

Principles Based Regulations- Some Myths and Paradoxes



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1. "The Supreme Court banned on Thursday (Dec. 15, 2016) all liquor shops within 500 meters of national and state highways across the country, a move aimed at reducing drink driving and road accidents that claim thousands of lives every year"¹.

2. A bar in Ernakulam decided to make a way around it literally. The Aishwarya Bar in North Paravoor, a Kochi suburb built a 250m-long maze-like walkway to the entrance, theoretically making it more than 500m away from the highway. "We have done nothing illegal. The plot behind the bar also belongs to the owner and we have constructed an extended way to reach the bar. Now it is 520 meters from the highway. We are set to approach the circle inspector of excise with the new route map to authorize the reopening of the bar," said, bar manager².



3. There were various other ways to circumvent the ruling, including de-notification of highways by the state governments. Then in August 2017, Economic Times³ reported that the Supreme Court clarified that the ban on sale of alcohol within 500 meters of state and national highway does not apply within city limits, granting relief to the liquor and hospitality industry. Financial Sector Regulator can draw some little solace that they are not the only ones who find it difficult to make rules on subjects far more complicated.

4. The last decade since Financial Services Authority (FSA) of UK initiated Principles Based Regulations (PBR), has seen the debate going through wild swings. From being seen as a cure-all panacea it has

been accused of causing Global Financial Crisis. Global Financial Crisis proved that neither Rules Based Regulations that are generally followed by the US regulators, nor the PBR followed by UK regulator could prevent the crisis. Yet it cannot be denied that the concept of PBR is a powerful concept and needs to be understood and internalized both by the regulators and the regulated entities. It is heartening that the Prime Directory has chosen me to write on this topic.

5. SEBI took a major initiative in moving towards Principles Based Regulations (PBR) when it issued the Listing Obligations and Disclosure Requirements (LODR) Regulations, 2015. Though regulations like Alternative Investment Funds Regulations, 2012 were largely principles based yet LODR is different in the sense that it explicitly declares the principles and gives supremacy to them. The regulations devote a whole chapter to the principles governing disclosures and obligations of listed entity. It is stated clearly that in case of any ambiguity or incongruity between the principles and relevant regulations, the principles specified in this Chapter shall prevail. The principles are in line with international standards like IOSCO Principles and OECD Principles of Corporate Governance. Past three years have seen these regulations stabilize and may be in future, more regulations will move in that direction.

6. However, before we discuss the issue of principles based regulations further, it is necessary to do two things. First, we must clear our minds of the myths surrounding the subject and second, we must prepare ourselves for the complex situation that we are called upon to deal with. Towards this end, I shall try to bust some myths surrounding principles based regulations and also describe some paradoxes about PBR so as to prepare us for the complexity on ground. I must acknowledge that this article is, to a great extent, draws on the works of Prof. Julia Black of the London School of Economics.

7. The first myth is that it is necessary to have detailed rules because the market participants cannot be relied upon to adhere to principles and take steps of their own that might hurt their commercial interests unless there is a specific rule. It must be realized that the rules are made to address the situations or behaviours that happened in the past. Anyone who is intent on cutting corners will find it actually easier if very detailed rules are laid down. He can easily create a structure that will avoid each of the rules while actually displaying the behaviour that the rules intended to avoid.

8. The second myth is that with principle based regulations the volume of regulations will come drastically down. Perhaps Ten Commandments will be written on a stone tablet and nothing more will be required. (Actually, even the Ten Commandments were not sufficient and voluminous religious texts had to be written subsequently). Principles need elaboration and also their situation specific application is to be talked about. The only difference is that the regulated entity has to proactively apply the principles to his situation and reach a solution instead of approaching authorities to change the rules pleading their impracticality. The erstwhile FSA is said to have more than eight thousand pages of regulations written down.
9. The third myth is that principles based regulations create uncertainty while the detailed rules means certainty. Anyone who has actually dealt with regulations will vouch that more detailed the rules are the more is the likelihood of gaps and overlaps. Further, there are issues about interpretation of different regulations that have been drafted in different times and ages and also in very different contexts. Finally, there are downright contradictions between rules that need regulatory intervention and god forbid if different regulators have written the contradictory regulations.
10. The fourth myth is that principles based regulation is either a light touch regulation or downright it means de-regulation. Actually, it might mean very tough regulatory regime. One has only to go through the UK regulations on Treating Customers Fairly to realize how tough the customer protection regime has become.
11. The fifth and the last point I would like to make is in respect of the conceived voluntary nature of the principles based regulations. It is true that the PBR is based on mutuality and trust and the regulated entity has to itself decide among the various possible courses of action. The market pressure can be very high. Conforming to the generally accepted behaviour can be a very potent force. If you don't believe me, ask any teenager about peer pressure. Why teens, look for dark suits and light shirts in any gathering of financial sector. Are there any rules that people must attend corporate governance conferences in dark suits and light coloured shirts?
12. Before we continue our journey on we must be prepared to deal with uncertainty and ambiguity. What is better way for preparing ourselves than dwelling upon paradoxes about PBR? Paradox is an apparently self-contradictory statement, the underlying meaning of which is revealed only by careful scrutiny. The purpose of a paradox is to arrest attention and provoke fresh thought. The statement "Less is more" is an example⁴. Paradoxes allow us to continue expanding our understandings outside of what we feel comfortable with. If we learn to accept that some things are "insolvable" we can approach them at a new level, which allows us to try to understand them⁵.

PARADOX 1: THE INTERPRETIVE PARADOX: PRINCIPLES CAN BE GENERAL YET PRECISE

Suppose the principles say that holding of sponsors of a fund should be reasonably large so that they have skin in the game. Now how large is reasonable? One could fear that this may vary from 5% to 51%. It is here that the role of the interpretive community comes into play. The interpretive community might lie within the regulator or with the consultants and advisors. For example, the AIM (a platform where startups list in London Stock Exchange) regulations do not say that what should be the appropriate percentage of shares offered to the public, but almost everyone is unanimous that it should be 10%.

PARADOX 2: THE COMMUNICATIVE PARADOX: PRINCIPLES CAN FACILITATE COMMUNICATION BUT CAN ALSO HINDER IT.

Laws and regulations become unreadable and incomprehensible because the drafters want the language to carry only one meaning and making it immune to interpretation. The principles, on the other hand, are direct communication to the regulated as to what is expected of them and this can be put directly to the regulated entities in simple and direct language which should make communication easy. However, in practice what happens that the PBR are interpreted through a plethora of speeches, press releases, guidance, and enforcement actions and to understand and interpret the principles, one must deeply understand all these. At a deeper level this paradox arises out of the different way in which lawyers and regulators use language. The legal language tries to use mononyms and words with restricted connotations. Regulators try to use common day-to-day language. That is why what appears to be clear as daylight to the regulators appears murky and unclear to lawyers.

PARADOX 3: THE COMPLIANCE PARADOX: PRINCIPLES PROVIDE SCOPE FOR FLEXIBILITY IN COMPLIANCE YET CAN LEAD TO CONSERVATIVE AND / OR UNIFORM BEHAVIOUR BY REGULATED FIRMS

The basic idea behind PBR is that compliance is provided with flexibility. But in practice, the guidance provided or examples given are taken as detailed rules. Only a few consultants offer interpretation and these are taken as virtual rules by everyone. Worse, the most conservative of the interpretation gets to be widely accepted.

PARADOX 4: THE SUPERVISORY AND ENFORCEMENT PARADOX: PRINCIPLES NEED ENFORCEMENT TO GIVE THEM CREDIBILITY BUT OVER-ENFORCEMENT CAN LEAD TO THEIR DEMISE

If you do not enforce hard enough, no one takes you seriously. If you enforce very hard, then the system degenerates quickly into detailed rules. The regulators need a deft touch to remain at the golden mean. There is always an issue of retrospectivity in the enforcement actions in case of Principles Based Regulations. This

problem arises because generally regulations are considered to be mala-prohibita (wrong because it is prohibited) while the PBR considers them as mala-in-se (wrong because it is inherently wrong). This was the reason why so many enforcement actions in case of miss selling of Insurance Policies in UK was seen as retrospective application of regulations.

PARADOX 5: THE INTERNAL MANAGEMENT PARADOX: PBR CAN PROVIDE FLEXIBILITY FOR INTERNAL CONTROL SYSTEMS TO DEVELOP BUT CAN OVERLOAD THEM

PBR makes unprecedented demands on the compliance system. Compliance is easy if it can be delegated to the Enterprise Risk Management System, which pare down the compliances to a detailed computer programme. In PBR, this approach does not work. Compliance Officers have to understand both business and the regulatory philosophy in order to make good use of flexibility provided. PBR can make the compliance function strong only if it is already strong. Otherwise, the system breaks down and becomes even weaker.

PARADOX 6: THE ETHICAL PARADOX: PBR CAN FACILITATE A MORE ETHICAL APPROACH BUT IT COULD RESULT IN AN EROSION OF ETHICS

With PBR, the compliance function becomes a form of risk management. With each interpretation of principles, the compliance is taking call on the interpretative risk.

What is the downside if the regulator does not accept the interpretation? Ideally, an ethical approach taken by the regulated entity should never lend it into conflict with the regulator. However, under the pressure of the business side, this might lead to a undesirable situation where compliance is seen as optional. You may not comply if you think that risks are small. I can travel ticketless because I can afford to pay the fine. This leads to erosion of ethics.

PARADOX 7: THE TRUST PARADOX – PBR CAN GIVE RISE TO RELATIONSHIPS OF TRUST, MUTUALITY AND RESPONSIBILITY BUT THESE ARE THE VERY RELATIONSHIPS WHICH HAVE TO EXIST FOR IT TO BE EFFECTIVE

PBR can help strengthen the mutuality and trust between the regulated entities and the regulators. But to make PBR work, mutuality and trust needs to exist beforehand. What comes first, chicken or the egg?

I think we can end with a quote of Hector Sants, former director of FSA:

“Principle based approach does not work with individuals who have no principles”.

¹ Hindustan Times December 16, 2016 <https://www.hindustantimes.com/india-news/supreme-court-orders-closure-of-liquor-shops-on-national-state-highways/story-7z6sMkQukzBsfHC2uDLa5J.html>
² <https://www.indiatimes.com/news/india/a-bar-in-kerala-just-made-a-250m-long-maze-wall-to-beat-supreme-court-s-500m-rule-275175.html>
³ <https://economictimes.indiatimes.com/news/politics-and-nation/highway-liquor-ban-sc-clarifies-order-says-no-ban-within-city-limits/articleshow/60195764.cms>
⁴ <https://www.britannica.com/art/paradox-literature>
⁵ <http://greatparadox.weebly.com/why-are-paradoxes-important.html>