# Creating robust capital markets: The role of regulators

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Capital markets are the backbone of economic growth. They play a critical role in mobilizing savings, facilitating investment, and improving resource allocation. A well-functioning capital market ensures financial stability, investor protection, and market integrity. However, achieving this ideal requires a delicate balance between heavy regulatory oversight and market freedom. In this context, the role of regulators becomes pivotal. This brief explores the role of regulators in creating robust capital markets, with a particular emphasis on the pillars of people, process, autonomy, and accountability.

**Role of regulators in capital markets**

Capital markets encompass a wide range of activities, including primary and secondary trading of equities and bonds, derivatives and other securities like units etc. These are done through market infrastructure institutions like stock exchanges, depositories and clearing corporations as well as market intermediaries. These markets are inherently complex and dynamic, requiring a sophisticated and responsive regulatory framework to ensure their smooth functioning. Regulators are tasked with overseeing these markets to prevent fraud, protect investors, and promote fair competition.

Regulators, such as the Securities and Exchange Board of India (SEBI) and the Reserve Bank of India (RBI), play a critical role in maintaining the integrity of capital markets. Their responsibilities include licensing and supervising market participants, securing compliance with regulations, and ensuring transparency and disclosure. By doing this, regulators create a conducive environment for investment and economic growth.

**People**

The effectiveness of a regulatory body is significantly dependent on the quality of its personnel. Skilled and knowledgeable regulators are essential for understanding market dynamics, detecting irregularities, and enforcing rules effectively. However, the current landscape of regulatory staffing in India points to several challenges.

Regulators have two categories of personnel: the top level, including governing board members like RBI Deputy Governors and SEBI Whole Time Members appointed by the government, and the second level, comprising staff appointed by the regulator with minimal government involvement.

Senior level individuals in Indian regulators often come from government backgrounds due to a government-dominated appointment process. Past data shows that their tenures are also varying and unpredictable. The goal of having a body of diverse experts with fixed, long, predictable tenures and minimal political influence is still some distance away. Operational staff are recruited through annual examination processes akin to the civil service recruitment process. Most of them spend their entire working lives in the body and hence increasingly resemble civil servants. The idea of flexibility in recruitment leading to fresh induction of talent periodically and people moving in and out of regulators is not what we see. These trends in personnel are leading to an insular regulatory organization.

**Process**

The process through which regulations are formulated and enforced is another critical aspect of effective regulation. A transparent and inclusive regulatory process not only enhances the legitimacy of regulatory actions but also fosters trust among market participants.

One of the key issues in the current regulatory framework in India is the lack of detailed processes for regulatory bodies to exercise their powers. Most statutes provide broad mandates without specifying the procedures for regulation-making, enforcement, and adjudication. This can lead to inconsistencies in regulatory actions and undermine the rule of law.

To address this, it is essential to establish clear and detailed processes for all regulatory functions. This includes a clear articulation of the market failure and the problem being addressed, public consultation on draft regulations proposed to solve the identified problem, rigorous impact assessments, and transparent decision-making procedures. Public consultation, in particular, plays a vital role in ensuring that regulatory measures are well-informed and balanced.

Moreover, enhancing parliamentary scrutiny of regulatory actions can provide an additional layer of oversight and accountability. The level of parliamentary scrutiny over regulations and regulators is woefully inadequate. Over a twenty-three-year period between 1999 and 2022, the Lok Sabha parliamentary committee has reviewed 13 regulations issued

by statutory regulators and the parliamentary committee of Rajya Sabha has reviewed 4 regulations. Just one regulator, SEBI, has issued more than 650 regulations, including amendments, since its inception. Only a negligible number of regulations are subject to parliamentary scrutiny in India. Regular debates and discussions in Parliament on regulators and their activities can help identify areas for improvement and ensure that regulatory bodies are consistently acting in the public interest.

There is yet another concerning trend: the increasing practice of regulation through instruments other than formal regulations, such as through circulars and directions. For instance, when SEBI imposed restrictions on mutual funds due to alleged insider trading issues, it issued a series of circulars that bypassed the formal regulatory process and parliamentary oversight. Regulated entities are unlikely to challenge SEBI on this due to their extreme dependence on the regulator for their operations. As a result, binding obligations are created without following the prescribed minimal legal procedures.

**Autonomy**

Regulators must have the freedom to make decisions based on technical expertise and market realities, without undue influence from political or vested interests. However, achieving true autonomy remains a challenge in many regulatory environments.

In India, regulatory bodies often face pressures from various quarters, including government ministries and influential market participants. For instance, government-owned entities may receive preferential treatment, undermining the level playing field that regulators strive to create. Additionally, some regulatory bodies lack financial independence, relying on government budgets for their operations. This dependence can limit their ability to pursue long-term objectives.

Equally troubling, paradoxically, is the emerging trend where financial regulators often accumulate substantial resources through fees and taxes, creating large resource pools.

The issue of autonomy is complex. We need to establish mechanisms to ensure that regulators are functionally autonomous, even if they rely on government budgets. Simultaneously, we must implement safeguards and checks to prevent them from using their autonomy for mission creep, self-aggrandizement, or other unintended purposes.

**Accountability**

While autonomy is essential, it must be balanced with accountability. Regulators wield significant powers that can impact the economy and society at large. Therefore, they must be held accountable for their actions and decisions. Accountability mechanisms ensure that regulators act in the public interest, maintain transparency, and uphold the rule of law.

In Indian statutes, the regulator’s accountability primarily hinges on placing its annual reports before Parliament for discussion. However, such discussions have rarely ever occurred for any statutory regulator, reflecting broader issues with parliamentary functioning. Resolving this larger issue is essential, but in the meantime, improved public reporting can enable academia, think tanks, and civil society to analyze and critique the regulator’s operations.

Notably, the RBI lacks a statutory requirement to present its annual report to Parliament, unlike SEBI and the insurance regulator (IRDA), which are audited by the CAG of India. The RBI’s financial statements are audited by private firms, highlighting a gap that requires legislative action.

The Securities Appellate Tribunal (SAT) handles appeals against SEBI orders effectively but the tribunal faces challenges like staffing and resource shortages. There is no similar appellate body which reviews regulatory orders of the RBI. Following the inclusion of appeals against IRDA and the pensions regulator (PFRDA) within the SAT, a logical next step in Indian regulatory reform would be to extend SAT’s jurisdiction to handle appeals against RBI decisions. This would ideally involve renaming SAT to the Financial Sector Appellate Tribunal (FSAT) to better reflect its expanded mandate.

In conclusion, the role of regulators in creating robust capital markets cannot be overstated. By focusing on the pillars of people, process, autonomy, and accountability, regulators can navigate the complexities of modern capital markets and ensure their stability, integrity, and growth. This holistic approach to regulation will not only benefit investors and market participants but also contribute to the broader goal of economic prosperity and development.