CHAPTER IV
APPROACHES TO REGULATION AND PRINCIPLES

In the context of regulatory framework analysed in the earlier chapter, this chapter seeks to analyse various approaches towards making of regulation such as rule based or principled basis. It will also outline the intricacies in handling various approaches. It also discusses the ideal combination for making of regulation as also challenges that exist in Indian regulatory environment.

The success or soundness of a regulatory framework for financial services can be gauged from the way they are structured for the purpose of its implementation. Though there is no hard and fast rule on the methodology of structuring a regulatory framework, the Rule based or Principle based are generally two approaches that are adopted for creation of Regulation.

4.1 RULE BASED REGULATION

In Rule based approach, the regulator is guided by the letter of law, statute book and emphasis is more on adherence to the statute book. There is a very high degree of intolerance to even minor violations. Penalty is imposed irrespective of the severity of the offence. There is no graded structure of penalty. In a rule based approach, the possibility of innocence does not arise. The lawmakers prescribe in minute detail exactly what companies must and must not do to meet their obligations to stakeholders or customers.

4.2 PRINCIPLE BASED REGULATION

In a principle based approach, there is a greater amount of latitude given to the market players who operate in a financial system. It provides a greater amount of freedom to the operators and it fosters a culture of
mutual trust and faith in the regulator and regulated. Further, in principle based approach only broad principles are outlined leaving the specific methodology to the regulated and making them responsible for end result. In a principle based approach, since the onus is shifted to the regulated, there are twin advantages, one the responsibility of self-regulation promotes better ethical standards amongst the regulated and to that extent releases the strain on the regulator to monitor each activity of the regulated. In Principle based approach, regulators are not worried about “tick boxes”. On the contrary, they assess the entities on the basis of broadly laid down principles.

4.3 DISCRETION BASED REGULATION

There is also one more approach to regulation called “Discretion based regulation.” In terms of this approach, there is a differentiation made in regulating entities based on their size, structure, financial stability, risk profile of the entity etc. Under this model, though there may be common thread of regulation present in all the entities in the market, still a certain degree of latitude is given to certain entities due to the above factors on the ground that it is too big to fail. One major shortcoming of this approach would be to presume too much in its favour from the risk perspective. Resultantly, in the event of its ultimate failure, it could lead to a very big systemic risk. However, this approach does not operate on a stand alone basis as either it is based on rule based or principle based approach.

Financial Services Authority, UK, before its abolition, operated on the principle based regulation. The Principles based regulation is not new. Eleven high level principles for business have been in place since 2001 and have their roots in the
former Financial Services Act regime.\textsuperscript{36} These sets of overarching requirements for financial services firms have also formed the basis for successful enforcement action. FSA also supervised extensively on the basis of principles. Its supervisors had to make judgments about the adequacy of firm’s controls to mitigate the risk of breaking its regulatory requirements.\textsuperscript{37} This is difficult but a much more effective approach than ticking boxes to ensure that the firms are complying with patterns of behavior that have been laid down for them. That is the essence of principles-based regulation.

The FSA Handbook, however, still contains thousands of rules setting out in detail the way in which firms are required to behave. And the number has increased considerably over the past few years. While there will always be a need for rules, the current regime is out of balance and over time, to effect a significant shift in favour of principles.\textsuperscript{38}

“Principles-based regulation is essentially about outcomes or ends while rules based regulation are about means. Principles-based regulation allows firms to decide how best to achieve required outcomes and, as such, it allows a much greater alignment of regulation with good business practice.”\textsuperscript{39}

Firms should be able to operate a single set of controls which allows them simultaneously to meet their business objectives and supervisory requirements rather than being forced to operate rafts of controls that have no purpose other than to satisfy the regulators. This emphasis on ends rather than means supports another precept to which attach great importance - that of senior

\textsuperscript{36} John Turner, \textit{Speech by Chief of Financial Services Authority, U.K} (October 13, 2006).


\textsuperscript{38} \textit{Id.}

\textsuperscript{39} \textit{Id.}
management responsibility. Firms' managements - not their regulators - are responsible for identifying and controlling risks. A more principles-based approach allows them increased scope to choose how they go about this. In short, the use of principles is a more grown-up approach to regulation than one that relies on rules.\footnote{Id.}

There appears to be a felt need across borders to shift in favour of principle based regulation including Europe and United States. Nonetheless, the intensity of debate is increasing in recent times especially in United States of America and Europe on preference of one approach over the other. While the regulatory structure in United States is more rule based, those in U.K. especially Financial Services Authority is principle based. In the wake of recent financial crisis world over, there is an attempt in USA to move the regulatory structure towards principle-based from its current rule based regulation.

The experts’ views are divided on the issue. Be that as it may, in practice, the distinction between the rule based and principle based approach appears to be thin as the rule based regulatory structure may have certain principles which may guide those rules and interpret them. Similarly, a principled based regulation may still have musty tome of rules. For instance, in the case of FSA in UK, which is said to be operating on principle based regulation, there is a Handbook of detailed Rules and guidance as to how entities need to comply with regulation.

Similarly in USA, it had been argued that Enron fiasco could have been avoided if there was a clearly laid down set of principle based regulations. The reason being that while the company appeared to have followed accounting rules, it violated the fundamental principles of financial reporting. The case of missing wood for the trees was cited as the reason for the failures.
An ideal and good regulatory framework should be guided by both rule based as well as principle based approaches. There can be no perfect structure under which only one is preferred over the other. A legislation prescribing the contours of the regulatory framework may contain provisions for “compounding of offences” which is in a way extension of principle based approach. This would be very useful for giving greater operational latitude to entities that do not commit deliberate acts of omissions or lapses. Normally, this power is used by the regulator where there is technical error or innocent lapse. For serious offences (with *mens rea*) there would exist a strong penal structure which is non compoundable in nature and in consonance with the criminal jurisprudence of the country. Some of the offences of non-compoundable are orders of disgorgement, imprisonment and deterrent penalties. A regulatory system based on right mix of both rule based as well as principle based would impart to any financial market greater stability and promote growth.

In the above context, experts in India have debated at great length on whether regulatory structure in India should be rule based or principle based regulation. Theoretically, rule based regulation is a sub-set of principle based approach. As mentioned *supra*, a principle based approach sets out broad contours of regulation leaving the methodology or rules to be self-defined by the regulated whereas in a rule based approach, everything to the micro level of methodology are prescribed and regulated. It may be noted that in Indian environment, some regulators such as Ministry of Corporate Affairs through Regional Director under the Companies Act, 1956 and Reserve Bank of India under the Payment and Settlement Systems Act, 2007 have the power to compound the offences which implicitly admits of principle based regulation to some extent. The regulators in some cases have also adopted the “discretionary approach” mentioned *supra*, while regulating some entities. A case in point is that State Bank of India is considered too big to fail and hence slightly yardsticks of different nature may be followed for regulation of such entities. As there exists merits and demerits in adoption of both the approaches, there is a need for suggesting common thread
of principles governing all the regulators with specific rules to be stipulated by regulators in their areas of operations. Similarly, there is a need for prescribing similar rules in respect of penal provisions of various statutes to bring about commonality of approach in dealing with severe lapses in the market. Since the regulatory structures governing different activities are guided by substantive and subordinate legislations, there must exist common rules for legislative drafting. For instance, in the excessive zeal to implement special legislations, a non-obstante clause is introduced in every legislation overriding the provisions of other legislations which at times may create obstacles for the other regulator. This leads one to cogitate whether a fair mixture of rule based as well as principle based regulation would be ideal to India.

From the above, it is evident that a well structured regulatory framework with a fair mix of rule based and principle based approach of regulations would infuse a very high degree of confidence in the market and trust of the market participants under such a framework, they could function with high level of clarity. The crux lies in creation of clarity in the regulatory framework.