

Tips for sensible regulation

Pratibha Jain

M.S. Ananth



Competition is the best regulator.

Businesses will be better at regulating themselves, like the guilds of old.

Problems relating to economic behaviour are better regulated through economic solutions than legal measures.

Social and economic behaviour moves at a pace faster than laws. With rapid growth of technology and greater integration of labour, capital and enterprise across borders, simplistic regulatory models do not work.

Facilitate or restrict?

Although we have moved from an environment of regressive restrictions under the Licence Raj, commercial transactions continue to be subject to multiple regulations.

There is no empirical or economic evidence to argue that these regulations promote trade and commerce. From failures at the macro level such as the sub-prime-induced world financial crisis, to failures at the micro level such as the collapse of Barings Bank, Enron, and our very own Satyam scam, regulators often fail to detect instances of wilful non-compliance and fraud, despite stringent laws relating to such activities.

It is a moot point whether, and if so to what extent, laws effectively regulate economic behaviour. Therefore, an effective law should distinguish between regulations that facilitate trade and commerce on the one hand, and fraudulent transactions on the other.

The Supreme Court, in a ruling on imposition of taxes in inter-State trade, recognised and distinguished between regulations that interfered with business, and others, though undoubtedly restrictions, that helped effectively regulate business.

But this Goldilocks line of regulation is something that a court has the luxury of examining *ex-post*. How should a regulator decide regulations *ex-ante*?

To start with, transactions that help economic activity should be distinguished from those that harm economic activity; consequently, transactions relating to the former should be encouraged and those relating to the latter prosecuted. It is easier to prosecute offences through clearly prohibited transactions than seek to enforce generic regulations.

The purpose of regulations is defeated if they are enforced *ex-post*, since regulatory laws are not meant to operate like criminal investigation of a murder.

Regulations should therefore be aimed at identifying and preventing fraudulent transactions using behavioural models and econometrics rather than merely seeking more information and compliance with disclosure requirements.

Admittedly, fraudulent transactions are designed to defeat regulatory measures and are difficult to detect *ex-ante*. Information regarding such transactions is suppressed and regulators and even conscientious directors of the company might not know about them till the occurrence of the fraud. Therefore, an emphasis on regulating transactions that inhibit business and trade rather than applying the law in a strict manner would help effectively regulate businesses.

Fundamentally, regulators need to recognise that an overwhelming majority of enterprises are bonafide and seek to carry out business on a long-term basis. Implementation of laws in a manner that presumes guilt is an unreasonable restriction and is the antithesis of rule of law.

Who regulates?

As early as 1776, in his treatise *An Inquiry into the Nature and Causes of the Wealth of Nations*, Adam Smith commented on professional guilds and how they could effectively regulate business, rather than government being involved in regulation.

This view has been echoed by eminent economists such as George Stigler, Milton Friedman, John Buchanan, and Avinash Dixit, among others, to argue that businesses are better placed to regulate each other than allowing government to regulate business. This is because no one monitors the performance and activities of a business entity better than its competitor.

The internal dispute resolution mechanism between brokers of the Securities and Exchange Commission *inter se* and approach of the Entertainment Standards Review Board, a voluntary and non-statutory board that sets standards for media content are examples of businesses setting standards and enforcing them without assistance of government.

Reputation and goodwill are extremely valuable assets for a company and no company would like news regarding regulatory non-compliance to be in the news. In India, election petitions operate on a similar basis where contesting candidates are the best method to ensure compliance by a candidate. Private regulation of contract as an alternative to public regulation.

It is not, however, possible to completely exclude the government from its role as a regulator. An independent and impartial regulator inspires trust in the regulatory framework.

This is desirable even though a regulator operates under several constraints and does not have insider information on latest developments in the business or transaction model and is generally handicapped from enforcing the laws *ex-ante*. Therefore, while cooperation between industry and regulators is essential, regulatory capture should be prevented.

An important aspect that arises in the context of regulation is settlement of disputes without litigation. For instance, the settlement of a dispute relating to Citibank misleading investors, between the Securities and Exchange Commission and Citibank, was rejected by the court on the ground that the issue related to public interest and could not be settled by a regulatory agency.

Absence of clarity on settlement of regulatory disputes creates an air of uncertainty with respect to enforcement and litigation.

Don't micro-manage

As explained by Avinash Dixit from Princeton University, problems relating to economic behaviour are better regulated through economic solutions than legal measures.

Regulators and academicians should also consider strengthening the interaction between law and economics and

imparting training on law and economics to professionals and bureaucrats.

This has already been recognised by the Competition Commission of India; it is imperative for efficient regulation that regulators and policy makers in India are educated on law and economics.

It is no one's case that there should be absolute de-regulation or that regulators do not have any role in effective enforcement of specialised laws. Regulations can help in protecting rights of genuine business entities. Regulations also give consumers the right to enforce claims against erring companies or even industries. However, a fresh examination of the role of regulation will go a long way in encouraging business and reinforcing faith in the system.

(Jain is Head Regulatory Practice and Ananth, senior member of Dispute Resolution Practice, Nishith Desai Associates.)

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