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Building State capacity for regulation in India

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The economic reforms in India envision shifting from regulation of markets being run by departments of government, to oversight by specialised regulators. While many regulators have been created in recent decades, the outcomes have often been disappointing. In this paper, we analyse the features of organisation design that cater to high performance regulators. We propose sound designs for: clarity of purpose, the board, the legislative process, the executive process, the judicial process, and reporting. We argue that when these features are mandated by legislation that creates the regulator, feedback loops will be established through which State capacity will be gradually obtained.

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1 Introduction

When India embarked on market oriented reforms in 1991, there was a desire to break with central planning; with detailed government control of entry barriers, product design and processes within firms. This is not synonymous with deregulation: there are market failures in many industries that require addressing. This led to the establishment of *regulators*. While the Reserve Bank of India has existed since 1934, there was a wave of establishment of new regulators after Securities and Exchange Board of India (SEBI) was created in 1988.

Regulators were to have legislative powers, to write subordinate legislation which would embed intricate knowledge and change rapidly with the evolution of fast-paced private industries. They were intended to have executive power in licensing and investigations. They were designed to shield transactions (licensing, investigation) from political interference. They were expected to achieve greater State capacity when compared with departments of government improving upon processes such as human resource policies.

The early optimism about shifting from central control to specialised regulators has given way to concerns about the working of regulators. Regulators have also been plagued by poor State capacity. They have too often veered into controlling as opposed to regulating, with creation of entry barriers and micro-management through regulations. Firms and groups of firms actively seek to co-opt regulators in their business objectives, which has given a return to the political economy of central planning. Entry barriers have sprung up with irrational and arbitrary decisions in licensing. Enforcement of regulations, and substantive law making, is selective and weak. This has induced large costs upon the economy. There is arbitrary power to initiate investigations and punish, and a climate of fear where private persons are afraid to criticise regulators. India of 2018 is uncomfortably similar to the India of 1991.

It is hence important to review the Indian experience, diagnose the sources of failure of existing regulators, and envision how high performance regulators can be obtained.

There are two blind alleys in this quest. It is possible to focus on one episode of a mistake by a regulator, and undertake analysis and advocacy about solving this problem. While a great deal of *knowledge* can be produced through case studies of failure, it is important to go upstream, to ask questions of incentives and information that lie at the source of repeated regulatory failure.

The second non-solution is a focus on personalities. When institutions are weak, the character of the institution is determined by its staffing. There is, then, a

clamour to recruit great men, and then give them all power to do as they like (i.e. extreme regulatory independence). It is important to look deeper, to build *institutions* that have impersonal capability. For any change to be more than skin deep, it cannot be an idea in the minds of certain individuals; it has to be about the formal structures of governance, accountability, and processes.

Conversely, individuals working in regulators sometimes take criticism personally. However, the failures of an organisation are primarily induced by the design of the organisation. The same individuals would deliver superior outcomes if placed in a better designed organisation.

The focus must be on the incentives of the individuals who man the regulator. If regulators are merely given arbitrary power, public choice theory and the Indian experience shows that this power will be used poorly. What is required is systems of accountability, and checks and balances, through which the individuals working inside regulators have incentives to do the right things. This requires seven elements.

Clarity of purpose. Accountability for an organisation requires clarity on its goals. Every regulatory organisation must have a compact and clearly understood objective. Sprawling mandates, and particularly conflicting mandates, yield poor performance.

Role and composition of the board. The board must be dominated by non-executive members, through which the board can play the role of the Principal vis-a-vis the management which is the Agent. The board must control the organisation design, including organisation diagram, internal process manuals and the budget process. The board must control the legislative function.

Legislative process. When Parliament places law-making power upon unelected officials in a regulator, this calls for commensurate checks and balances in the process of regulation-making. The regulation-making process must start from the board. The staff must document the problem that is sought to be solved, the proposed intervention, and conduct a cost-benefit analysis. This packet must be put out for public comment. After this, the staff must address the public comments on the draft and make appropriate modifications to the draft regulation, and bring the draft back to the board for a discussion. Finally, only the board should have the power to issue a regulation.

Executive process. Sound processes are required in licensing and investigations, which protect citizens from arbitrary power. The non-award of a license causes harm for the applicant, and should use processes similar to those employed when punishing a citizen.

Judicial process. An administrative law department should contain administrative law officers, who play no role in legislative or executive functions. This would yield an element of separation of powers. A hearing must take place before an administrative law officer, where the prosecution leads an argument and the defendant is given an opportunity to argue her case. This should lead to the drafting of a reasoned order as a structured document which shows the state of law, the facts of this case, demonstrates that law has been violated, or explain why this conclusion cannot be reached, and uses proper reasoning to determine the penalty. Orders should be published. There should be the possibility of efficacious appeal at a court or tribunal against the order. These three stages of due process (internally, at the administrative law officer, and externally, through publishing orders and at the appeal) create pressure upon the investigation and prosecution staff of regulator to produce high quality work, and protect citizens from arbitrary power.

Reporting and accountability. Regulators should be obliged to release statistical details about their functioning. Reporting should not concern the broader economic environment, e.g. the fluctuations of the stock market index, but should focus upon the actual work of the regulator, e.g. the win rate at the tribunal when orders are appealed. High quality reporting of all aspects of the working of the regulator will create the pressure of accountability, and feed into the budget process where targets can be set and incremental resources allocated in a way that pursues those targets.

The role of the department. Alongside the creation of well structured regulators, there is a need to clarify the role of the department of government, and create capacity in the functions that the department has to discharge.

These seven elements need to be coded into the Parliamentary law. This can be done at the level of one sector (e.g. the draft Indian Financial Code that envisages a single good governance framework for all financial regulators) or for all regulators in the Union government, as was done in the US by the Federal Administrative Procedures Act in 1946.

When compared with these seven elements of the design of a regulator which foster high performance, the present Indian landscape contains large gaps. The regulators of today are defined by skimpy laws, which give arbitrary power to the management, and lack a Principal-Agent perspective upon the working of the regulator. The present legislative framework is grounded in the notion that regulators are good people and will work towards the welfare of the people. This creates poor incentives for good behaviour by regulatory officials.

The Financial Sector Legislative Reforms Commission (FSLRC), chaired by one

of us (Justice Srikrishna) drafted the Indian Financial Code, from 2011 to 2015. This draft law embeds the key ideas of this paper. Across the Indian landscape, many experiments are now taking place in building State capacity in regulators. This paper provides a conceptual framework, and 140 sections in the draft Indian Financial Code provides the draft law, for this journey.

2 The problems of State capacity in regulation in India

Under central planning, government intervened extensively in the economy, through tools such as bans, price controls, public ownership, entry barriers, and restrictions upon private persons. There were a large number of government schemes which intervened in the working of the economy in various ways.

By 1991, it was clear that this added up to an excessive involvement of the government in the economy. On many issues, there was a need for removing these restrictions upon the private sector. The liberal idea in Indian economic policy is to create private competitive industries as opposed to the old world of bans, price controls, entry barriers, public ownership, onerous restrictions and schemes. There is a significant agenda of unfinished work of this nature. Indeed, a steady pace of introduction of new bans, schemes, price controls, government monopolies etc. continues.

Alongside this program of establishing economic freedom, however, there are market failures which call for regulation. Across a large swathe of industries, there are concerns about health – safety – environment which require regulation of a private industry. Concerns about consumer protection and market power motivate a parallel class of restrictions upon firms. In industries ranging from infrastructure to finance, there is often a role for regulation. Establishing a market economy is as much about removing the old ways of intervention as about establishing regulators.

2.1 Coercing private persons through the concept of a regulator

In the India of old, coercion of private persons was done through Parliamentary law enforced by government departments. This approach has difficulties:

1. With the fast paced evolution of technology, products and processes, it was difficult for Parliament to keep up, with numerous amendments of law.
2. Laws required intricate industry knowledge, while Parliament worked at the level of high principles.
3. Departments of government had a limited ability to police the compliance with law.
4. Departments of government had weak processes to absorb market feedback, and low State capacity.
5. Departments of government were invested in a culture of central planning.
6. Departments of government were headed by ministers, which brought political considerations into individual transactions which are found in licensing, investigation and prosecution.
7. Departments of government have conflicts of interest through owning elements of the production process. Regulators would be at arms length from the industry that they regulate.

A specialised organisation, the regulator, was envisaged to address these seven problems. The regulator would build dedicated teams with specialised knowledge. The regulator would improve upon processes that are utilised in government departments, and thus develop greater capability. It would recruit experts, and break with the established culture of central planning. The regulator would have regulatory independence to the extent of shielding the processes of licensing, investigation and prosecution from political interference.

These capabilities would enable the rapid evolution of subordinated legislation – the regulations – so as to keep up with the innovations and technological change of the private sector. They would also enable sophisticated enforcement of these regulations.

Departments of government tended to own public sector companies and other elements of institutional infrastructure that directly participated in the market economy. Regulators would have the arms length arrangement: they would be referees and not players.

An integral part of the 1991 reforms was the program of establishing regulators. The idea was to free up private persons to start firms and innovate in what is done within firms, within a set of rules established by regulators that address market failures. While the first regulator, Reserve Bank of India (RBI), had been established in 1934, a wave of new organisations came about, starting with SEBI (1992). Other regulatory agencies were built in finance (Pension Fund Regulatory and Development Authority (PFRDA), Insurance Regulatory and Development Authority (IRDA)), competition (Competition Commission of India (CCI)), company law (Insolvency and Bankruptcy Board of India (IBBI)), infrastructure (Telecom

Regulatory Authority of India (TRAI), Central Electricity Commission (CEC), Airports Economic Regulatory Authority (AERA)), food (Food Safety and Standards Authority of India (FSSAI)), real estate (Real Estate Regulatory Authority (RERA)), etc. New regulators continue to be established.

2.2 How have we fared?

The outcomes obtained in India through the establishment of regulators have been disappointing. Some regulators have been associated with important economic reforms (e.g. SEBI and TRAI). Other journeys have been less desirable, such as RBI's oversight of repeated banking crises.

At the essence of the establishment of regulators was the desire to move away from central planning to dynamic competitive innovative industries. In most cases, regulators have created a new kind of central planning, where every detail of products and processes is codified into regulations, and the pace of innovation "permissible" in the industry is determined by the pace of thinking at the regulator.

As an example, India was the only country where the Uber cashless payment process was blocked by a regulator (Rai and Shah, 2014-09-18). Similarly, we see newspaper headlines that say *RBI has introduced interest rate futures*. The 'cost of doing business' in India is high, and the conduct of regulators is an important part of this problem.

While regulators had an opportunity to use improved processes as compared with government departments: this opportunity has been utilised to a slight extent. The weak processes in government departments have generally been carried forward into regulators.

Regulators were intended to make a clean break with the culture of central planning, particularly with a new style of recruitment of practitioners and researchers. However, in practice, almost all recruitment by regulators has been from the pool of civil servants or based on recruitment practices of the government. This gave an overhang of the erstwhile socialism.

Regulators were intended to have regulatory independence on individual transactions but not on questions of legislative functions and the governance of the regulator. All too often, regulators accepted political interference on individual transactions in return for reduced accountability and untrammeled regulation-making power.

Regulators were intended to avoid conflicts of interest, to be referees and not players. While this is generally true, there are many deviations. As an example,

RBI is a participant in the markets that it regulates. At (RBI) old assets were not divested, and new assets have been steadily added.

New regulators have been a vital part of important economic reforms, such as SEBI's role on the equity market, TRAI's role in the telecom reforms and AERA's role in private airports. However, the overall picture of regulation in India is an unsatisfactory one. India of 2018 is uncomfortably like the India of 1991, with entry barriers, central planning, and the political economy of firms jockeying for competitive advantage by co-opting the regulator.

The establishment of regulators in India raises traditional concerns about the administrative state. When power is wielded by unelected officials, this raises concerns. When the laws that define the checks and balances for regulators are weak, regulators amass arbitrary power. Under these conditions of the lack of rule of law, private persons are fearful of regulators and fail to exert voice or legal challenge against the actions of the regulator, even when appellate remedies are provided by law. This reduces the quality of checks and balances. In the limit, arbitrary power in the hands of regulators yields central planning, laziness, corruption, and autocratic behaviour.

An important lens through which regulators should be examined is the separation of powers (Sahoo, December 2012). The separation of powers doctrine suggests that legislative, executive and judicial wings should be separated so as to reduce the concentration of power. Regulators worldwide obtain improved efficiency by fusing legislative and executive powers. While this yields greater efficiency at a practical level, it is important to see that this also induces concentration of power, which makes it more difficult to achieve State capacity.

In India, with pervasive gloom about the working of the judiciary, regulators such as RBI or SEBI have also been assigned judicial functions with jurisdiction of courts being ousted by law. With this, there is a full violation of the separation of powers. Many regulators in India fuse legislative, executive and judicial functions. This exacerbates the concentration of power, and makes it even harder to achieve State capacity.

The concept of a regulator continues to be an important one in the construction of the Indian State. But fresh thinking is now required, on how foundational changes can be made, through which high performance regulatory organisations can be obtained. The seven elements of logic, that motivated the establishment of regulators, continue to resonate, but they do not immediately suggest a program for action through which the shortcomings can be addressed. This paper offers a group of tangible ideas through which State capacity in regulation can be obtained.

2.3 Two dead ends and the way forward

In the mainstream Indian debate, there is a lot of focus upon and criticism of regulators and their actions.

For the department, and for the larger policy community, there is a temptation to engage with the regulator, to try to advocate an alternative approach, on one decision by a regulator at a time. However, the existing structures of law that govern regulators has given them substantial powers. The cost, to external parties, of getting involved in any one faulty outcome is fairly large. Hence, this approach for remedying bad regulatory outcomes can occasionally work but it does not scale. The policy community should block the flow of bad regulatory outcomes at the root cause, rather than fire fight the steady flow of failures.

The weak outcomes from regulators has given an emphasis upon staffing. Many in India subscribe to a "great man" theory of regulatory outcomes. There is an emphasis on the individuals who are hired into senior positions, particularly the chairperson. There has been a cycle of hope giving way to despair, where the media hails the appointment of a great man, and then looks back at how little was done on his watch. The substantial power wielded by the chairperson has also created interest in obtaining the position for the wrong reasons.

However, building State capacity requires building capabilities in the institution, and a reduced importance of individuals. We should go beyond individual regulatory actions and regulatory appointments, and look deeper. Why are regulators in India often performing poorly? Why are highly capable persons placed into senior positions unable to deliver improved outcomes? This takes us to questions about organisation design and the nature of incentives. In this paper, we offer a set of features of organisation design which will induce improved performance. We offer arguments and examples which show the gains that can be obtained from these features. All the proposals are actionable and can be coded into laws and process manuals. We do not engage in exhortations towards good behaviour or the need to recruit remarkable people.

In this, we draw upon considerable international experience on these questions. As an example, in the US, there was a wave of creation of regulatory institutions from the 1930s to the 1970s. There were concerns about arbitrary power being wielded by unelected officials. This led to the Federal Administrative Procedures Act (APA), 1946. The APA establishes good governance procedures for all federal organisations, including all regulators. The APA has been highly influential, worldwide, in the thinking about good governance procedures for regulators. The analysis of other advanced economies, such as Canada, Australia and the UK, also

reveals a sophisticated doctrine of checks and balances through good governance procedures, that induce high performance regulators.

The simple transplantation of law is of course not feasible across countries. We must think from first principles about the problems seen in the Indian environment, and design the checks and balances that will induce good incentives under Indian conditions.

3 Elements of a high performance regulator

In our analysis, there are seven elements of a high performance regulator:

1. Clarity of purpose
2. Role and composition of the board
3. Legislative process
4. Executive process
5. Judicial process
6. Reporting, accountability
7. The role of the department

These seven elements add up to a tangible set of actions, in the law that governs the regulator and in the working of its parent department, through which State capacity can be obtained. We now turn to examining each of these in some detail.

3.1 Clarity of purpose

Without clarity of purpose, there is no way for the legislature, or the broader public, to hold a regulatory agency accountable for its functioning. When there is clarity of purpose, failures of the regulator create pressure upon the board members, in particular the independent board members, who would translate the failures into modifications in the functioning of the organisation.

Table 1 compares three examples of the *purpose* of regulatory agencies: the US Securities Act, 1933, the SEBI Act, 1996, and the Payments and Settlement Systems Act, 2007.

The U.S. Securities Act, 1993 captures the tension that the regulator has to maintain when regulating the securities market. The primary objective of the regulation is to *protect investors*. But the legislature also asks the regulator to balance this objective with the need to *promote efficiency, competition, and capital formation*. This balances the regulator by requiring it to look at the bigger role of the securities

U.S. Securities Act 1933 Section 2	**SEBI Act 1996** Section 11.(1)	**PSSA, 2007** Section 3.(1)
Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.	*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.*	*The Reserve Bank shall be the designated authority for the regulation and supervision of payment systems under this Act.*

Table 1: Comparing objectives regulators must pursue

market in a country, especially the raising of capital. There are clear objectives that the regulatory has to meet.

In comparison, the *SEBI Act* does not have this tension. The law oddly requires SEBI to protect the *interests of the investor* and *to promote the development, and to regulate the securities market.* Regulation is a means and not an end. The purpose of the Board should not be to regulate the securities market.

Compared with the U.S. law, the objective of the regulator is not as clear. The tension between protecting investors and making it easy to raise capital is not recognised in the law. The law also puts a vague objective on SEBI as compared to the one on the SEC: A "market" is not an identifiable group, it is difficult to measure if a market has developed. On the other hand, it is easier to measure the efficiency, competition and capital formation in the securities market. For example one good measure of efficiency of the securities market is the *bid-ask spread* of the most liquid securities. Similarly, capital formation ease can be measured by *cost of raising capital* in a country. For example, the U.S. U.S. Securities and Exchange Commission (SEC) compares the cost of raising capital in the U.S. markets with those in other Organisation for Economic Co-operation and Development (OECD) countries as a measure of its efficiency.

The objective of the *PSSA* lacks clarity. In this text, regulation is not the means; it is the end. There is no outcome that the regulator is required to deliver: all it is obliged to do is to use coercive power and regulate. If this power retards the development of the industry, harms the interest of consumers, prevent efficient payments: these outcomes do not offend the governing legislation in any manner. There is no possibility of any failures of the organisation creating pressures of accountability.

For RBI the problem of clarity of purpose is compounded by *conflicting*, and *multiple* objectives. As the debt manager for the government, it is required to issue securities at the lowest price for the government. On the other hand as the manager of inflation it may be required to keep interest rates high, thereby increasing the cost of government borrowing. In addition to these conflicting targets RBI is expected to (1) manage inflation, (2) regulate banks and their competitors, some kinds of non-banks, (3) regulate debt securities, (4) regulate derivatives on currency and debt securities, (4) manage foreign exchange reserves, (5) control the flow of foreign capital, (6) manage debt for central and state governments, (7) regulate cooperative banks, (8) act as a development financial institution, (9) regulate payments, and (10) monitor and enforce social lending targets. It is hard for the Principal (whether the RBI board or the Ministry of Finance or the Parliament) to judge the extent to which the Agent is performing, when the Agent has such extensive and internally conflicting goals.

One element of the clarity of purpose is the distinction between player and referee. An organisation like TRAI is a pure referee: it has no ownership or control over players of any kind. At RBI, however, an array of infrastructure systems are directly or indirectly controlled by RBI. These include the Subsidiary General Ledger (SGL), Negotiated Dealing System (NDS), National Payments Corporation of India (NPCI), Clearing Corporation of India Limited (CCIL), etc. There are proposals to create more such elements, such as a public credit registry (Regy, 2017). Achieving clarity of purpose requires divesting these assets, and becoming a pure referee as is the case with TRAI.

3.2 Role and composition of the board

Regulatory failures in India often elicit demands for a "*Lok Pal solution*": appointing an exceptionally honest or competent person to lead the regulator. Alongside, it is generally assumed that *regulatory independence* is required, which is used to lobby for reduced accountability.

However, the feedback loop of elections leading to Parliament and Cabinet is a key source of accountability and performance. This is missing with unelected officials. If un-elected officials are hired to run an agency, and given job security and full freedom to do as they like, they are unaccountable.

At present, regulatory boards in India are often ineffectual, and power is concentrated in the chairman of the board who is also part of the management of the regulator (i.e. an executive chairman). In addition, many boards have a substantial representation of interested parties who are not balanced by a healthy number of

non-executive and non-government experts. As table 2 shows, while some boards like that of RBI show a predominance of independent non-executive members, other boards have flaws in composition.

Regulator	Executive	Non-executive	Ex-officio/government
RBI	5	8	2
SEBI	3	1	3
IBBI	4	0	4
IRDA	5	4	0

Table 2: Comparing board composition of regulators

The institution of the board has matured to a greater extent in private companies through the *Companies Act, 2013*, and the global evolution of thinking on the role of the board. For example, listed companies in India are required to have at least one-third independent directors.[1]. The RBI mandates that bank boards should have a non-executive chairman. This body of knowledge has important insights into the structuring of an effective board. At the same time, commercial organisations have an easier governance problem as they see frequent and timely data for profits and stock prices. The governance problem for government organisations is harder.

As a concrete example, we will envision a regulatory board which is made up of the key managers of the organisation (one chairman and say, two members), a nominee member (representing the relevant department) and a majority of independent members (five independent members). This adds up to a nine-member board. At a conceptual level, the purpose of the board is to be the hands-on principal that holds the agent (the management) accountable. The five independent members, and the nominee member, should dominate board meetings, and challenge the work of the management (the three internal members).

The functioning of boards in Indian regulators today is opaque. Patnaik and Roy, 2017 show that RBI's board functioning does not compare well with other central banks. For example, while the minutes of a single meeting of the New York Federal Reserve Board are around 6000 words, and those of the BoE Court of Directors are around 2100 words, RBI's only puts out a press release of 142 words. The Parliament has set very low standards for the transparency and accountability of the RBI board. Details of the agenda, discussions, transcripts or votes are not released by the central bank. Some other regulators in India work differently: SEBI publishes the board agenda and the decision taken by the board on each

[1] See S.149.(4) of the *Companies Act, 2013* n.d.

agenda item on its website. But the SEBI board functioning also has weaknesses: the board routinely delegates to the executive chairman the full power to modify and finalise draft regulations that have been "approved" by the board.

The difference in the transparency in meetings arises from the legal requirement placed on the regulator. As Table 3 shows, in India, this is left to the regulator. As an example, the *U.S. Government in the Sunshine Act* lays down detailed requirements for any U.S. agency/regulator board meetings. By default, meetings have to be held in the *open*: the public may watch and record the board meeting. Meetings can be closed only if they discuss items which are mentioned in the Act. In such closed meetings, as per the legislation:

U.S. Government in the Sunshine Act Part of provision governing meeting minutes	***Competition Act, 2002*** Entire provision governing commission meetings S.22.(1)
the agency shall maintain either such a transcript or recording, or a set of minutes. Such minutes shall fully and clearly describe all matters discussed and shall provide a full and accurate summary of any action taken, and the reasons therefor, including a description of each of the views expressed on any item and the record of any roll call vote (reflecting the vote of each member on the question). All documents considered in connection with any action shall be identified in such minutes.	*The Commission shall meet at such times and places, and shall observe such rules and procedure in regard to the transaction of business at its meetings as may be provided by regulations*
The regulations for CCI are made by the board of the CCI, not surprisingly, there are no provisions governing minutes or voting.	

Table 3: Comparing requirement to publish meeting minutes

One additional function that should be placed with the board of a regulatory organisation is the legislative function. Every regulation-making project must start and end with the board. This is discussed in greater detail in Section 3.3.

In India, many boards have ex officio members from other organisations. This has generally become a way for those organisations to obtain a veto power upon board decisions. From the viewpoint of the management of a regulator, such passive members are convenient as they exercise their veto occasionally, and otherwise do not hold the management accountable. However, on-management board members are the essence of regulatory accountability. This requires a lean board structure of the kind described above.

3.3 Legislative process

In a liberal democracy, the power to write law is ordinarily wielded by elected representatives of the people, who are accountable through elections. When the power to write law is given to un-elected officials, this is an extraordinary arrangement. It requires a corresponding extraordinary set of checks and balances. This involves (a) Clarifying what falls under the legislative functions of the regulator, (b) The process that the regulator should undertake to make regulations, and (c) The system of parliamentary scrutiny.

3.3.1 Clarifying legislative functions

Before any meaningful discussion about the quality of regulation making can be initiated; what constitutes regulations under law need to be clarified. This is a murky territory in India. As an example, financial sector regulators in India issue many *types* of instruments, all of which coerce private persons and thereby constitute "law". Box 1 emumerates the regulatory instruments issued in some regulators.

Box 1: Plethora of subordinate legislation instruments

Indian regulators issue a plethora of subordinate legislation instruments. There is usually no clarity as to why a specific type of legislative instrument is used for a purpose.

- **SEBI**
  Types: Regulations, rules (made by government), circulars, general orders, guidelines, master circulars, and press-release (since they are now used to stay the operation of circulars)
  Legislative Scrutiny: rules and regulations only
- **PFRDA**
  Types: Regulations, notifications, master circulars, circulars, orders & notices, public notices, exposure drafts
  Legislative Scrutiny: rules and regulations only
- **IRDA**
  Types: Regulations, guidelines, circulars, orders & notices
  Legislative Scrutiny: rules and regulations only
- **RBI**
  Types: Rules, regulations, notifications, press-release, directions, master directions, circulars, guidelines,
  Legislative Scrutiny: rules and regulations only

While *SEBI Act* S.31 requires that every rule or regulation must be laid before Parliament, S.11B. allows SEBI to make any directions on its own subjective satisfaction, without parliamentary review. Going beyond the scope of the Parliamentary legislation, SEBI has created multiple types of legal instruments: rules,

regulations, general orders, guidelines, master circulars, circulars and informal guidance. However, out of these six, only regulations are laid before Parliament. The remainder face no legislative oversight. Since they are not considered judicial orders, there is no possibility of judicial review of such legal instruments also. Public choice theory predicts that the staff of SEBI will prefer the instruments which have no Parliamentary oversight. SEBI does, in fact, favour issuing *circulars*.

While some regulatory instruments escape parliamentary scrutiny because the parliamentary legislation does not provide for them; in other legislations the drafting of the law itself is flawed and enables the regulator to make subordinate legislation without any scrutiny. For example, *RBI Act* S. 45W.(1) empowers RBI to give directions to all entities dealing in securities. These directions are not required to be placed before Parliament. There is no definition of the nature of instruments which may be issued under any provision. This also allows the regulator to avoid the entire process mandated under the law for *effectively* making subsidiary legislation which affects all parties.

The first step towards State capacity at regulators is to require that there must be only one kind of legal instrument that regulators can issue: a 'regulation'.

3.3.2 Process of making regulations

What process must the regulator follow to make regulations? Regulators are un-elected officials who have been given an extraordinary law-making power by Parliament. Legal theorists and legislators have grappled with this problem in many countries and have come up with two main procedural checks drawn from the nature of regulators:

Address the democratic deficit: Since regulators are not elected and therefore do not reflect the *will of the people*, they must attempt to involve the public in their regulation making process. This is done through processes called *public notice and comment*, where regulators provide draft regulations to the public.

Demonstrate expertise: One reason for creating regulators is to bring in expertise which is not normally available in government. However, this expertise will not be *presumed*. The regulator must *demonstrate* that it has expertise in the subject of regulation by showing how the regulations will be beneficial for society. This is done by requiring the regulator to publish a documentation packet including a *cost-benefit analysis*.

These ideas are absent with regulators in India today. Box 2 highlights some of the provisions governing process of regulation making in different regulators.

Box 2: Procedural requirements for making regulations

Currently, most regulators in India do not need to meet any procedural requirements before making regulations.
Section *SEBI Act* merely states in S. 30:

> *(1) The Board may, by notification, make regulations consistent with this Act and the rules made thereunder to carry out the purposes of this Act.*

The *TRAI Act, 1997* puts a general requirement which would apply to regulation making in S. 11(4):

> *The Authority shall ensure transparency while exercising its powers and discharging its functions.*

The state-of-the-art legislation in India (in this aspect) is the *AERAI Act, 1997* where what constitutes transparent functioning of the board/authority has been defined in S.13(4) as:

> *(a) by holding due consultations with all stake-holders with the airport;*
> *(b) by allowing all stake-holders to make their submissions to the authority; and*
> *(c) by making all decisions of the authority fully documented and explained.*

The way forward lies in requiring a regulator to comply with multiple steps which (1) provide regulated persons with the reasoning behind the regulation, and (2) allow the public to *effectively* participate in the process of regulation making. Box 3 are extracts from laws in other jurisdiction which are analogous to S.30 of the *SEBI Act*. These requirements ensure that the regulator considers the costs and benefits of the regulation and allows effective participation.

An analysis of requirements under various legislation in other jurisdiction; history of regulation in India; and best practices identified by organisations like OECD shows that there are some common requirements all regulators should follow while making regulations. These are:

1. All regulations should commence from an instruction from the board of the regulator after a formal vote on the issue.
2. After the formal board resolution, the employees of the regulator must make a documentation packet which answers the following with reason and evidence:
   (a) What is the problem we seek to solve?
   (b) Is it a market failure? Is it within the jurisdiction of this agency?
   (c) What is the proposed intervention?
   (d) Does the proposed intervention address the claimed market failure?
3. This documentation packet must be accompanied by:
   (a) A Cost-benefit analysis: Do the benefits outweigh the cost? Was there an alternative intervention which would would achieve the same outcome at a lower cost to society?
   (b) The draft regulation.

Box 3: Notice and Comment procedure in legislation

The *UK FSMA 2000* lays down in quite detail the processes that the U.K. Financial Conduct Authority (FCA) has to carry out before enforcing regulations. S. 155 of the Act, reads:

> **Consultation.**
>
> (1)If the Authority proposes to make any rules, it must publish a draft of the proposed rules in the way appearing to it to be best calculated to bring them to the attention of the public.
>
> (2)The draft must be accompanied by—
> (a)a cost benefit analysis;
> (b)an explanation of the purpose of the proposed rules;
> (c)an explanation of the Authority's reasons for believing that making the proposed rules is compatible with its general duties under Section 2; and
> (d)notice that representations about the proposals may be made to the Authority within a specified time.
>
> (3)In the case of a proposal to make rules under a provision mentioned in subsection (9), the draft must also be accompanied by details of the expected expenditure by reference to which the proposal is made.
>
> (4)Before making the proposed rules, the Authority must have regard to any representations made to it in accordance with subsection (2)(d).
>
> (5)If the Authority makes the proposed rules, it must publish an account, in general terms, of—
> (a)the representations made to it in accordance with subsection (2)(d); and
> (b)its response to them.

The US SEC is also bound by the US Administrative Procedure Act, 1946 S.553 which mandates a system of notice and comment:

> ...
> (b) General notice of proposed rule making shall be published in the Federal Register, unless persons subject thereto are named and either personally served or otherwise have actual notice thereof in accordance with law. The notice shall include -
> (1) a statement of the time, place, and nature of public rule making proceedings;
> (2) reference to the legal authority under which the rule is proposed; and
> (3) either the terms or substance of the proposed rule or a description of the subjects and issues involved.
>
> ... [text ommitted]
> (c) After notice required by this section, the agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation. After consideration of the relevant matter presented, the agency shall incorporate in the rules adopted a concise general statement of their basis and purpose. When rules are required by statute to be made on the record after opportunity for an agency hearing,...

Cost-Benefit analysis by regulators are mandated by a separate Presidential Order.[a]

[a] See Sunstien and Wahn, 2002.

4. The board of the regulator must approve these documents, agree that they meet minimum quality standards, and approve them to be published.
5. This entire packet of documentation should be available for public comment for a reasonable period, say a month.
6. All public comments should be categorised and then the management of the regulator must make a category-wise response to all the comments from the public.
7. The first packet, comments from the public, categorised comments and the management response should be placed before the board for approval.
8. The board of the regulator, in a formal meeting, by resolution should approve the final regulations for release.
9. At some regular interval, say 3 years after a regulation is made, a formal review of the working of the regulation should be carried out. It should ask:
   (a) Was the problem solved?
   (b) Did the intervention solve the problem?
   (c) Was the original cost-benefit analysis correct or need to be reviewed from the experience of implementing the regulation.
   (d) Are there any new interventions which could get the same outcome at lower costs to society.

At present, this process is not required of any regulator in India. While some regulators may sporadically carry out public consultation, they are not meaningful. Burman and Zaveri, 2016, show that regulators in India hardly follow through with public consultations. There are long delays between consultation and final regulation and there is no evidence that public consultation changes the thinking of regulators in any way. However, the authors do find that variation in the governing law of regulators (i.e. laws which require some form of consultation) leads to relatively more involvement in regulation making. They show that the telecom regulator TRAI has more public engagement than the securities regulator SEBI.

3.3.3 Parliamentary oversight

The final legal process requirement is subjecting the regulations formulated by the regulator to Parliamentary scrutiny. Since the Parliament is the sole repository of legislative power, laws usually require all subordinate legislation to be placed before Parliament when it is in session. Parliament has some time (usually 30 days) to either modify or annul the regulations, through a resolution.

While regulators are required to place regulations before Parliament, this process suffers from two defects. First, as shown in Box 1 most regulatory instruments,

which have the same effect as regulations are never seen by Parliament.

Second, the current system places only the bare text of the regulation before the legislature. Neither the legislature or the public is able to form an informed view about the appropriateness and quality of the subordinate legislation. For a counter example, the Federal Register, which is the repository of all regulations made by U.S. regulators/government contains the entire document packet of regulations, cost-benefit analysis, statement of purpose, public comments and response to public comments.

3.3.4 Poor outcomes

As a result of this poor *regulatory legislative process*, the regulator or its board (1) does not have a systematic process to evaluate proposals to regulate that arise from the management of the regulator; or (2) does not get any feedback from the regulated about the appropriateness of any proposed regulation. This is the root cause of the flow of poor, unenforceable regulations with frequent changes. Box 4 is an example of an unexplained change in subordinate legislation.

3.4 Executive process

The executive functions of a regulator are the third group of activities, which are not regulation making or quasi-judicial functions. This includes issuing licenses or permissions to carry out regulated activity, inspecting regulated businesses, investigating alleged violations of the law, *etc.* In the licensing, investigative and prosecutorial functions, government organisations run the risk of veering into arbitrary power, intimidation and corruption, which gives low capabilities.

High capability requires (1) formal procedures with service level assurances and (2) the ability to demonstrate that the procedures are adhered to. While the importance of formal processes is well understood in private management settings, in public management, there is an additional requirement of adherence to two principles of the *rule of law*: (1) a substantial reduction in discretion and (2) a duty to explain the reason behind any executive action. Private persons should feel there is high predictability before the event: this reduces regulatory risk. Once an action is taken, they should know the rationale.

At present, in India, there are many violations of these principles. For example, (Roy and Shah, 2015) show that the procedure for granting payments bank licenses was inconsistent with the rule of law (See Box 5).

Box 4: Regulatory uncertainty: an example

The basic tenet of securities regulation is to enable investors make informed decisions about the issuer of a security. Banking regulation in India was not transparent about defaults. Information about defaults gets delayed as listed borrowers are not required to release information about defaults to banks.

The securities regulator: SEBI attempted to correct this situation with a *circular* to require listed companies to disclose any delay in repayment of bank loans. The following is the series of events that precipitated.[a]

4^{th} August, 2017 SEBI issued a circular stating that there is a discrepancy about level of information that listed companies have to release about default in payments. While a single day single Rupee default in bonds is required to be disclosed, similar disclosures were not stipulated with respect to loans from banks and financial institutions. Therefore, from 1^{st}, October, 2017 all listed companies would be required to report defaults to banks to the exchanges (public dissemination).

30^{th} September, 2017 , one day prior to the circular coming to effect; SEBI came out with a single line *press release*, stating in passive tense, that the circular was deferred until further notice. There was no information about the reasons for deferring the circular

After the fraud at Punjab National Bank in last week of February of 2018, the demand for information about loan defaults was raised. However, by withdrawing its circular SEBI has undermined its own regulatory authority and reduced clarity about upcoming regulations. Firms which had prepared to comply with the first circular have wasted resources in setting up systems to report defaults. More importantly, investors expecting more clarity about issuers are now on an indeterminate wait about disclosure requirements.

[a] See Sundaresan, 2017, for a detailed analysis of events.

Box 5: Payments Banks Licenses

The process by which RBI granted permission to open *payments bank* was similar to that of the coal block allocation through the committee system. This system was held to be unconstitutional by the Supreme Court in *Manohar Lal Sharma v The Principal Secretary & Ors.*

No identifiable criteria were identified for the selection of successful applicants. *After* the selection was complete the RBI released a press-release stating that the selection was done by an external committee which determined its own procedure and analysed the applications. While the press-release claimed that the applications had been granted based on some criteria, there was no explanation on how the committee evaluated each criterion.

There was no explanation provided to the 30 applicants who were rejected. Instead the press-release stated:

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

It seems even the RBI was unsure about the reasons why these entities were rejected.

In addition to licensing, other executive processes need similar checks and balances. As Roy, 2018 argues, regulators in India are particularly weak in *demonstrating* that there is a sound inspection process (See Box 6).

Box 6: Missing Inspection Manuals

The recent Rs 11,400-crore bank fraud in Punjab National Bank, that was allegedly perpetrated by billionaire Nirav Modi in collusion with a few bank employees, highlights the failure of inspection processes in Banks.

Section 35 of the Banking Regulation Act empowers the RBI to carry out inspections. How the inspection will be carried, what will be checked, how will sampling be done, and other details of the inspection process is not provided by legislation. It is expected that, based on this provision, the RBI would have developed rules, regulations and other documents setting out the detailed system of inspections.

In contrast, the Federal Deposit Insurance Corporate of the U.S. (which plays a similar role in bank inspection) releases detailed manuals on the process of inspections. The compliance manual is 1,275 pages long and it has its own website. Any person can read the manual and comment on the robustness of the procedures. All the 1,28,755 words of the compliance manual is open to scrutiny. The Japanese financial regulator's inspection manual for deposit taking institutions is 446 pages. It provides detailed information about how inspections will be carried out, including a checklist for inspections.

These principles are usefully applied into each of the three elements of the executive functions.

Licensing should be given only on predetermined criteria and evaluation processes. The denial of a license imposes harm upon the applicant. Hence, if an application is rejected, it should be with a reasoned order (containing all information the regulator relied on), and after providing the regulated entity a hearing. Denial of license orders should be subject to judicial review.

Inspections can easily turn into a tool for harassment and intimidation. The regulator must demonstrate that inspections are effective. The process manual used by inspectors should be visible to the inspected, who should be able to check excesses. The findings of inspections should be recorded by the regulator and made available to the regulated. Inspection reports should available for judicial scrutiny at a later stage.

Investigations can easily turn into witch-hunts or continual harassment of regulated entities. Sometimes, open ended fishing expeditions are begun starting from one claim and ending up in a very different outcome. Investigation requires a clear direction from the regulator about the alleged violation, carried out in a time bound manner and overseen by the judicial wing of the regulator. Before the investigator disrupts the functioning of any regulated entity or other person,

he should be able to demonstrate (on record), reasonable grounds for doing so. If investigations do not find violations within stipulated time, appropriate closure statements should be provided to the entities under investigation.

When there are checks and balances on these issues, this simultaneously addresses the civil liberties objective and fosters the creation of State capacity. When there is unchecked executive discretion, this becomes and oppressive environment, which fails on both objectives.

3.5 Judicial process

Regulators in India also have a judicial function: They award punishments. This can be a dangerous function from the viewpoint of developing State capacity. If there is arbitrary power in awarding punishment, this leads to arrogance and corruption. If investigators and prosecutors know they can easily inflict punishment, they lose incentive to do thorough work.

The moment we think of a State agency that awards punishments, we envision the minimum rule of law machinery that must surround it. Once an investigation has completed, a discussion should take place internally in the regulator with the prosecution team who would judge the information that was obtained, and decide whether there is a strong case. The prosecution team must be distinct from the investigative team. If there is a strong case, the first step should be that of issuing a show cause notice, and giving the accused an opportunity to present her side of the story.

After this, if the prosecution wishes to proceed, a hearing should take place in front of an adjudicating officer. The prosecution would show evidence and make the argument that there were violations of law, while the accused would have an opportunity to defend themselves.

Sadly, this is not the starting position of quasi-judicial regulators in India. Indian quasi-judicial functions start with a *show cause notice*. A typical show cause notice requires the recipient to *show cause* why some penalty should not be imposed on the recipient. The starting position of the show cause notice is the *presumption* that the person has violated the law. The classical legal concept of *presumption of innocence* is turned on its head to a *presumption of guilt*.

It is for the recipient to prove that the she is innocent of the action the regulator has already decided to impose penalty on. Many times the information or evidence on which the regulator came to the conclusion is not provided to the defendant/accused. Even a basic a right as to get access to the evidence against

a defendant is not established in legislation. Parties have to resort to constitutional courts to gain access to documents, information and even the quasi-judicial decisions of a regulator.

To make progress in India, it is useful to create an administrative law vertical, within the regulator. This vertical should headed by a member of the board who is termed the administrative law member. Employee performance assessments within this vertical would be insulated from unhappiness (or lack thereof) among investigators and prosecutors about the orders that were written by the adjudicating officers.

Orders must be reasoned orders: they must state the position of law, the facts that were uncovered by the investigators, demonstrate that the law was violated, and show the rationale for the punishment awarded. A doctrine for calculating punishment is required in the Parliamentary law, which will then engender jurisprudence. Orders must be released in the public domain. This improves public scrutiny, and hampers arbitrary exercise of power.

There must be an efficacious procedure for appeal against the order. As an example, orders written by SEBI, IRDA and PFRDA can be appealed at the Securities Appellate Tribunal (SAT).

These processes uphold the rule of law and ensure fair play. These are important values in their own right. But it is important to see that these good governance procedures are the pathway to State capacity. When there is arbitrary power with prosecutors, the quality of work done by investigators and prosecutors will go down, and the arbitrary power will breed corruption. The checks and balances that have been described here impose pressure upon the investigation, prosecution and quasi-judicial parts of the regulator, to rise to higher levels of capability.

SEBI offers an interesting example of these links between fair-play, the rule of law and State capacity. When SEBI was first created in 1991, there was no possibility of appeal against a SEBI order in a neutral judicial forum. An appeal was to be made to the Government of India. In 1995, the SAT was created where some of SEBI orders (adjudication orders imposing monetary penalty) could be appealed. In 1999, every order of SEBI became appealable in the SAT. It was a new experience for SEBI, to go from arbitrary power to the prospect of having numerous orders being scrutinised by SAT. However, over the years, this drove SEBI to higher levels of State capacity, towards higher quality work in the investigation, prosecution and quasi-judicial functions. This has helped create significant State capacity within SEBI on these dimensions.

3.6 Reporting, accountability

Reports produced by regulators in India expend many pages discussing the overall environment. As an example, SEBI and RBI make many reports discussing developments in the economy. The economy is not, however, under the control of the management of SEBI or RBI. The focus of reporting should be upon the work of the organisation: to disclose the operational and financial MIS of the organisation.

Transparency in executive procedures cannot be provided contemporaneously, while the actions are underway. Post-hoc disclosure creates check-and-balance against wide powers. The operational MIS for SEBI should show detailed information about the working of the organisation. How many days does it take for SEBI to process an IPO? How many investigations commenced? How many man-days were spent, on average, per investigation? What fraction of investigations became a prosecution? What fraction of prosecutions led to an order with punishment? How many days did it take from the start of an investigation to the issuance of the order? What fraction of orders was appealed, and what was SEBI's win rate at SAT? These kinds of statistics reveal information about the performance of the organisation, which is under the control of the management. The management can be held accountable for the absolute values and the time-series variation in these measures.

Such reporting helps identify the areas of concern, and guide the management and the board towards remedial actions. Such aggregate information also helps in justifying the resources spent by the regulator.

Performance reporting by a regulator has to be supported by financial reporting of the executive functions. This reporting would clearly transmit to the public the level of resources that the regulator is investing in executive action. Parliament and government would also be able to review the regulatory quality from aggregate statistics compared with the financial resources dedicated to executive functions. At present, this is not done in India. Table 4 compares the annual reports of the SEC and the SEBI for the year 2011.

A reading of a number of annual reports of various regulators in India and regulators carrying out similar functions in other jurisdictions with high capacity throws up a thematic difference in the annual reports. Table 5 is an analysis of the difference between annual reports of Indian regulators *vis-a-vis* regulators and those from other jurisdictions.

Milestones and targets do not provide adequate information about the functioning of the regulator, till the public and legislature are informed about the resources

SEC	SEBI Report
201 pages for entire report	172 pages for Performance & Accounts
10 pages of steps taken	85 pages steps taken
4 Strategic Goals identified	No Strategic Goals
Each goal Measured on 9 to 17 measures	No measures of Goals
Each Measure has Actual and Target	Report has no targets at all
Each Section has deficiencies measured	No deficiencies identified
Corrective Action plans for each deficiency	No future plans
Dedicated Performance Results	No performance Results
Prosecution details with targets	Prosecution details but no targets

Table 4: Comparing SEC and SEBI annual report

Table 5: Summary of Report Making

Feature	India	Others
Major Part	Regulated Markets	Functions of the Regulator
Statistics	About regulated market	About regulators functions
Targets	Broad Targets	Broad and Narrow targets
Metrics	None	Objective, Subjective review, Independent Review
Enforcement	Statistics	Expenditure, Statistics, Targets

expended to achieve the target. This enables the board and the public to measure the efficiency of the regulator. Figure 1 is an example of how the SEC reports targets in its annual report. For each outcome the SEC:

1. Attributes the amount of money spent to achieve the outcome.
2. Provides a detailed definition of what constitutes *success* in achieving the outcome.
3. States the target that was set in the last annual report.
4. Compares it with the actual achievement in the present annual report.
5. Sets out the target for the next year.

Figure 1: Milestone Reporting of SEC

Outcome 1.3: The SEC prosecutes violations of federal securities laws and holds violators accountable. In FY 2010, the SEC dedicated approximately $322.7 million to achieve this outcome.

GOAL 1 MEASURE 9: Percentage of enforcement actions successfully resolved

DESCRIPTION: An action is considered "successfully resolved" if it results in a favorable outcome for the SEC, including through litigation, a settlement, or the issuance of a default judgment. In general, the SEC strives to successfully resolve as many actions as possible but, at the same time, aims to file large, difficult, or precedent-setting actions when appropriate, even if success is not assured. This measure does not include any actions in which the SEC awaits a final outcome. The measure is calculated on a per-defendant basis. Large actions may involve several defendants.

Fiscal Year	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010		FY 2011	FY 2012
	Actual	Actual	Actual	Actual	Target	Actual	Target	Target
Percentage	94%	92%	92%	92%	90%	92%	92%	92%

Target: Exceeded

Analysis: The division has implemented controls and strategies to resolve actions on a favorable basis, while at the same time, will strategically file precedent setting or complex matters that are programmatically important, even if success is not assured

Responsible Division/Office: Division of Enforcement

Amount of money spent for objective

Definition of success

Previous performance

Present target & performance

Future Targets

This in turn links the entire financial reporting of the regulator to its performance report. In addition to providing the normal balance sheet, a regulator is required to produce a financial statement which maps total expenditure to each function the regulator is required to carry out. This is not done in India. Indian regulatory annual reports rarely have information about the functioning of the regulator and do not map any functions to expenditure. Without such financial and performance reporting, the board of the regulator is unable to make *strategic* decisions about spending and performance and establish a link between the two.

To summarise, sound reporting systems help create feedback loops that improve State capacity.

3.7 The role of the government department

Most of this paper has been about structural reforms of regulators that are conducive to State capacity. This logically leads to the question: What is the role of the relevant government department? The 25 years of experience with regulators in India is a story of skirmishes between departments of government and the statutory regulators. How can we do better?

Every regulator is grounded in a law and has an administrative department of government. As an example, Parliament enacted the TRAI Act, 1997. Parliament, represented by the Department of Telecommunications, is the Principal and TRAI is the Agent. The law, in this case the TRAI Act, is the contract that defines the relationship between the Principal and the Agent.

A good contract should induce a good relationship. Both sides of a well structured contract should work as a smooth machine. Most of the time, this has not come about with Indian regulators. The leadership of departments has myriad complaints about what regulators are doing, and vice versa. There are some good periods, but they are about personalities on both sides. Low intensity warfare is the norm, which periodically erupts into the public domain with journalists taking sides. The media tends to assume that all regulators should have complete independence. However, placing absolute power at regulators is unlikely to deliver good outcomes.

We propose seven principles that should shape the relationship between the department and the regulator:

1. Regulators *should* fuse legislative, executive and judicial functions. The regulator must have the authority to write law, which is termed 'a regulation', within parameters clearly laid down in the Parliamentary law. Many

departments are stingy about giving regulators this authority, and this is an incorrect approach.

2. All members of the board of a regulator must be appointed by the department. The board should have a majority of independent directors. The chairman of a regulator should gracefully accept the board recruitment decisions of the department; the board should not be the appointing authority for the board.
3. The department must have one nominee member on the board. Membership of the board is a position of high responsibility, as the board's role is to push the management of the regulator towards performance. The board must continuously analyse the performance of the regulator, and reshape the organisation structure, process designs and resourcing. Failures of the regulator should result in feedback to the board, which should diagnose sources of failure and make consequential changes. Regulatory staff should gracefully accept their accountability to the board, and the power of the board to continually reshape the organisation to improve performance. The nominee member should rise up to the level of knowledge and hard work that is required to discharge the function.
4. The staff of the regulator should not have the power to write law; this power must only vest with the board. This means that the department (in its capacity as a member on the board) must develop a point of view on all regulations. The appropriate forum for expressing these views is board meetings.
5. External board members must not be involved in executive and judicial activities. This is the narrow space for regulatory independence. The department should have no say in any individual transaction, i.e. licensing, investigation or orders. Phone calls should not be made by the department to the management asking for favours on transactions.
6. When private persons are unhappy about an order written by a regulator – e.g. rejecting an application for a license – the appropriate port of call is an appellate tribunal and not the department.
7. The department is the Principal. It must constantly ask itself whether the contract (the law) is appropriate. It must regularly change the law in order to refine the Principal-Agent relationship, and to modify the work allocation to the Agent. The regulator must respectfully stay out of questions of its turf or the drafting of the law. The department must regularly modify the agency architecture, of what work is done by what agencies, in the quest for performance.

The department should thus have four functions: (1) appointments, (2) regulation-making, (3) watch performance, and continuously refine the organisation design of

the Agent and (4) continuous refinement of the contract between the Principal and the Agent. It must create capacity for discharging these functions. This includes internal skills, connections with research institutions, a stream of conversations with practitioners, and process manuals.

In the Indian experience with regulation, there is a large divergence from these principles. A low level equilibrium that is often attained is one where the department asks for favours on transactions, i.e. on executive and judicial functions, and in return cedes power on everything else. In the low level equilibrium, the bureaucracy in the regulator zealously guards its turf, and the department stops thinking about regularly reshaping the regulatory architecture.

4 Translating these elements into action

In the previous section, we have shown seven elements of the checks and balances through which the incentives of individuals inside regulatory organisations can be reshaped. How can these seven elements be operationalised? How does this program for reform go from ideas to action?

4.1 The law as the contract between Principal and Agent

The difference between high performing regulators in other jurisdictions and the behaviour of regulators in India can be traced back to the legislation governing the regulators.

The Parliament, represented by a department of government, is the Principal. In order to overcome the Principal-Agent problem, a contract has to be put into place, that constrains the behaviour of the agent, and establishes a structure of information and incentives. The law that defines the regulator is this contract. The seven elements described in this paper must drive the drafting of the law that defines the regulator.

The seven elements described in this paper need to be coded into the parliamentary law with considerable procedural detail. This is true, in general, in thinking about contracts that seek to address principal-agent problems. In the India of old, a power purchase agreement used to be a skimpy document; it has now become a detailed 1000 page document. In similar fashion, we need to go from the skimpy *SEBI Act*, *IRDA Act*, or *TRAI Act, 1997* to a detailed treatment through which the agency conflict between Parliament/department and the regulator will be addressed.

This can be done for one regulator at a time. As an example, we can envision chapters in the *Insolvency and Bankruptcy Code, 2016* (*IBC*), which place these provisions into the working of the new bankruptcy regulator, the IBBI. However, these ideas are general and need not be applied to one regulator at a time. As an example, the draft Indian Financial Code authored by the FSLRC has a single set of 140 sections of law, which setup these mechanisms, for use with all financial agencies. Whenever a law has to be drafted in India, that establishes a regulator, these 140 sections of law can be used. Similarly, in the US, the *U.S. Federal Administrative Procedure Act*, is a single law that governs the working of all Federal agencies.

In India, in the past, the drafting of the law that establishes a regulator is often done by the regulator. As an example, the SEBI Act of 1992 and every amendment thereafter was first drafted at SEBI. The RBI Amendment Act of 2006 was drafted at RBI. There is a conflict of interest rooted in public choice theory here. If the Agent gets an opportunity to draft the contract between the Principal and Agent, the Agent is likely to favour more arbitrary power and less accountability. Hence, it is important to ensure that regulators do not control the drafting of the laws that create regulators.

4.2 Principles based law vs. detailed procedural law

There is a conventional wisdom in India that Parliamentary law should never embed concrete detail, that well drafted law is always principles-based law. It is useful to make a distinction between elements of the law that coerce private persons versus the elements of law that are designed to solve public administration problems.

When the law is designed to prohibit persons from carrying out specific activities, it is indeed valuable to draft the law in a principles-based way. As an example, the Indian Penal Code has defined theft in a timeless way. As the world changes, as new concepts of property and new concepts of crime arise, the definition of theft in the *Indian Penal Code, 1860* will remain sound. Another approach to coercing private persons consists of writing down principles in the law, and setting forth a regulator that translates these principles into regulations that change repeatedly.

However, when law is drafted to rein in the behaviour of employees of government, the main focus is upon Principal-Agent problems, upon public choice problems. Here, giving officials the power to define their own procedures is inappropritae. As an example, the procedures that must be employed by a policeman before stepping into the home of a citizen have to be prescribed in an extremely detailed

way in the primary law. If this is not done, public choice theory predicts that policemen will possess and abuse arbitrary power. Hence, Parliament has drafted 40,000 words in the Criminal Procedure Code, all of which constrains employees of the State. This drafting has not been delegated to the police.

While regulators do not have power to imprison, they have powers to fine a person to an infinite amount, ban them from their livelihood, etc. However, existing laws are silent on governing how these powers will be exercised. This in turn leads to arbitrary use of power by officers who may not even have legal training.

5 India's journey towards high performance regulators

In the first flush of liberalisation, in the 1990s, there was a broad notion that India needs to move away from central planning, and that there was value in creating sectoral regulators that would address market failures. There was relatively little understanding of what regulation constitutes, of the dangers associated with creating independent regulators, of the distinction between central planning and regulation, and the hurdles in creating State capacity in regulation.

A large number of regulators were created. In some areas, these regulators were part of important economic reforms (such as SEBI and TRAI). However, the overall experience with regulators, old and new, has been disappointing.

The question of the age is about State capacity in regulators. How should high performance regulators be constructed? A small set of recent developments shows the early beginning of this journey in India.

The laws that shape some regulators have improved provisions when compared with others. As an example, the regulation-making process embedded in the law governing AERA was unusually sound (Roy and Chatterjee, 2011-04-15). Similarly, the consultative processes followed by TRAI have been superior to that of financial sector regulators like SEBI.[2]

In the area of finance, in 2011, the Ministry of Finance created the *Financial Sector Legislative Reforms Commission*, chaired by Justice Srikrishna. This was an unusual project in that it set out to repeal all existing financial law, and replace it by a single coherent law, the *Indian Financial Code*. As India lacks a general statute setting out administrative law governing regulators, the draft Indian Financial

[2]See, Burman and Zaveri, 2016.

Code contains the 140 sections of good governance procedures that set the stage for a high performance regulator. Most of the ideas of this paper are expressed in version 1.1 of the draft Indian Financial Code, which was released in 2015.

In 2014 and 2015, it was felt that enacting the Indian Financial Code will be a time consuming process, but good governance procedures could be brought about voluntarily by existing financial regulators even without a new law. The idea was the regulators will altruistically rise to higher standards of governance. This led to the drafting of a *Handbook on adoption of governance enhancing and non-legislative elements of the draft Indian Financial Code*. This was associated with an MIS system for tracking the adoption by financial regulators of the elements of good governance embedded in the Handbook. These documents work out the thought process of this paper in greater detail.

Public choice theory predicts that the management of a regulatory agency will favour arbitrary power over good governance procedures. This prediction was borne out: The present state of compliance, by financial regulators, of the requirements of the *Handbook on adoption of governance enhancing and non-legislative elements of the draft Indian Financial Code* is near zero. This emphasises the idea that the Principal (Parliament / Department) must place good governance procedures into the Parliamentary law.

When the *IBC* was enacted in 2016, it envisioned a new regulator, the IBBI. This was an opportunity to establish good governance procedure. The *IBC* as enacted by Parliament, however, uses the regulatory governance sections from the SEBI Act. This was a lost opportunity to improve the working of IBBI. The Ministry of Company Affairs setup a Working Group to recommend the design of the IBBI, chaired by Ravi Narain. This report embedded many important improvements, compared with conventional Indian regulators.[3] Some of these have found their way into the actual functioning of IBBI.

From its outset in 2016, IBBI was the first regulator in India where the judicial function is placed in a separate vertical wing where employees do not also perform legislative and executive functions. In 2018, IBBI released a draft regulation that established a good procedure for how IBBI would make regulations. This would be the first formal regulation-making process, approaching FSLRC quality, among regulators in India. However, as these initiatives are not codified in the law, they can be shed by future management teams at IBBI.

The Ministry of Skill Development and Entrepreneurship is at the early stages of building a regulator of the private industries that will provide skills and certification: the National Council of Vocational Training (NCVT). Early drafts of the legal

[3] See Working Group to recommend the design of the IBBI, 2016.

instruments that will create the NCVT feature the full set of good governance provisions.

6 Conclusion

At the beginning, we had Indian socialism, a world where departments of government indulged in bans, schemes, public sector enterprises which were often monopolies, entry barriers, price controls, and intervened in detail in products and processes. The objective of the reforms was to get to private competitive industries. However, there is a need to address market failures. It was felt that this would be done by specialised sectoral regulators which would bring a new style of limited intervention in the working of private competitive markets.

A few decades into this journey, the results are disappointing. At its worst, the regulator has become like the erstwhile department of government, operating bans, schemes, entry barriers, owning or controlling organisations that are players or even monopolies in the regulated industry, forcing price controls and intervening in detail in products and processes. These outcomes derive from limited understanding of regulation in the 1990s, which led to errors in the drafting of law. There was inadequate understanding of what is a regulator, and inadequate understanding of the principal-agent problems between Parliament/department and the regulator. Too often, Indian laws have treated the text of the SEBI Act as a template for the construction of other regulators, and this is a poor foundation to build on.

The way forward lies in focusing on the incentives of employees of the regulator. State capacity does not come from exhortations to better behaviour, or by recruiting great men. The individuals who man regulators respond to incentives. Institutional capabilities arise through modifications of these incentives. These incentives are determined by the text of the contract between principal and agent, i.e. the Parliamentary law that creates the regulator. The key insight lies in addressing these problems using the tools of public administration and legal thinking.

A regulator will be put on the road to steadily improving State capacity when its foundational law has about 140 sections that set up good governance procedures for the clarity of purpose, the working of the board, the legislative process, the executive process, the judicial process and reporting.

These features need to be placed in Parliamentary law, with considerable procedural detail. If this detail is not specified, public choice theory predicts that persons

in the regulator will utilise the flexibility given to them in ways that diminish accountability.

This roadmap to State capacity – place about 140 sections of good governance procedures into the law that defines the regulator – is a finite and tangible action that can be undertaken by lawmakers. It will, however, not immediately create State capacity. It would create modified incentives, and kick off feedback loops, through which institutional capacity would be continually improved.

The key theme of the path to State capacity is to initiate forces of accountability. Detailed reporting of the operational and financial MIS of the regulator would encourage the public and the board to ask questions about bang for the buck, and improvements over time. These demands would become the feedback that continuously come to the independent board members, who are the majority in the empowered board.

Efficacious challenge of orders at a tribunal would push the quality of investigation, prosecution and judicial functions inside the regulator.

Well defined processes for the executive functions (licensing, investigation, prosecution) would remove arbitrary power in the hands of the regulator, and encourage regulated persons to challenge the regulator to a greater extent, in the public discourse and in court. This would force increased capabilities in the regulator.

An open and participatory process for the legislative function would help induce the institutionalised application of mind, by the regulator, when writing regulations. The public and the board would create pressure on the staff of the regulator that would improve the quality of the work in writing regulations.

A board dominated by external persons, that held the management accountable, and controlled the organisation design, would yield greater deliberation and improvements of the organisation, when compared with the present arrangement, of an organisation controlled by its own management.

India is a liberal constitutional democracy, and the exercise of legislative, executive and judicial powers must be undertaken within the rule of law. In this article, we see a happy synergy between constitutionalism and the objective of State capacity. The path to State capacity lies in upholding the rule of law. Dispersion of power, due process, and checks and balances, create the incentives for persons in regulatory organisations to achieve knowledge and competence.

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