained by the Government at all times, consisting of experts in the fields of finance, economics, law and public administration.
   (b) It will consist of: a representative of the Government (who will serve as the chairperson), the chairperson of the regulator (and in the case of selection of the chairperson, another Government representative), and three experts from the list maintained by the Government.
   (c) The majority of the members must be persons who are not related to the Government. This is to ensure that the selection committee is not biased towards short listing only Government officials.
4. Merit will be the guiding principle for the appointment of board members. Therefore, if the pool of applicants in a selection process is weak, the selection committee will have the right (after recording the reasons) to suggest other names to be considered for selection. Nominations by any member of the selection committee should be in writing, accompanied by a statement of competence and experience of the person.
5. The regulator must, in advance, inform the search and selection committee of any foreseeable vacancies and it will be the duty of the selection committee to forward the names of short-listed candidates before the vacancy arises, and give the Government reasonable time to make a decision.

utilised by rotation as and when appointments to the board are to take place. The selection system will be governed by the process provided in Table 3.2.

The selection procedure should be designed in a manner that achieves a balance between the requirements of flexibility and transparency. Therefore, the draft Code does not lay down such level of detail that the selection committee is unable to shortlist deserving candidates or takes too long to do so. At the same time, the integrity of the selection procedure will be protected by requiring that all short-listing and decision making are done in a transparent manner - the committee should disclose all the relevant documents considered by it and prepare a report after the completion of the selection procedure. This will include the minutes of the discussion for nominating names, the criteria and process of selection and the reasons why specific persons were selected. The committee would however, not be required to disclose any discussion about candidates who were not short-listed.

3.2. Composition of the board of the regulator

The Commission suggests that the Board of a regulator should have four types of members:

1. *Chairperson* - There will be one chairperson of the board of a regulator. He/she will be responsible for the functioning of the board and the office of the regulator. He/she will also be responsible for and empowered with the day-to-day management of the regulator. In the event the chairperson is not available, the longest serving member of the board shall act as the chairperson.
2. *Executive members* - The chairperson will be accompanied by a set of executive members. Within

Table of Recommendations 3.3 Types of members on the board of the regulator

1. Chairperson of the board
2. Executive members, including a set of designated administrative law members
3. Non-executive members
4. Government nominees

this category of members, some persons will be designated as administrative law members. *Administrative law members* will be responsible for:

(a) Reviewing the performance and carrying out the oversight of a designated set of employees of the regulator, referred to as administrative law officers; and

(b) Reviewing the decisions taken by the administrative law officers.

The executive members will devote their entire time to the management of the regulator and will not be permitted to take up any other employment during their appointment. These members will be responsible for the oversight of the regulator's personnel, except for administrative law officers who will be monitored only by administrative law members.

3. *Non-executive members* - This category will consist of persons who are experts in the fields of finance, law, economics, etc., and are appointed to the board on a part-time basis. They will not be involved in the day to day functions of the regulator. Non-executive members may take up other engagements but will have to manage conflict of interest issues when participating in board meetings.
4. *Government nominees* - The Government will have the right to nominate ex-officio members on the board of the regulator. These members will represent the perspective of their departments/ministries or other regulators in the functioning of the regulator.

The Commission believes that it is crucial for the draft Code on regulatory governance to lay down the functions and powers of each type of member on the board of a regulator. Accordingly, the law will state that the chairperson and executive members are responsible for the day to day functioning of the regulator. The role of the administrative law members will be to focus on the regulator's adjudication and administrative law functions. Having a category of non-executive members is a continuation of the present system of appointing part-time members on the boards of financial regulators. Such non-executive members will provide two important benefits to the management of the regulator:

1. Since they will not be employees of the regulator, it is expected that they will be neutral observers in the functioning of the regulator and alert the Government of any violations of law by the regulator.
2. Such members should have expertise in finance and allied fields, and preferably also some experience in providing financial services. This will bring in expertise and information about the financial sector to the board of the regulator.

Unlike ordinary civil servants, board members are appointed for a limited time and do not have a guarantee of continued employment. Therefore, one of the crucial requirements of independence is that the members should be protected from pressure through change in their terms of appointment.For this reason, the Commission recommends that the draft code should provide the conditions of appointment of members - duration, entitlements, system of removal and conflicts of interests (see Table 3.4).

3.3. Functioning of the board

The functioning of the board of regulators should primarily be left to the rules and regulations formed by the regulator. However, in the interest of accountability, certain principles must be laid down to govern the actions of the board. The Commission is of the opinion that best practices of conducting the functions of deliberative bodies should be incorporated in the functioning of the regulator. The recommendations with regard to what should be contained in the draft Code to govern board meetings is provided in Table 3.5.

Table of Recommendations 3.4 Appointment conditions for board members

1. *Duration of employment:* All members of a board (including the chairperson) would have a fixed term of five years, subject to a retirement age for executive members. The age of retirement for executive members must be equivalent to the age of retirement for the equivalent senior-most Government positions.
2. *Protection of entitlements:* The salaries and other entitlements of the members of the board should be fixed by the Government. However, once they are set, they should not be varied to the detriment of the incumbent members of the board, or require further approvals from the Government.
3. *Terms of removal:* The draft Code provides for both, the reasons for which a member may be removed and the process by which removal will take place. This may be done for:
   - **Regular Reasons:** Completion of term, reaching the prescribed age limit, declaration of insolvency and conviction by a criminal court which involves imprisonment.
   - **Special Reasons:** Incapacity (physical and mental), behaviour unbecoming of the position held, conviction by a criminal court which does not involve imprisonment and dereliction of duty. For removal under special reasons to take place the Government should establish a judicial committee (under the supervision of the Supreme Court), which will investigate whether removal is necessary on the suggested grounds and create a public report on the issue.
4. *Re-appointment:* Members of the board can be reappointed for another term of five years as members. This provision will however not be available for the chairperson of the board who cannot be reappointed. There will be no automatic re-appointments - the incumbent member will be considered by the selection committee alongside other prospective candidates. If the selection committee finds the member suitable, he/she will be short-listed and the Government then may choose to reappoint such members. The Commission believes that this will ensure that the tenure of members is not extended as matter of course.

Table of Recommendations 3.5 Law governing board meetings

The principles governing the following matters must be covered by the draft Code:

1. Frequency of meetings;
2. Quorum;
3. Method of taking and recording decisions;
4. Decisions without meetings;
5. Legitimacy of decisions; and
6. Conflicts of interest.

The Commission is of the view that very high regard should be given to the need for transparency in the board meetings of the regulator. While there may be some specific decisions or deliberations of the regulator which may have commercial implications and may not be released immediately, this should not be unduly used as a reason to deviate from the general principle of transparency. The draft Code will therefore require the regulators to be transparent about meetings *as far as possible* and when any information is kept confidential, reasons for doing so must be recorded. For instance, pending investigations and queries about violations by a regulated entity should be kept outside the purview of publication as they have an impact on the reputation on the institution without a finding of violation of laws. However, the decisions of the regulator should be published to provide information to the regulated entities on the standards of conduct expected by the regulator.

There is also a need for a formal mechanism to evaluate the regulator's compliance systems. This will be achieved by setting up a *review committee* that will be comprised only of non-executive members of the board (see Table 3.6).

3.4. Advisory councils of the regulator

The regulators will be responsible for regulating a large and rapidly developing financial system in India consisting of a large number of stake-holders, including financial service providers, intermediaries, consumers and other users of the financial system. It is not possible to ensure that all these stake-holders are adequately represented at all times

Table of Recommendations 3.6 Role of the review committee

The Commission recommends that the non-executive members of the board of a regulator form a special committee called the *review committee*. This committee will discharge the following functions:

1. Oversight of compliance of the regulator with the governing laws;
2. Maintaining whistle-blower policies about violations of process within the office of the regulator;
3. Ensuring that all board meetings are held in compliance with the law and all meetings are minuted and votes are recorded by creating a report;
4. Creating a system to monitor compliance of the office of the regulator with the decisions of the board through reporting systems; and
5. Reviewing all risk management policies of the board of the regulator.

The review committee will make its observations in a report which will be annexed to the annual report of the regulator. The objective of this procedure is to ensure greater transparency in the functioning of the board of the regulator.

at the level of the board of the regulator. In particular, it is extremely difficult to identify persons who can represent the interests of the common Indian household. Similarly, special fields of financial service may require the regulator to gain expertise in specific areas, such as, insurance, algorithmic trading, detailed analysis of data, etc. The Commission proposes that these issues should be addressed by creating advisory councils to advise the board of the regulator (see Table 3.7).

3.5. Resource allocation of the regulator

Financial sector regulation is a resource intensive function. The sophisticated character of financial markets coupled with rapid innovations in products and processes make it necessary for the regulator to have the capability and resources to keep pace with developments in the sector. The need for financial independence is one of the primary reasons for creating an independent regulator – it allows the regulator to have the required flexibility and human resources that are more difficult to achieve within a traditional government setup.

As the regulator is empowered to hold assets independently, it can create physical infrastructure dedicated to the enforcement of financial regulations. These resources can be scaled up and modified quickly. Being independent of the Government also allows the regulator to develop its own recruitment criteria and processes, which are necessary for mobilising required human resources. The Commission notes that the provisions governing financial independence of the regulators are wide and have worked till now. Therefore, the Commission is of the opinion that there is no need to substantially modify them.

The present financial laws allow regulators to charge fees from the regulated entities to cover their costs of functioning. In certain cases the Government has also provided

Table of Recommendations 3.7 Advisory councils

The Commission recommends creation of advisory councils to advise the board of the regulator. The councils will be created by the board of the regulator (unless specifically created by the law). The composition and functioning of the advisory councils will be as follows:

1. *Composition*:
   (a) Include experts in the field for which it has been created; and
   (b) Include persons with relevant experience in the area of finance.
2. *Functions*:
   (a) Inform the board about issues in the specific areas for which they have been constituted; and
   (b) Create a report on all draft regulations published by the regulator stating the council's views.

Table of Recommendations 3.8 Principles governing regulator's resources

1. The regulator should be funded through fees levied on the financial firms.
2. The regulator should have the freedom to allocate the resources in the manner that it considers most appropriate to meet its regulatory objectives.
3. The Government may loan money to the regulator to offset initial setting up costs. However, apart from this the involvement of the Government in the financial matters of the regulator should be minimal.

initial grants or loans to regulators as a corpus to start their operations. Table 3.8 covers the recommendations of the Commission on the principles governing the finances of the regulator. It includes the recommendation that the regulator should be funded primarily through fees.

Allowing the regulator to fund itself from fees collected from regulated entities has the following advantages:

1. It ensures that financial stake-holders, who are the main beneficiaries of regulated markets, bear the cost of regulation instead of the cost being spread across the entire budget of the Government.
2. It creates operational efficiency for the regulator. As the financial market grows, the number of transactions and firms increase and that increases the resource flow into the regulator. In turn, the regulator can increase its spending on enforcement, inspections and other functions which help improve the confidence of users.
3. It helps achieve freedom from Government rules on pay and budgeting, and thus facilitates the hiring of experts.
4. It helps address issues of conflict of interests in a context, where, in addition to other dimensions of political economy, the Government is the owner of many regulated entities in the form of public sector financial firms.

The Commission recognises that the power to impose fees on regulated entities leads to cost on all consumers of financial services and therefore the draft Code provides certain guiding principles on the charging of fees instead of simply empowering the regulator to make the collection (see Table 3.9). It is particularly important to ensure that the imposition of fees should not impose an undue burden on regulated firms or transfer the cost of regulating one class of firms or transactions to others. To pursue this policy, the Commission recommends that regulators be empowered to charge three different types of fees.

1. **Flat fees for registration:** This fee should be as small as possible to ensure that it does not prevent entry of new financial firms.
2. **Fees dependant on the nature of the transaction:** This type of fee will vary depending on the *nature* of financial business being carried out. For example, if the cost of regulating an insurance firm is higher than the cost of regulating a brokerage firm, the fees levied on the insurance firm should be higher.
3. **Fees dependent on the number or value of transactions:** This type of fee will vary depending on the frequency and size of transactions. For example, a brokerage firm may have to pay fees depending upon the number of transactions it carries out. Similarly, an insurance firm would be charged depending on the number of insured contracts it executes.

As noted earlier, regulatory independence requires that the Government's right to intervene in the financial matters of the regulator is kept at a minimal. The Commission therefore recommends that the Government must only control the salary and perquisites of the members of the board of the regulator. The board should in turn be responsible for maintaining adequate staff and expertise to meet its statutory objectives within its financial capacity. The board should therefore be charged with the responsibility of designing a set of Human Resources (HR) practices that are conducive to the accomplishment of its regulatory objectives.

Table of Recommendations 3.9 Principles governing the charging of fees by the regulator

The legal provisions empowering the regulator to charge fees will incorporate the following aspects:

1. The regulator should charge fees only to cover expenses and keep adequate reserves;
2. Fees should be charged only through regulations made after following the legislative processes specified in the draft Code;
3. The regulator should clearly explain the fees it is charging and demonstrate that the fee is not disproportional to the cost for the regulator;
4. Applying the principle of proportionality, the regulator should place higher financial burdens on firms that have more transactions, and thereby increase its work load and functions; and
5. The regulator should break up the fees into different categories.

Table of Recommendations 3.10 Performance measurement and reporting

The allocation of resources by the regulator is intrinsically tied to the performance of the regulator. Therefore the Commission recommends the following principles for the measurement of the regulator's performance and financial reporting:

1. The regulator should create two annual reports:
   (a) Audited report which is comparable to traditional financial reporting; and
   (b) Performance report which incorporates global best practice systems of measuring the efficiency of the regulatory system.
2. The performance report should use modern systems of measuring each activity of the regulator as objectively as possible.
3. Performance systems must require the regulator to create and publish performance targets.
4. All performance measures must be published in the annual report.
5. Performance measurement system should be reviewed every three years to incorporate global best practices.

3.6. Performance assessment and reporting

The Commission noted that the present system of financial accounting of the regulator is focused primarily on the reporting of expenditures incurred by the regulator under various heads. This, according to the Commission, does not constitute a sufficient test of the fulfilment of *regulatory objectives* or the assessment of the regulator's *performance*. Therefore, there is need to require regulators to adhere to a more comprehensive system of measuring their performance.

Measurement systems for assessing the performance of regulators should include an assessment of the regulator's processes on metrics such as, the time taken for granting an approval, measurement of efficiency of internal administration systems, costs imposed on regulated entities and rates of successful prosecution for violation of laws. Adopting such an approach would constitute a departure from the present system where most financial regulators focus on measuring the activities of regulated entities and financial markets as a standard for their own performance. The Commission noted that while these measurements are important, measurement of various activities undertaken by the regulator will provide much greater transparency and accountability.

The measurement of activities of the regulator also needs to be tied with the financial resources spent by the regulator to carry out those activities. A system which merely measures the expenses of the regulator was therefore considered to be inadequate and the Commission recommends a move towards tying the measurement of regulatory activities and the expenditure incurred for it as a crucial link for improving regulatory governance. Accordingly, the Commission recommends the following measurement processes for the regulator (Table 3.10):

1. **Budgeting Process:** This process will measure the allocation of resources by the regulator for its different objectives and try to assess the regulator's performance in pursuing each objective in

the most comprehensive manner possible. Emulating the performance measure based auditing system used globally by financial regulators, this process will:

- relate the exercise of functions by the regulator with its expenses;
- require the regulator to create performance metrics and targets which it will be required to achieve;
- help in tracking the regulator's performance across financial years.

2. **Financial Accounting:** This will be the traditional accounting of expenses for the purposes of maintaining financial control and audit, which is currently being done by financial regulators. The financial accounts will be audited by the CAG.

CHAPTER 4

Functions and powers of the regulator

The regulator acts like a mini-state in that it exercises legislative powers in the form of drafting regulations that are binding on regulated entities; it acts as the executive in its supervision and enforcement actions; and it performs a quasi-judicial function while assessing compliance with the law by regulated entities and compliance of processes by the regulator while imposing penalties on them.

While giving these wide ranging powers to the regulators, the draft Code on regulatory governance needs to put in place appropriate checks and balances to ensure that the powers are not misused and proper regulatory governance processes are followed in every action taken by the regulator.

The Commission has identified the following areas for which regulatory governance processes need to be clearly detailed in the draft Code:

1. Process for issuing regulations and guidelines;
2. Executive functions - granting permission to carry on financial activities, information gathering, investigation, imposition of penalties and compounding of offences; and
3. Administrative law functions.

4.1. Issuing regulations and guidelines

The primary function of a financial sector regulator is to set down standards of behaviour expected from regulated entities. This encompasses making regulations governing how the regulated entities should interact with the regulator, consumers, financial markets and other regulated entities. Regulations also guide the internal functions and actions of regulated entities in the conduct of financial activities.

In a system governed by the rule of law, no action should be judged against unknown standards. Therefore, before the regulator can carry out any supervision or adjudication functions it has the responsibility to lay down in clear and unambiguous terms, the behaviour that it expects from regulated entities. While doing so, the regulator needs to follow a structured process that allows all stake-holders to be fully informed of and participate in the regulation-making process.

Some existing regulators have already adopted the good practice of carrying out public consultations in the course of making regulations. However, the Commission noted that since this is not mandated by legislation, the processes employed are not adequately rooted in a thorough analysis of the public administration problems faced in the regulation-making process. In addition, as with most other aspects of the legal process in Indian financial regulatory governance, the practices followed by different financial regulators differ in idiosyncratic ways.

The Commission has therefore identified detailed requirements to define the process that the regulators should follow while making regulations and the mechanisms for the judicial review of legislative powers exercised by regulators.

If laws do not define a fixed set of instruments that can be used by the regulator, the same regulatory agency might adopt multiple regulatory instruments – circulars, notices, letters, regulations, guidelines, master circulars, press notes – with similar outcomes but differing regulation-making processes. To avoid this situation, the Commission recommends that the draft Code should clearly define the legislative powers of the regulator and the instruments. The Commission recommends that the regulator should be empowered to issue only two types of instruments – regulations and guidelines.

4.1.1. Process for making regulations

The draft Code must determine the process to be followed for the formulation of regulations, starting with the manner in which the drafting of regulations is to be initiated. Given the wide impact of regulations, the Commission recommends that the regulation-making process should be directly overseen by the board of the regulator. This will ensure that the issues that require regulatory intervention are discussed and approved at the highest level within the regulator's organisation. Therefore, after the process of drafting regulations has been initiated within the regulator, it will have to be approved by the board of the regulator before being published to the public for comments.

The Commission believes that effective public participation in the regulation-making process is necessary to ensure that subsidiary legislations are responsive to the actual requirements of the economy. It will also help check and improve the information used and analysis done by the regulator. Therefore, the Commission recommends that the details of the process to be followed for carrying out consultations and receiving public comments should be laid down in the draft Code. Doing so will allow for the standardisation of best practices and hence lead to a more structured system for making subordinate legislations. The expected overall impact is that regulations will become more responsive to the needs of the financial system.

4.1.2. Emergency regulations

The Commission recognises that the regulator may sometimes be faced with an emergency situation that requires the rapid introduction of a new regulation. In such cases, it may not be feasible for the regulator to follow the detailed regulation-making process discussed above. Therefore, the draft Code envisages a separate emergency regulation-making process, as outlined in Table 4.3.

The Commission recommends that the draft Code will require the regulator to carry out the consultation process in two stages. The first stage will be the issuance of a set of introductory documents to inform the public of the proposed regulations and provide a system for giving comments (see Table 4.1). This will be followed by a requirement to respond to the comments received by the regulator and the issuance of final regulations (see Table 4.2).

4.1.3. Issuing guidelines

In a system of principles-based provisions that are to be interpreted and applied by the regulator, there is a genuine need for clarifications and explanations. This would require

Table of Recommendations 4.1 Issuance of documents for public consultation

The regulator will have to publish the following documents in the process of formulating new regulations:

1. The *draft regulations*;
2. The *jurisdiction clause* to identify the legal provision under which the proposed regulations are being made, and the manner in which the regulation is consistent with the principles in the concerned legislation(s). If the parent legislation does not specifically refer to the subject matter of regulations, the regulator will have to establish a logical connection between the subject matter and the empowering provision in the law. The document must contain explanation on how the regulation stands vis-a-vis each of the relevant principles in the part(s) of the draft Code from which the powers are being drawn;
3. A *statement of the problem or market failure* that the regulator seeks to address through the proposed regulations, which will be used to test the effectiveness with which the regulations address the stated problem. The statement must contain:
   - The principles governing the proposed regulations; and
   - The outcome the regulator seeks to achieve through the regulation; and
4. An *analysis of the costs and benefits* of the proposed regulation. This is required because every regulatory intervention imposes certain costs on regulated entities and the system as a whole. The Commission recommends that regulations be drafted in a manner that minimises these compliance costs.

   In some cases where a pure numerical value based cost-benefit analysis is not possible, the regulator should provide the *best possible* analysis and reasoning for its choice of intervention.

After publishing the above documents, the regulator will specify a designated time for receiving comments from the public on the regulations and the accompanying documents. The draft Code will ensure that the time period and the mode of participation specified by the regulator is appropriate to allow for widespread public participation.

Table of Recommendations 4.2 Process after receiving public comments

After the time specified for making comments has lapsed, it will be the responsibility of the regulator to:

1. Publish all comments received;
2. Provide reasoned general response to the comments received, and specific response to some comments if there is requirement stipulated in the draft Code for such response;
3. Publish the review of the draft regulations carried out by the regulator's advisory council;
4. Have the final regulations approved by the board of the regulator. In the interests of transparency, the Commission recommends that deliberations and voting by the board members should be available publicly; and
5. Publish the final regulations.

Table of Recommendations 4.3 Emergency regulation making

In emergency situations the regulator would be empowered to pass regulations without following the consultation process and without conducting a cost-benefit analysis, subject to the following conditions:

1. Regulations passed under this provision will lapse after a period of six months; and
2. The regulator must publish a reasoned order for using this power.

the regulator to have the power to issue guidelines explaining the interpretation of the regulator of laws and regulations. The Commission believes that allowing the regulator to issue guidelines of this nature will constitute an important step in reducing uncertainty about the approach that the regulator may take.

The mechanism of issuing guidelines should not be used to (in effect) make regulations without complying with the procedural requirements laid down for regulation-making. For this reason, the draft Code clarifies that guidelines are merely recommendatory in nature and the violations of guidelines alone will not empower the regulator to initiate enforcement action against regulated entities. Table 4.4 shows the recommendations of the Commission in relation to issuance of guidelines.

4.1.4. Accountability to the Parliament

Since the power to issue regulations is a legislative power delegated by the Parliament to the regulators, regulations formulated by the regulator should be placed before the Par-

Table of Recommendations 4.4 Issuance of guidelines

The law governing the issuance of guidelines should:

1. Require the regulator to clearly explain the connection between the guidelines and the principles and provisions in the Parliamentary law that the regulator seeks to enforce;
2. Ensure that the guidelines are not used as a mechanism to create substantially new regulations;
3. Allow guidelines to be issued without a cost-benefit analysis but subject to the consultation process under which the draft guidelines will be issued for comments and responses of persons affected by the guidelines;
4. Clearly state that violation of guidelines alone would not constitute the violation of regulations or law; and
5. If regulated entities ask for the interpretation or application of law for a specific transaction, the regulator should provide it for a reasonable fee.

Table of Recommendations 4.5 Judicial review of regulations

The Commission recommends that any challenge to a regulation framed by the regulator should be reviewed by the appellate tribunal on the following grounds:

1. The regulations should have been made within the bounds specified by the law. This would include ensuring compliance with the specific provision of law under which the regulation is made and the general objectives and principles of the regulator;
2. The regulations should have been made in compliance with the process laid down in the law; and
3. The documents published along with the regulations should not have any substantive material defects, which may be proved through expert evidence or data.

liament. This allows the Parliament to review whether the regulator, acting in its capacity as an agent, has acted within its scope of authority while formulating the regulations.

The current system of review by the Parliament involves sending subordinate legislation (regulations made by the regulator in the present case) to a different committee than the one which reviews laws presented to the Parliament. The Commission recommends that it may be appropriate for these to be considered by the same committee.

4.1.5. Judicial review of regulations

At present, judicial review is largely limited to executive actions. However, the Commission recognises that it is equally important to have a mechanism that allows regulated entities and others to question the regulations made by the regulator in exercise of its legislative powers, if regulations exceed the mandate given to the regulator under the primary law or if the specified process for making regulations has not been duly followed. The Commission therefore recommends that the process to challenge subsidiary legislation made by regulators should also be provided in the draft Code.

The first point of challenge of regulations would be before the FSAT, a specialised tribunal that will be created for the financial sector as a whole. In addition to this, the power of the Constitutional courts to review legislation would of course continue.

The judicial review of the regulation-making process by the appellate tribunal should ideally provide a more detailed scrutiny than compliance with Constitutional provisions. In the course of this process, the regulations should be checked for compliance on the grounds mentioned in Table 4.5.

4.2. Executive functions

A major responsibility of any regulator involves the exercise of executive functions. This includes inspections, investigations, enforcement of orders and processing of complaints. The exercise of supervision and monitoring powers is fundamental to the effective enforcement of laws by the regulator. However, it is often seen that the manner of exercise

Table of Recommendations 4.6 General executive functions of a regulator

The Commission recognises that regulator must carry out certain general executive functions on a routine basis. These include:

1. Grant of approvals, including licensing or registration;
2. Inspections, which may be routine or special;
3. Proving violation of regulations to the judicial officers (by leading evidence);
4. In the case of successful prosecution before the administrative law department, suggesting enforcement actions; and
5. Compounding of offences with the involvement of the administrative law department.

of executive function may place an undue burden on regulated entities and financial markets.

Long pending investigations create uncertainty for businesses. When news of ongoing investigations leaks, it may inflict damage to the reputation of any financial firm. Similarly, injunctions placed on businesses under investigation have strong economic implications and should be placed for the shortest possible period. These problems can be checked by putting in place legal measures that require investigations to be finished within specified time, and kept confidential from the public.

The Commission notes that the overall approach of the draft Code should be to provide for strong executive powers, balanced with greater transparency and accountability, to prevent abuse. Executive functions of regulator do not have standardised statutory checks under present legislations. Therefore, the Commission recommends that adequate transparency requirements, checks and judicial oversight be placed on the exercise of executive functions by regulator. This will also reduce allegations of possible bias and arbitrariness to the minimum.

It is also important to ensure that there is no overlap in the legislative and executive functions of the regulator. The executive should not be allowed to issue instructions of a general nature to all regulated entities or a class of regulated entities. Such instructions should only be possible after the full regulation-making process has been followed.

Table 4.6 sets out the areas in which the Commission has made specific recommendations regarding the exercise of executive powers.

4.2.1. Permission and approvals

Granting permissions to start a business is the core function of any regulator. This is also the first barrier to entry for new entrants to any business. Each new business permission also increases the burden on the regulator as it increases the number of entities it has to monitor. The draft Code must grant the regulator discretion to approve or reject applications. The Commission has decided that the power must be exercised in a manner guided by regulations. As far as possible the discretion of the regulator should be guided through an underlying duty to explain. The power of the regulator to reject applications should be balanced with the requirement for allowing legitimate parties getting approvals in a time bound manner for smoother functioning of the regulatory system. Table 4.7 summarises the recommendations of the Commission for governing the procedure for disposing applications.

4.2.2. Information gathering

Regulator requires information about the activities of their regulated entities. It may also require information from private sources and other government agencies. At present, a diverse array of mechanisms are used by firms to submit information to regulatory

Table of Recommendations 4.7 Giving permission to carry out a business

The system of giving permission to new entities must be strictly governed by regulations and finished within a time bound manner. The provisions must:

- Provide a system for persons to apply for authorisation to provide financial services;
- Ensure that all applications are accepted or rejected within a specified time;
- Ensure that whenever an application is rejected, reasons for the rejection are provided; and
- Provide that the regulator gives warning to the applicant before rejecting an application.

Table of Recommendations 4.8 Information gathering

The draft Code contains the following provisions on information gathering:

1. The regulator should have the power to collect information from regulated entities;
2. The regulator should have power to collect information from other government agencies;
3. Information should be collected in electronic format as far as possible; and
4. The regulator should publish information it generates (orders, decision, list of regulated entities) in the public domain (apart from confidential information).

agencies. Harmonisation into a single mechanism for electronic submission of information will reduce the cost of compliance for firms and also reduce the cost of information management for regulator. The Commission proposes to create a centralised database, through which all the information is collected by regulator and other agencies. A more detailed discussion on this centralised database can be found in the chapter on systemic risk. Maintaining and analysing this information is an important indicator of violation of provisions in many situations. Even at present, most regulators have the power to require regulated entities to produce documents and information in normal course of regulation. This power should be continued in the proposed legislation. Table 4.8 contains other details regarding information gathering powers.

The Commission also noted that the use of technology is crucial in the context of the information gathering function. Using electronic systems will affect stake-holders in the financial system in the following ways:

1. **Regulator:** Use of electronic data management will provide regulator with real-time information about financial entities. It will also provide regulator with modern analytical systems to track violations or risks. Toward this end, the Commission proposes to create a centralised database that will use state-of-the-art data management systems to route regulatory data.
2. **Regulated entities:** Use of electronic reporting systems may reduce compliance costs for regulated entities. It will also allow regulated entities to provide information to the regulator in a seamless manner.
3. **Consumers:** Access to records of the regulator about regulated entities in electronic format will allow consumers to gain information quickly. It will also help consumers to access their own records and check for financial frauds.

4.2.3. Investigations

It is important that the powers of investigation and enforcement are carried out in the least arbitrary and the most effective manner. The Commission has noted that executive functions in the financial market can have serious consequences. The information that a firm is under investigation may cause undue panic in the market and even if the result of investigation is a positive outcome for the firm, the intervening period may cause irreparable damage to the reputation and business of the firm. The system of investigations should therefore be such that it does not harm or unduly burden the entity under investigation (see Table 4.9).

The Commission is of the opinion that the executive investigation process should be carried out in:

Table of Recommendations 4.9 Investigations

The Commission recommends that investigations should be:

- Carried out according to the written terms of investigation;
- Carried out by an appointed investigator;
- Finished within a time bound manner, unless extended by an administrative law officer; and
- Carried out with least disruption to the function or reputation of a business.

The investigators empowered under the draft Code should have the power to:

1. Require production of documents;
2. Require persons to answer questions;
3. Require co-operation of non-regulated entities in investigation; and
4. Require co-operation from other government agencies.

Table of Recommendations 4.10 Information-sharing between regulators

1. The draft Code should require the regulator to create a framework for sharing of information.
2. The electronic information framework of each regulator should be compatible with that of other regulator(s) and agencies with which it regularly shares information.
3. The legal framework should have adequate checks and records to prevent misuse of informations.

1. A confidential manner so as to prevent panic before any finding; and
2. A time bound manner so as not to unduly burden the entity under investigation.

4.2.4. Sharing of information

Investigations are greatly assisted by a strong database providing details of the regulated entities and the transactions they have undertaken. The Commission recognises that this information may not be available at a single source. Hence, the Commission suggests the creation of a single database, through which all information collected by regulator (and other agencies in the financial sector architecture), will be routed (see the chapter on systemic risk for a detailed discussion on this issue). Where regulator needs to obtain information from other regulator(s) or government agencies, the draft Code creates a framework for sharing information between the agencies. Table 4.10 provides the system suggested by the Commission for sharing of information.

4.2.5. Consequence of violations

The Commission found that different regulators have different consequences for violations of laws and regulations enforced by them. This creates detriment to the rule of law and increases uncertainty about violations.

The Commission recommends that:

1. The consequence of violations be standardised;
2. The way the consequence is determined be regulated by law;
3. Similar violations be treated with similar consequence; and
4. The consequence be proportional to the violation and the behaviour of the violator.

The Commission recommends that whenever a violation is detected the regulator must determine which of the following conditions led to the violation:

1. The violation was a result of an informed intent to commit the violation;
2. The violation was a result of serious negligence of maintaining standards expected of a reasonable person carrying out the activity; or
3. The violation was a result of a mistake or was of a technical nature.

The Commission recommends that depending on the cause of the violation the regulator must apply the following consequences in increasing order:

1. Issuing a private warning;
2. Issue a public notice;
3. Require a corrective action applicable to the violation;
4. Impose a monetary penalty;
5. Suspend the permission to carry out certain transactions;
6. Permanently revoke the permission to carry out regulated activities; and/or
7. Institute criminal proceedings in appropriate courts.

4.2.6. Imposition of monetary penalties

The Commission noted that the present system of specifying statutory limits on the amount of penalties that can be imposed for any violation has a critical flaw – it does not ensure that a violator pays a fine higher than the gain made through the violation. This is because it is impossible to predict the benefit a violator will gain by committing an offence. The maximum limit on penalties is sometimes lower than the benefit gained by the violator through violation. This leads to a situation where even if the violator is caught and required to pay the fine, he or she may still emerge monetarily better off.

The Commission notes that the level of penalties should be an effective *deterrent* to future violations and signal all other regulated entities that the potential of gain from violation will be outweighed by the penalty which will be applied in the case of detection of the violation. This principle also acknowledges that all violators of any law are never detected. Therefore, to act as a deterrence, the penalty should be a *multiple* of the illegitimate gain from the violation. The amount of penalty should also be dependent on whether the action was deliberately done or due to reckless behaviour or due to negligence of the person.

The system of imposing financial penalties should be guided by the following principles:

1. The penalty system should require the violator to pay a multiple of the illegitimate gain made from the violation;
2. Out of the penalty collected, the regulator should try to compensate any directly identifiable victims of the violations;
3. Any surplus at this point should be deposited with the Consolidated Fund of India;
4. In the event that there are no direct victims, the regulator must transfer all the penalty (after deducting administration costs) to the Consolidated Fund of India;
5. If there is no clearly identifiable illegal gain from the violation, the regulator must impose a penalty that is a proportion of the income of the violator from financial activities; and
6. All systems of monetary penalties must be regulated by regulations that consider the magnitude of the violations and the previous violations of the violator.

The doctrine of unjust enrichment allows the regulator to recover all the profit the violator made from the violation. Unjust enrichment should be recovered, in addition to the fine applied for violation of regulations. This should be recovered and then, if possible, distributed amongst persons who were adversely affected on account of the violation. Punitive damages create a deterrence for future violators who will know that in the event that they are successfully prosecuted the penalty they will face will surely outweigh the profits that they make. It requires the regulator to expressly impose fines which are higher than the benefit gained out of the violation. This is usually carried out by providing penalties as a multiple of the amount of gain by the violator. The Commission found that this principle has already been provided in some Indian legislations and should be extended to the financial sector as a whole.

Table 4.11 summarises the recommendations of the Commission for creating a legal system governing penalties.

Table of Recommendations 4.11 Requirement for proportional penalties

The regulator must ensure that the penalties deter potential violators in the future. It is impossible to ensure that all violators are caught. However, violators must pay fines proportional to the damage and the illegal gain. The following are the steps the regulator must follow:

- For each violation, the regulator must carry out an investigation on the illegitimate gain made by the violator;
- The regulator must make an effort to determine the amount of illegitimate gains made by the violator;
- The penalty will be a multiple of the illegitimate gain, but limited to a maximum of 3 times the illegitimate gain;
- The regulator must compensate any direct victims of the violations if they can be ascertained; and
- The regulator must have regulations and processes for calculating and enforcing the fines.

Table of Recommendations 4.12 Compounding of offences

The system for compounding offences must:

- Be guided by a policy set out by the regulator;
- Have adequate checks and balances to prevent interference from external parties;
- Be transparent to prevent allegations of favouritism;
- Consider previous behaviour of the party; and
- Consider whether the party itself offered compounding before any investigation was started.

4.2.7. Compounding of offences

The Commission believes that the system of compounding offences is important for reducing judicial burden and addressing minor violations, which are common in the financial sector. However, the system of compounding offences requires a standardised structure across all regulators which is not present as of date. The recommendations of the Commission are provided in Table 4.12.

4.3. Administrative law and role of tribunals

In exercise of their supervisory and enforcement powers, regulators need to assess whether or not regulated entities have adequately complied with the provisions of financial laws and in case of any detected breach, they have the power of impose appropriate penalties. These wide ranging executive powers given to regulators necessarily need to be balanced with proper systems governing the application of administrative law. Therefore, the Commission recommends that the exercise of quasi-judicial (administrative law) functions by regulators needs to be carried out within the bounds of a sound legal framework that ensures the separation of administrative law powers from other powers of the regulator.

In addition, there also needs to be a mechanism to review the actions taken by regulators in exercise of their quasi-judicial functions. Given the specialised character of financial markets and the complicated nature of issues involved, the Commission finds that there is a strong case for having a dedicated appellate tribunal.

The Commission therefore makes specific recommendations in respect of the processes governing these two areas:

1. *Administrative law functions carried out by the regulator*: How the regulator separates and carries out regulatory function within its organisation.
2. *Judicial review by appellate tribunals*: How the decisions of the regulator are reviewed through a dedicated financial sector appellate tribunal.

4.3.1. Administrative law functions of the regulator

At the level of the regulator's board, at least one executive member should be designated

Table of Recommendations 4.13 Requirement of administrative law officers

The system of administrative law functions requires:

- The board of the regulator will appoint one of its member as administrative law member;
- The creation of a special class of officers called administrative law officers; and
- While serving as administrative law officers, these persons shall not carry out other functions. This is necessary to maintain separation of their roles and responsibilities from the other staff members of the regulator.

Table of Recommendations 4.14 Judicial review of executive actions

The Commission recommends the following principles for application of administrative law by the regulator:

1. All investigations and internal processes should strictly conform to procedures of fairness;
2. Even minor non-compliance to procedure should be required to be adequately explained by the regulator;
3. Administrative law officers should act as disinterested third parties in a dispute; and
4. The decisions of administrative law officers will lead to the development of a body of cases similar to common law jurisprudence.

Table of Recommendations 4.15 Procedure for administrative law functions

1. All decisions to impose penalty or decisions requiring any action against any regulated entity should be carried out by administrative law officers;
2. Administrative law officers should place the proposed decision of the executive and the material on which the decision was arrived at, before the regulated entity through a notice called a *warning notice*;
3. The regulated entity must be allowed to respond before a decision is taken;
4. The decision of the administrative office must be a reasoned decision and should be provided to the regulated entity or other concerned person through a notice called the *decision notice*; and
5. The regulated entity may ask the administrative law member of the board to review the decision taken by the administrative law officer.

as an administrative law member. Under the member, the regulator will maintain a class of administrative law officers. The administrative law member will be responsible for oversight of the functioning of the administrative law officers. Consequently, such member will not take active part in executive functions of the regulator and not be involved in any investigation, inspection or similar other functions.

Like the administrative law members, the administrative law officers will also not be involved in any investigation proceedings. This would, however, be achieved without creating a wall of separation within the regulator – administrative law officers would be drawn from the general pool of employees of the regulator but as long as such persons are involved in judicial functions they would not be involved in any other regulatory functions (see Table 4.13).

4.3.2. Procedure for administrative law functions

The administrative law functions of the regulator are at two levels. The first level adjudication will be done by administrative law officers who will work inside the agency of the regulator but will not be involved in executive functions. While exercising their functions, the administrative law officers will examine the data and evidence collected by the regulator's executive officers and will assess the appropriateness of their executive orders (see Table 4.14).

Appeals from the orders of the administrative law officers will go to the administrative law members of the board. This process will act as a performance review of the administrative law officers and also reduce the number of appeals to the tribunal by weeding out flawed orders. Table 4.15 summarises the administrative law related processes of the regulator.

Table of Recommendations 4.16 Approach to judicial review of regulatory actions

1. All functions including the quasi-judicial function of regulator should be subject to judicial review;
2. This review should be done through an appellate mechanism;
3. There should be a single dedicated appellate tribunal for the entire financial sector that will cover all financial regulators;
4. The appellate tribunal will hear appeals against the decisions made by and the regulations framed by financial regulators;
5. The appellate tribunal will be funded by an appropriate fee from all regulated entities; and
6. The appellate tribunal's structure is clearly detailed out in the draft Code.

The Commission is of the opinion that while the entire Code for Civil Procedure, 1908 (CPC) need not be followed by the administrative law officers and members, the draft Code provides the basic rubric of the procedure of judicial determination and appeals. Therefore, it will be the responsibility of the board of the regulator to create appropriate subsidiary legislation to establish the procedures to be followed for the discharge of administrative law functions by the regulator.

4.3.3. Judicial review and appellate tribunals

The Commission recognises that actions taken by regulators can impose significant penalties and burden on regulated entities. Therefore, the *rule of law* requires that a clear judicial process be available to persons who seek to challenge regulatory actions. The needs of a modern financial system require us to move beyond a system where appeals against regulatory decisions can be made to an authority within the regulator or to the Government to the creation of a specialised FSAT. The appellate framework envisaged by the Commission is outlined in Table 4.16.

4.3.4. Structure of the appellate tribunal

As regards the structure and functioning of the FSAT, the Commission finds that there is need for clearly demarcating and concentrating on two important functions:

1. Judicial functions of the tribunal, which require persons with qualification and experience in law and finance; and
2. Administrative functions of the tribunal, which include service of documents, collecting evidence, accepting written submissions, managing dates for hearings and arguments.

The judicial functions of the tribunal requires expertise in various fields of law and finance. In order to satisfy the requirements of separation of powers envisaged in the Constitution, the Commission recommends that the tribunal must remain under the control of judicial officers. This is also consistent with the present structure of tribunals in India. Table 4.17 summarises the recommendations of the Commission in relation to the judicial functions of the appellate tribunal.

4.3.5. Functioning of the tribunal's registry

The present systems of management of courts and tribunals often involve mandating the chief judicial officer of the court or the senior-most judge to be responsible for the administration of the tribunal or court. This can interfere with the person's core appellate functions by causing him or her to divert attention to administrative matters. In some cases, this challenge has been addressed by appointing a separate *registrar* for the court or tribunal.

The Commission recommends that the appellate tribunal should be supported by an efficient registry which will be headed by a *registrar* having specialised management

Table of Recommendations 4.17 Judicial structure of tribunal

For creating a clear judicial structure for the appellate tribunal, the Commission recommends the following provisions:

1. The appellate tribunal will be headed by a presiding officer who is qualified to be a Judge of Supreme Court, Chief Justice of a High Court, or has served for at least seven years as a Judge of a High Court;
2. The tribunal will have at least two members; the specific number of members of a tribunal will be determined by the case load;
3. The members of the tribunal must have experience in the fields of finance, economics, accountancy and law;
4. The members may be formed into benches, in which case, each bench must have a person who is qualified in law; and
5. There will be a statutory appeal available against the decisions of the appellate tribunal to the Supreme Court.

Table of Recommendations 4.18 Rules of procedure for appellate tribunal

The appellate tribunal should devote attention to standardising the systems for:

1. Application of complaints and responses;
2. Implementation of temporary orders;
3. Introduction of evidence;
4. Hearing of arguments;
5. Determination of the case; and
6. Determination of the penalty.

skills who will be responsible for all the infrastructure and administrative functions of the appellate tribunal. To ensure that the separate registry does not undermine the independence of the tribunal, the registrar should be under the supervision of the chief judicial officer of the appellate tribunal.

The Commission recommends the following provisions relating to the registry of the appellate tribunal to ensure its efficient functioning:

1. *Developing details of procedure*: The draft Code requires the appellate tribunal to formulate its own regulations on procedure, and publish them so as to induce clarity amongst financial firms. These regulations, on the areas mentioned in Table 4.18, should be formed by the appellate tribunal itself.
2. *Using information technology*: The processes of the appellate tribunal should be geared towards using information technology to integrate its entire judicial functions into an electronic form. The objective of the use of technology would be to reduce the cost of approaching the tribunal, greater efficiency in the functioning of the tribunal and greater transparency in the performance of the tribunal. Information technology should be used to reduce requirements for physical travel, keeping paper records, and following up on compliance with orders.
3. *Resources and reporting*: The efficiency of the tribunal's procedures need to be continuously monitored and measured. The draft Code will help achieve this by specifying that the tribunal must comply with accountability requirements through the production of detailed performance statistics, annual reports and audit reports similar to that of regulators.

4.4. Conclusion

The functioning of regulatory agencies is a critical component of financial law. Regulatory agencies are remarkable in featuring a combination of regulation-making power that is delegated by Parliament, executive functions, and quasi-judicial functions. In addition, there are sound reasons for favouring significant political and operational independence in regulatory agencies. In order to obtain sound outcomes, the Commission has applied meticulous care in clearly establishing unconflicted objectives, processes governing legislative and executive functions, bringing in an element of separation of powers for performing quasi-judicial functions, and establishing an effective specialised mechanism for substantive judicial review of regulations and orders.

The basic public administration challenge of establishing a regulatory agency does not vary from one agency to the next. Hence, the Commission proposes a single and consistent framework that is applied to all regulatory agencies.