INDIAN MERCHANTS' CHAMBER
AND
FINSEC LAW ADVISORS

FINSEC
Law Advisors

PAPER ON

REGULATORY IMPACT ASSESSMENT

IS IT GETTING ITS DUE?

Release Date:
Wednesday, April 3, 2013

The Firm

Finsec Law Advisors is a financial sector law firm based in Mumbai. The firm provides regulatory advice and assistance in the financial sector, focusing on securities, investments and banking industries and the work extends to transactional and litigation. We provide advice on complex securities market and financial market issues, on areas such as takeover regulations, market infrastructure regulations and derivatives. We assist in domestic and in-bound fund formation including FIIs, mutual funds, alternative investment funds, PMS and cross border private equity deals, to capital raising through IPOs, private placements and QIPs. Finsec also advises and represents clients on adversarial issues and litigation in cases of fraud, insider trading, front-running, manipulation and takeover violations. We have represented large institutional clients in cross border enforcement and arbitration matters in the financial space.

The firm in its short history has advised financial sector regulators, quasi sovereign funds, set up domestic and offshore investment fund structures, advised mutual funds, FIIs, large brokerages, leading private equity players, stock exchanges, merchant bankers, leading chambers of commerce, custodians, banks, etc. The firm has been regularly working with the big four firms and several clients on structuring and documentation for setting up alternative investment and PE funds. As a 'lawyer's lawyer' firm, Finsec Law Advisors has advised or worked with several other law firms and professionals. Finsec not merely helps navigate the law but also helps clients in communicating with regulators to improve the policy framework of the country for the longer run – it routinely writes to regulators offering its own comments about proposed regulations.

709 Raheja Centre, Free Press Road, Nariman Point, Mumbai 400021
T: +91 22 43470750 | W: www.finseclaw.com | E: info@finseclaw.com

Content

Section No.	Section Title	Page No.
I.	Objectives of Regulation – An Introduction	3
II.	Introduction to Regulatory Impact Assessment	4
III.	Why is RIA required?	5
IV.	What are the costs to be considered in RIA?	9
V.	How it has been implemented – An example	10
VII.	Implementation of RIA in USA	11
VIII.	Implementation of RIA in the UK	16
IX.	RIA in India: Are we on the right track?	18
X.	Summary and Conclusion	26

REGULATORY IMPACT ASSESSMENT - IS IT GETTING ITS DUE?

I. Objectives of Regulation – An Introduction

1. Regulation is fundamental to governing complex, open and diverse societies and economies. Regulatory processes allow policy-makers to balance competing interests and have been critical to the development of the modern state. Regulations are an essential part of the "toolkit" of policy instruments governments and regulators, through delegated legislation, can use to achieve their objectives. When regulations are framed, many of its effects are "hidden", or at least difficult to identify when its content and scope of applicability is being considered.

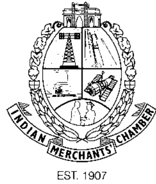
2. It has become a crucial goal for the regulators to regulate better, especially in industries as dynamic and continually-evolving as the securities market. Improving the quality of regulation has shifted its focus from identifying problem areas, advocating specific reforms and eliminating burdensome regulations, to a broader reform agenda that includes adopting a range of explicit, overarching policies and tools. It is widely agreed that the <u>primary goals sought to be achieved by regulatory supervision</u> are as follows:

   - Safeguarding the stability of the financial system, especially the safety and soundness of the settlement system;
   - Promoting efficiency in the operational methods and compliance of market intermediaries;
   - And most importantly in the case of developing markets like India, providing adequate protection to customers of financial services offered by intermediaries.

3. The International Organization of Securities Commissions ("IOSCO"), in its paper on *"Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation"*, dated September 2011, states that the IOSCO core objectives of securities regulation are:

   - The protection of investors;
   - Ensuring that markets are fair, efficient and transparent; and
   - The reduction of systemic risk.

4. An important feature this paper discusses is that risk taking is essential to the development and maintenance of an active market and instead of stifling legitimate risk taking, the regulators should allow for the effective management of risk and ensure that capital and prudential requirements



maintained are sufficient to address appropriate risk. It further encourages an efficient and accurate clearing and settlement process to reduce the time-lag for the delivery of traded securities.

II. Introduction to Regulatory Impact Assessment

5. Regulatory Impact Assessment (RIA) was originally conceived as an instrument for identifying the costs of regulation on the business sector, which would be followed by a process of reduction of the 'regulatory burden' through deregulation, and increasing competitiveness. This perspective was important because it recognised that regulation is not good, *per se*, but that each regulation needs to be assessed on a case-by-case basis and has led the call for better regulation, rather than more regulation. The most important contribution of a Regulatory Impact Assessment (RIA) to improving regulatory quality lies in its impact on policy-makers' approaches to decision-making and in the specific estimates of benefits and costs that it yields. It is important to distinguish 'estimates' from 'analysis', since most regulators worldwide, including the UK Financial Services Authority (FSA)[1], insist that strong quantitative basis[2] exist for any conclusion that is reached and there be strong empirical evidence of the benefits that are expected to accrue. It is widely agreed, that the following steps are the basis of good regulatory economic analysis:

- A statement of the need for the proposed action;
- The definition of a baseline against which to measure the likely economic consequences of the proposed regulation;
- The identification of alternative regulatory approaches, and;

---

1 See Isaac Alfon and Peter Andrews, *Cost Benefit Analysis in Financial Regulation: How to do it and how it adds value*, Occasional Paper Series 3, September 1999, Financial Services Authority.

2 It has been argued by the Chairperson of the Securities and Exchange Commission that the task of quantifying costs and benefits of a rule is harder to quantify than it sounded. Quantification of the benefits, even more so, because the outcomes of rules/regulations are usually social improvements that may not be accurately measurable, such as increased transparency and enhanced financial stability and it is *"often very, very hard to put a dollar number"* it – See Steven Sloan, "Cost-Benefit Analysis puts the Brakes on Dodd-Frank", Bloomberg News, May 7, 2012, last viewed on March 15, 2012; Available at: http://www.bloomberg.com/news/2012-05-07/cost-benefit-analysis-puts-the-brakes-on-dodd-frank.html

- An evaluation of the benefits and the costs – both quantitative and qualitative – of the proposed action and the main alternatives identified by the analysis[3].

6. RIA is a clear example of the trend towards an empirical based regulation and decision-making since globally, policy makers are increasingly valuing regulation that produces desired results as cost-effectively as possible. According to the Organization for Economic Co-operation and Development (OECD), as part of a systematic approach towards regulatory policies, institutions and tools, RIA by itself is not a sufficient basis for decisions, but clarifies the factors relevant to policy decision-making and the options available to the regulators.

7. The adoption of RIA as an approach to decision-making favours the use of rational and systematic approaches to policy. RIA is based on the need to consider any regulatory proposal in the context of a comparison of all different options for achieving regulatory objectives and it requires a systematic approach to be taken to identifying regulatory impacts and comparing the various costs and benefits. The OECD is of the view that RIA, as a tool of assessment, pushes the regulators to make balanced decisions that trade off possible solutions to specific problems against wider economic and distributional goals. Interestingly, an RIA can throw up results which show that "doing nothing" is a real option, particularly where action, or the cost of creation of regulation, can far outweigh the perceived benefits that may accrue[4].

III. Why is RIA required?

8. RIA can help to ensure a good understanding of who will be affected by a regulation. An RIA should be integrated with a public consultation process, as this provides better information to underpin the analyses and gives the affected parties (both beneficially and adversely) an opportunity to identify and correct faulty assumptions and reasoning. An important element of assessing regulatory impact is making a realistic assessment of the likely

---

3 See Memorandum to the Rule-writing Divisions and Offices by SEC's Division of Risk, Strategy and Financial Innovation and Office of General Counsel, dated March 16, 2012 regarding "*Current Guidance on Economic Analysis in SEC Rulemakings*" at page 4, last viewed on March 14, 2013; Available at: http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf

4 See Edward Sherwin, *The Cost-Benefit Analysis of Financial Regulation: What the SEC Ignores in the Rulemaking Process, Why it Matters, And what to do about it*, Draft Paper, 2005, last viewed on March 15, 2013; Available at http://www.law.harvard.edu/faculty/hjackson/pdfs/CBA.article.doc.pdf

rate of compliance with the proposed regulation. Regulation will obviously impact people only to the extent people comply with its requirements. In practice, there is a high non-compliance rate with much regulation.

9. Regulations often have wider effects than those originally intended by the regulatory authority: they affect many different groups in society and the effects may be of many different types. For any regulator in the world, the primary challenge lies in identifying risks and in devising the appropriate mechanisms to mitigate/address those risks. This assessment involves the cost-benefit analysis for each regulation that is proposed. It is worth noting that prominent scholars believe that "good regulation" will be both *effective and efficient.* Effective in the sense of achieving its planned goals and objectives and efficient in terms of the regulator's enforcement and administrative costs, and there is a compelling case for the systematic appraisal of the positive and negative impacts of any proposed or actual regulatory change or implementation[5]. There is no single agreed definition of the term RIA.

10. UK's legal commentators state it to mean '*a tool which informs policy decisions... an assessment of the impact of policy options in terms of the costs, benefits and risks of a proposal*'[6]. The OECD, on the other hand, considers it as a regulatory reform practice and a tool of public policy analysis which contributes to better policy selection. RIA, it is said, can contribute both to the outcome as well as the process of the policy[7]. The process contribution will primarily be focused on the principles of proportionality, where the regulation should be appropriate to the size of the problem it intends to address. Second, targeting, where the regulation focuses only on the problem and does not cause unintended consequences on other market players. And finally, consistency in decision-making and interpretative scope so as to avoid uncertainty and creating accountability for regulatory actions and outcomes.

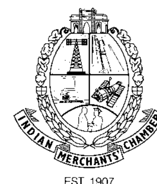
11. This aspect of ascertaining what, if any, regulatory framework is required, holds true even for securities regulators, like the Securities and Exchange Board of India (SEBI). Subsequently, these identified mechanisms should be allocated to different regulatory structures keeping in mind what exactly needs to be regulated and what is to be left for self-regulation. Keeping in

---

5 See Colin Kirkpatrick and David Parker (Eds.), *Regulatory Impact Assessment: Towards Better Regulation?*, Edward Elgar Publishing at page 2.

6 See Colin Kirkpatrick and David Parker (Eds.), *Regulatory Impact Assessment: Towards Better Regulation?*, Edward Elgar Publishing at page 2.

7 Ibid, at page 3.



view sound economic growth, it may be agreed that the general attributes of effective regulation are the following[8]:

- there should be no unnecessary barriers to entry and exit from markets and products;
- markets should be open to the widest range of participants who meet the specified entry criteria;
- in the development of policy, regulatory bodies should consider the impact of the requirements imposed;
- there should be an equal regulatory burden on all who make a particular financial commitment or promise.

12. RIA is a systemic approach to critically assessing the positive and negative effects of proposed and existing regulations and non-regulatory alternatives. Analysis shows that conducting RIA within an appropriate systematic framework can underpin the capacity of governments to ensure that regulations are efficient and effective in a changing and complex world[9] and is a process of systematically identifying and assessing the expected effects of regulatory proposals, using a consistent analytical method, such as cost/benefit analysis. The UK's National Audit Office explains the purpose of an RIA as:

    to explain the objectives of the regulatory proposal, the risks to be addressed by it and the options for delivering the objectives. In doing so, it should make transparent the expected costs and benefits of the options for the different bodies involved.... and how compliance with the regulatory options would be secured and enforced.

    ...

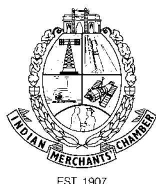
    evaluating a range of options (including not regulating) and encouraging self-regulation where feasible. If regulation is required, policymakers should consider how to encourage compliance by those affected.[10]

---

8 See Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation, OICU-IOSCO, International Organization of Securities Commissions, FR08/11, last viewed on March 14, 2013; Available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD359.pdf.

9 See http://www.oecd.org/gov/regulatory-policy/ria.htm, last viewed on March 13, 2013.

10 See Report by the Comptroller and Auditor General, *Better Regulation: Making Good Use of Regulatory Impact Assessments*, November 15, 2001, National Audit Office, last viewed on March 16, 2013; Available at: http://media.nao.org.uk/uploads/2001/11/0102329.pdf



13. RIA is a comparative process, based on determining the underlying regulatory objectives sought and identifying all the policy interventions that are capable of achieving them. These "feasible alternatives" must all be assessed[11], using the same method, to inform decision-makers about the effectiveness and efficiency of different options and to enable the most effective and efficient options to be systematically chosen. RIA is primarily a methodological approach that allows for the *ex ante* or *ex post* outcomes to be assessed against the goals set for the regulation. According to the OECD[12]:

   "...RIA's most important contribution to the quality of decisions is not the precision of the calculations used, but the action of analyzing – questioning, understanding real-world impacts and exploring assumptions"

14. Typically speaking, RIA consists of a number of tasks to be carried out at each stage of the process. It usually involves the following[13]:

   - A description of the problem and the objective of the proposal;
   - A description of the options (regulatory and non-regulatory) for achieving the objective;
   - An assessment of the significant positive and negative impacts, including an assessment of the incidence of the benefits and costs on consumers, business and other interest groups;
   - A consultation process with stakeholders and other interested parties;
   - A recommended option, with explanation of why it has been selected.

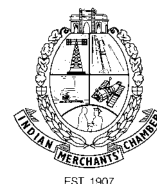
15. The option that answers all these questions, in addition to being within the acceptable cost bracket *vis-à-vis* the benefits proposed to be obtained should be the one ideally adopted.

---

11 See Andrea Renda, *Impact Assessment and the EU: The State of the Art and Art of the State*, CEPS, 2006, last viewed on March 15, 2013; Available at http://books.google.co.in/books?hl=en&lr=&id=b8lisPnYLj4C&oi=fnd&pg=PR1&dq=regulatory+impact+assessment+%2B+securities+regulation&ots=o4ElAfqZF6&sig=FKUfqaTAGGYITMN977Fet9-egleM#v=onepage&q=regulatory%20impact%20assessment%20%2B%20securities%20regulation&f=false

12 Regulatory Policies in OECD Countries: From Interventionism to Regulatory Governance; OECD (2002), page 47

13 See Colin Kirkpatrick and David Parker (Eds.), *Regulatory Impact Assessment: Towards Better Regulation?*, Edward Elgar Publishing at page 8.



IV. What are the costs to be considered in RIA?

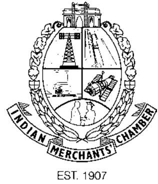
16. RIA, in today's day and age, is almost a tool of necessity, for its ability to allow regulators to clearly analyse the costs and benefits attached to any proposal. The costs of financial regulation can usefully be broken down into three broad categories: direct costs, compliance costs and indirect costs[14].

17. Compliance costs are the costs to firms and individuals of those activities required by regulators that would not have been undertaken in the absence of regulation. Thus the term 'compliance costs' as used here refers to the incremental costs of compliance caused by regulation. For the regulator, compliance costs include costs of additional systems, training, management time and capital required by the regulator, direct costs (the costs of the regulatory body) and the costs of enforcement (costs and resources devoted towards investigation of possible non-compliance, and prosecuting violators). These costs are closely related to the regulator's internal organisation, whereas there are several other costs that may be imposed on the business of market participants. These are of the following nature:

    - Costs of familiarising with the regulations and planning how to comply (may include purchase of external advice).
    - Cost of meeting reporting or record-keeping requirements imposed by the regulations.
    - Cost of internal inspections, audit fees, etc. to ensure compliance is being achieved
    - Costs of lost sales due to restricted access to markets
    - Opportunity cost may also be considered if the regulations have the effect of restricting financial innovation and curbing the ability to develop and market new products and services.

18. The indirect costs (negative market impact) are those costs that are least obvious from a cash perspective. They are important but hard to measure. They include the costs of reduced competition (e.g. the welfare loss associated with increased charges), the costs of imposed uniformity and the costs of moral hazard. This is an area where lateral thinking can be important.

14 See Introductory Handbook for Undertaking Regulatory Impact Analysis (RIA), Organization for Economic Co-operation and Development, last viewed on March 14, 2013; Available at http://www.oecd.org/gov/regulatory-policy/44789472.pdf



V. How it has been implemented – An example

19. For example, the Australian Government's Department of Finance and Deregulation has stated its Regulatory Impact Assessment Process to mean process of examining the likely impacts of a proposed regulation and a range of alternative options which could meet the government's policy objectives[15]. The Australian Government's RIA requirements are intended to achieve better regulation by supporting the following:

    Sound analysis: The case for acting in response to a perceived problem, including addressing the fundamental question of whether regulatory action is required, needs to be demonstrated. The analysis should also outline the desired objective of the response, a range of alternative options to achieve the objective, and an assessment of the impact of each option, and should be informed by effective consultation.

    Informed decision-making: To help decision makers understand the implications of options for achieving the government's objectives, they should be informed about the likely impacts of their decision, at the time they are making that decision.

    Transparency: The information on which government regulatory decisions are based should be publicly available.

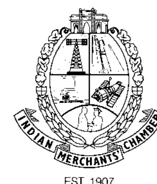
20. Central to the Australian Government's RIA process is the Regulation Impact Statement (RIS). An RIS is a document prepared by the department, agency, statutory authority or board responsible for any regulatory proposal within its jurisdictional authority, following consultation with the parties likely to be affected by the proposal. It formalises and provides evidence of the key steps taken during the development of the proposal, and includes an assessment of the costs and benefits of each option.

21. The Australian Government mandates that the RIS must be presented to decision makers so that the decision is informed by a balanced assessment of the best available information.

22. After a decision has been made, the RIS needs to be made public. In general terms, this means that the RIS must be posted on the central online RIS register maintained by the Office of Best Practice Regulation (OBPR) and, where applicable, tabled in Parliament with the enabling legislation.

---

15 See http://www.finance.gov.au/deregulation/riareview_overview_of_process.html, last viewed on March 13, 2013.



VI. Regulation for Intermediaries

23. Regulations, in respect of securities market intermediaries[16] are purpose-drafted within the broad framework that seeks to carry out the following tasks:

    - Identify the relevant risks associated with the intermediaries' businesses;
    - Measure and assess those risks;
    - Evaluate the internal controls and risk management systems present in intermediaries to mitigate those risks[17].

24. Based on the broad-based risk assessment results, regulators proceed to develop supervision plans for the intermediary which prioritises the deployment of regulatory resources based on the risk profiles of intermediaries, the time and amount of on and off-site work for the range of intermediaries under the regulatory jurisdiction[18]. We discuss below with reference to some important jurisdictions, how intermediary-focused regulation has been tackled through the use of systematic impact analysis.

VII. Implementation of RIA in USA

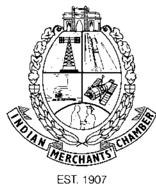
25. The United States of America is the leading country as far as RIA is concerned. During the 1970's, companies were faced with higher cost of compliance requirements, particularly due to the evolving regulatory climate. Towards the late-1970's and early 1980's, the US Government started to show increasing interest in promoting cost-benefit analysis in the assessment of the prospective impact of proposed regulations and the primary goal was to minimise regulatory burdens faced by the economy.

---

16 For the purpose of this paper, "*market intermediaries*" was defined as "*including those who are in the business of managing individual portfolios, executing orders, dealing in or distributing securities and providing information relevant to the trading of securities. These include securities brokers, mutual funds and CIS operators and investment advisors.*"

17 See Guidelines to Emerging Market Regulators Regarding Requirements for Minimum Entry and Continuous Risk-Based Supervision of Market Intermediaries, Final Report, OICU-IOSCO, Emerging Markets Committee of the International Organization of the Securities Commissions, December 2009 at page 19.

18 See Guidelines to Emerging Market Regulators Regarding Requirements for Minimum Entry and Continuous Risk-Based Supervision of Market Intermediaries, Final Report, OICU-IOSCO, Emerging Markets Committee of the International Organization of the Securities Commissions, December 2009, at page 11.

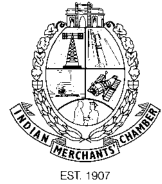


26. Although the SEC is not subject to an express statutory requirement to conduct cost-benefit analyses for its rulemakings, it is subject to statutory requirements to consider factors such as the effects on competition and the needs of small entities. It generally must provide the public and affected parties with notice of and opportunity to comment on its rulemakings. In addition, senior SEC management has indicated that it shares the goals of and adheres to several of the requirements of the executive orders (EO) that call for executive agencies to perform cost-benefit analyses for rulemakings even though, as an independent agency, the SEC is not bound by these executive orders. EO 12866 which was issued by their President Mr. Bill Clinton on September 30, 1993, was designed to ensure a regulatory system that, among other things, "*improves the performance of the economy without imposing unacceptable or unreasonable costs on society.*"

27. EO 12866[19] contains 12 "Principles of Regulation," which call for executive agencies, to the extent permitted by law and where applicable, to:

    - identify the problem to be addressed and assess its significance;
    - examine whether existing regulations (or other law) have created or contributed to the problem a new regulation is intended to correct and should be modified to achieve the intended goal of regulation more effectively;
    - identify and assess available alternatives to direct regulation;
    - in setting regulatory priorities, consider, to the extent reasonable, the degree and nature of risks posed by substances or activities under their jurisdiction;
    - design regulations in the most cost-effective manner to achieve the regulatory objective;
    - assess both the costs and benefits of the intended regulation, and propose or adopt a regulation only upon a reasoned determination that the benefits justify its costs;
    - base decisions on the best reasonably obtainable information concerning the need for, and consequences of, the intended regulation;

19 See Executive Order 12866 of September 30, 1993, *Regulatory Planning and Review*, Federal Register Volume 58, Number 190, last viewed on March 15, 2013; Available at http://www.whitehouse.gov/sites/default/files/omb/inforeg/eo12866/eo12866_10041993.pdf



- identify and assess alternative forms of regulation and, to the extent feasible, specify performance objectives;
- wherever feasible, obtain input from appropriate state, local, and tribal officials before imposing regulatory requirements that might significantly or uniquely affect those entities;
- avoid inconsistent, incompatible, or duplicative regulations;
- tailor regulations to impose the least burden on society, consistent with obtaining the regulatory objectives; and
- draft regulations in simple and easy-to-understand language

28. SEC Chairmen have made a commitment to the US Congress that the SEC will conduct cost-benefit or economic analyses in connection with its rulemaking activities. Specifically, according to Office of the General Counsel (OGC) officials, former SEC Chairman Mr. Arthur Levitt stated that there was an expectation that the SEC would perform cost-benefit analyses as part of the rule-making process.

29. The SEC Compliance Handbook also includes the following best practices, among others, for use by SEC rulemaking divisions and offices in preparing cost-benefit analyses. Some of its most salient features are:

    - At the proposing stage, the cost-benefit analysis should be tentative and should not reach any conclusions. As comments are received, the cost-benefit analysis should be refined.
    - The proposing release should include quantitative data only if the data have been verified in some way or were derived from an independent source.
    - The proposing release should include a request for comments soliciting data and views on costs and benefits.
    - Estimated compliance costs included in the adopting release must be verified (e.g., by surveying up to nine members of the affected industry segment).
    - A complete cost-benefit analysis should consider macro costs, such as anticipated changes in market behaviour, as well as micro costs, such as paperwork burdens.
    - A cost-benefit analysis should consider both direct costs, such as costs incurred by a market participant subject to a rule, and indirect costs, such as costs incurred by customers or clients of the market participant.

- The benefits of a rule generally will track the purposes of the statutory provision under which the SEC promulgates the rule (e.g., the protection of investors). Benefits may also include promoting competition, efficiency, or capital formation. The release for a rule should explain how and why, in particular, the requirements of the rule will result in identified benefits.
- In many cases, it will not be possible to quantify the benefits of a rule. In such cases, a detailed qualitative assessment of the anticipated benefits will be necessary.
- The benefits and costs of a proposed rule should be measured against a baseline — the best assessment of the way the world would look absent the proposed regulation (the "as is" environment).
- It is preferable to monetize costs and benefits when verifiable estimates are available. However, effects that cannot be fully monetized or quantified should be described.
- If a regulation includes a number of distinct provisions, the benefits and costs of the different provisions should be evaluated.

30. The SEC engages in economic analyses to inform its exercise of discretion in crafting rulemaking. The Commission sets forth its analyses in 'releases', to explain its rationale for the choices it proposes or adopts in light of the discretion it is exercising.

31. In the recent past, there have been notable changes in the SEC's regulatory impact assessment landscape and requirements. Foremost amongst these have been the attempts to improve the SEC procedure for carrying out justifiable, defensible and offer the most appropriate economic analysis to justify the imposition of a rule, particularly under legislations that leave a lot of scope for rule-making, viz., the Dodd-Frank Wall Street Reform and Consumer Protection Act (H.R. 4173), 2010[20].

32. Most relevant to the present discussion is the D.C. Circuit Court's decision in *Business Roundtable vs. SEC*[21], which has set a high bar for the justificatory

20 See Jacqueline McCabe, *The Need for Improved Cost-Benefit Analysis of Dodd-Frank Rulemaking*, The Harvard Law School Forum on Corporate Governance and Financial Regulation, May 12, 2012, last viewed on March 15, 2013; Available at: http://blogs.law.harvard.edu/corpgov/2012/05/12/the-need-for-improved-cost-benefit-analysis-of-dodd-frank-rulemaking/

21 647 F.3d 1144 (D.C. Cir 2011)

economic analysis in rulemaking by financial regulators[22]. Historically, in the 1970's, the SEC voluntarily began to include in its "proposing releases" and "adopting releases" (also termed "proposed rules" and "final rules" respectively) a section entitled "Cost-Benefit Analysis." Although it was never submitted to any US Federal Government oversight body, it was subject to public comment in the rulemaking process and, finally, to judicial review. The SEC continued with its releases for proposed regulations that included an economic analysis that provides a clear justification for the new requirements that includes the economic impact and cost of compliance[23]. In the case of *Business Roundtable*, the D.C. Circuit Court struck down a proposed SEC rule requiring companies to provide certain shareholder groups that wish to nominate director candidates access to their proxy statements, stating that the economic analysis supporting the draft regulations failed to measure the cost of the rule to companies[24].

33. Subsequent to the court's ruling, the US enacted the Financial Regulatory Responsibility Act, 2011 to ensure that all financial regulators conduct comprehensive and transparent economic analysis in advance of adopting new rules. The analysis, legal commentators state, would help regulators and the public think through what each rule intends to accomplish and what the costs of achieving those objectives would be. It sets forth the factors that agencies must consider in their analysis, allows the public to comment, and requires the agency to revisit the effectiveness of the rule five years after it takes effect. The bill would also establish a council of chief economists to bolster the quality of economic analysis being conducted and to ensure that the financial regulators work together to understand the aggregate effects that financial regulations are having on the economy. Through a judicial review mechanism, the bill would ensure that the agencies take their new economic analysis requirements seriously. Finally, the Act mandates that a rule shall not take effect if its *quantified* costs exceed its *quantified* benefits[25].

34. It is expected that such conditions would make the exercise of discretionary power by the market regulator, despite its expertise in financial markets,

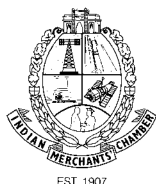
---

22 See Bruce Kraus and Connor Raso, *Rational Boundaries for SEC Cost-Benefit Analysis*, 30 Yale Journal on Regulation 2 (2013 Forthcoming), last viewed on March 15, 2013;

23 See David C. John, *Look before you Regulate: Measuring the Costs of Financial Rules*, September 28, 2011, last viewed on March 15, 2013; Available at: http://blog.heritage.org/2011/09/28/look-before-you-regulate-measuring-the-costs-of-financial-rules/

24 *Ibid*

25 See supra note 23 and supra note 22, at page 26.



much more limited and subject to judicial and parliamentary scrutiny. The simple premise, thus, on which the SEC operates at present, is that the benefits of a quantifiable nature must exceed the quantifiable costs, almost without regard to the qualitative benefits that cannot be assigned a justifiably accurate monetary value.

VIII. Implementation of RIA in the UK

35. In the UK, the Financial Services and Markets Act ("FSMA"), 2000, makes it incumbent upon the Financial Services Authority (FSA) to undertake a cost-benefit analysis (CBA) of any rules or regulations it proposes for the efficient governance of the UK's financial markets. A document titled 'Practical Cost-Benefit Analysis for Financial Regulators'[26] prepared as Central Policy by the FSA states that it would usually be worthwhile to integrate CBA into the policy development process from the earliest possible stages rather than leaving it as an "add-on" at the end. Delayed CBA might reveal that the favoured policy option would yield an excess of costs over benefits. That would be a significant problem in the absence of countervailing non-economic impacts.

36. At present, the legislation governing the operation of all the market participants is the FSMA. Notably, S. 155 of the FSMA is in the following terms:

- ***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.

26 Practical Cost-Benefit Analysis for Financial Regulators: Version 1.1., Central Policy, Financial Services Authority, June 2000; Last viewed on March 25, 2013; Available at http://www.fsa.gov.uk/pubs/foi/cba.pdf

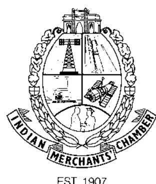
> *(3) In the case of a proposal to make rules under a provision mentioned in sub-section (9), the draft must also be accompanied by details of the expected expenditure by reference to which the proposal is made.*
>
> *(4) Before making the proposed rules, the Authority must have regard to any representations made to it in accordance with sub-section (2)(d).*
>
> *...*
>
> *(10) "Cost benefit analysis" means an estimate of the costs together with an analysis of the benefits that will arise—*
>
> *(a) if the proposed rules are made*

37. According to the FSA, CBA assesses, in quantitative terms where possible, and in qualitative terms when not possible, the economic costs and benefits of a proposed policy. Specifically, the requirement is that they publish "an estimate of the costs together with an analysis of the benefits to accompany the proposed draft rules". In addition, the FSA follows, as a policy that during the CBA, it is imperative to analyse, even in cases where the cost-benefit trade-off may be neutral, the distribution of such costs amongst different stakeholders. It is therefore worthwhile to state who gains and who loses, and why, as the result of a given regulatory proposal. Calculating a total for costs (and, where possible, benefits) will usually require that they be estimated separately for different groups or market participants. In this context, a useful thumb rule followed by the FSA is the adoption of an alternative perspective, i.e., if developing a proposal to reduce burden on firms, it is required to immediately assess the likely impact on consumers. Conversely, if it is developing a measure of consumer protection, its likely effect on the relevant businesses is to be considered.

38. The implementation of the Financial Services Act 2012[27] is expected to have commenced from April 1, 2013, to implement the UK government's amendments to the financial regulatory structure in the UK.

39. The OECD proposes, to the regulators in its member-states, carrying out a cost-benefit analysis that during the calculation of costs, not only the on-going costs of compliance with regulations be kept in mind, but also the one-

27 See text of the Financial Services Act, 2012, last downloaded on March 18, 2013; Available at http://www.legislation.gov.uk/ukpga/2012/21/pdfs/ukpga_20120021_en.pdf



off costs over an extended period of time the regulation is expected to be in force[28].

40. It also states that in order to arrive at a correct approximation, it is necessary to compare the impact over a considerable period of time (usually ten years or more), particularly because the costs are incurred and benefits accrued at different points in time and it can be dealt with by the use of 'discounting'. This is a method of adjusting the values of benefits and costs occurring at differing stages by a certain percentage rate to make them directly comparable by the measure of today's currency. By adding all the costs and benefits that are expected to arise over a pre-determined number of years and applying discounting factors, the Net Present Value ("NPV") can be calculated. The NPV is a single figure that summarises the present day value of the overall impact of the regulations and a positive figure will indicate that the benefits outweigh the costs and vice-versa if the figure is negative.

41. A vital aspect the regulators must consider is that an important element of conducting an RIA is making a realistic assessment of compliance with the proposed regulation[29]. Carrying out an assessment on this front would help in identifying any innate potential issues with the substance of the regulation, or with the compliance and enforcement mechanism. If the issues are not resolved by assessment, it remains likely that it shall be a case of "regulatory failure", where the costs are too high for compliance by the business entities or where the enforcement costs outweigh the penalty imposed or broader benefits expected to result in the market from successful prosecution.

IX. RIA in India: Are we on the right track?

42. In India, SEBI has been vested with the power to regulate the securities markets by virtue of the Securities and Exchange Board of India Act, 1992. The Act has also set out the functions to be performed by it, in the following terms:

    §11(1). *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.*

43. This provision sets out broad parameters for SEBI's functioning and delegates the authority to SEBI to enact regulations as it thinks fit, for the achievement

28 See Introductory Handbook for Undertaking Regulatory Impact Analysis, Organization for Economic Cooperation and Development, October 2008, last viewed on March 14, 2013; Available at http://www.oecd.org/gov/regulatory-policy/44789472.pdf

29 Ibid at page 21.

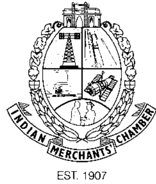
of certain objectives and the fulfilment of its declared responsibilities. Towards this end, many rules (by the government), regulations, circulars and guidelines have been issued, each with the intent of governing a specific entity, its operations or its interaction with other regulated entities.

44. The statutory framework, which has been continually evolving since 1992, has withstood the test of time and broadly ensures quality intermediation in the marketplace. Under the Act, SEBI has made a number of regulations to register and regulate intermediaries. While many of these Regulations, like SEBI (Merchant Bankers) Regulations, 1992 are dedicated to a category of intermediary, some Regulations, like the SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992, prescribe requirements for a few categories of intermediaries. While some, like SEBI (Criteria for Fit and Proper Person) Regulations, 2004] apply to the intermediaries in general, there are a few Regulations like SEBI (Central Database of Market Participants) Regulations, 2003, which apply to all participants, including intermediaries. These Regulations along with various circulars and orders issued by SEBI from time to time constitute the regulatory framework for intermediaries.

45. However, what is often alleged by the regulated participants is that SEBI imposes a heavy burden of compliance on the market participants. It would be pertinent to see that there is a separate set of Regulations for governing each kind of intermediary. These Regulations, in general, prescribe the following conditions:

- the requirements of becoming an intermediary;
- the procedure for becoming an intermediary;
- the fees payable;
- the general obligations and responsibilities;
- the conditions of registration;
- the code of conduct to be followed;
- investor grievance redressal procedure;
- the procedure for inspection;
- the procedure for action in case of default;
- the procedure for cancellation/surrender of certificate/licence, etc.

46. One of the prominent issues in SEBI's regulatory environment that comes to the fore is that of over-regulation of brokers. Under various Acts and Regulations like Section 11(2)(i) of SEBI Act, 1992, Regulations 20(1) and 21(1) of SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992, Regulation



17 of SEBI (Intermediaries) Regulation, 2008 and various applicable circulars from Stock Exchanges and Depositories, brokers have to undergo several layers of inspection and audits throughout the year. This is primarily on the following grounds:

- Inspection: Subjected to yearly inspection by three exchanges, three clearing corporations/houses and two depositories, conducted by the officials.
- Internal Audit: The three exchanges also require the broker to get an internal audit done by independent chartered accountants or CAs twice a year[30].
- Depositories: Further a concurrent audit is mandated by the depositories through independent auditors. Apart from this, brokers are required to undergo an internal audit through a CA firm twice a year for all the depository participants and the report has to be submitted to the two depositories.
- SEBI Inspection: SEBI's Market Intermediaries Regulation and Supervision Department (MIRSD): Conducts random inspection of all the intermediaries. Books/activities related to all the other businesses like PMS, DP, merchant banking are also inspected. Further, around 10% of sub-brokers/branches/authorized persons of a broker also require annual inspection.

Underlying Impact

47. The frequent audits and inspections every year increase the compliance costs, are time consuming and are considered to be duplication of effort that may easily be carried by a nodal agency on behalf of all the stock exchanges, clearing corporations, depositories and regulators of the broker. It is also contended that repeated inspections, notices and requests for information under these inspections distract the focus of the senior management and constrict the ability of brokers to expand operations without any gross or net benefit to society.

30 Twice a year, as per SEBI, Stock Exchange guidelines for stock broking operations and twice a year as applicable under exchange circulars. For instance, NSE circular NSE/INSP/19176 and Circular Reference No: 125/2011 dated October 19, 2011 on half yearly Internal Audit of Stock Brokers/clearing member stipulated by Exchange in line with requirements prescribed by SEBI *vide* their Circular dated August 22, 2008.

48. RIA has been carried out by SEBI, though in a limited scope, in a few situations. Notably, in SEBI's Board meeting on June 18, 2009, it was expressed that an RIA of the issue of shares with differential voting rights be carried out, in the backdrop of their impact on takeovers and corporate governance. Additionally, in the SEBI Consultative Paper on (Issue and Listing of Debt Securities) Regulations, 2008, issued on January 3, 2008, SEBI issued a regulatory impact assessment on the limited success of primary corporate bond offerings. It stated that the proposed regulations would impose lower regulatory burdens on the issuing companies without compromising on the rights of investors. In the Consultative Paper, issued on January 1, 2008 on amendments to SEBI (Prohibition of Insider Trading) Regulations, 1992, a limited RIA was conducted on each proposal that was put forward, in addition to asking for public comments on the same. In fact, SEBI had initiated a process of introducing RIA in its board's decision making for introducing new regulations around 2007, but has since not been used routinely.

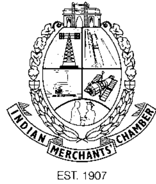
49. Self-regulation, as an alternative to the multiplicity of regulations, is a viable alternative that may be explored by the regulator for keeping a check on intermediaries and other market participants. Self Regulating Organisations (SROs) encompass authority to create, amend, implement and enforce rules of trading, business conduct and/or qualification regimes with respect to persons (i.e. legal and natural persons) subject to the SRO's jurisdiction and to resolve disputes through appropriate dispute resolution mechanisms. The regulator must ensure that no conflict of interest arises because of the SRO's access to valuable information about market participants.

50. The level and extent of regulatory oversight and the types of needed powers and protections may be affected by the structure of the self-regulatory authority. In some markets, certain very specific functions are delegated to self-regulatory authorities, while others are not, and duplication of efforts by different entities performing the same function must be avoided. All intermediaries, it is proposed, must be members of an SRO, which may act as the first level regulator.

51. The SEBI Act, in §11(2), lays out certain specific responsibilities to be complied with

    (*a*) register and regulate the working of the stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisors and such other intermediaries associated with the securities market,

    (*b*) register and regulate the working of the depositories, depository participants, custodian of securities, foreign institutional investors,



credit rating agencies, or any other intermediary associated with the securities market as the SEBI may specify by notification,

(c) register and regulate the working of the venture capital funds, collective investment schemes, including mutual funds,

(*e*) promote and regulate self-regulatory organisations.

52. In USA, FINRA (Financial Industry Regulatory Authority) — formerly, the NASD (National Association of Securities Dealers) — is the largest SRO in the securities industry, operating under SEC oversight. It regulates all the securities firms that do business with the public, including with respect to professional training, testing and licensing of registered persons, arbitration and mediation, and is at the frontline for exercising its authority over its members. It is a membership-based organization that creates and enforces rules for members based on the federal securities laws. The SEC is responsible for ensuring fairness for the individual investor and FINRA is responsible for overseeing all US stockbrokers and brokerage firms[31].

53. On a reading of this, justifications arise as to why it is important to incorporate self-regulation into regulatory frameworks. These are:

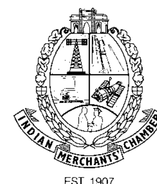
- Self-regulation, historically, works effectively, provided the organisation has a penal disincentive against violation and a charter authorising the enforcement of such action;
- Industry input made to the regulator prior to regulation-making also helps contribute to a strong and effective voluntary compliance culture;
- Self-regulation generally imposes fewer repetitive compliance and one-off costs on the regulator than government regulation;

Minimum Public Shareholding

54. While keeping in view the costs and the associated benefits that accrue from a proposed rule, another area where an impact assessment may be of assistance is in gauging compliance with the ruling of minimum public shareholding of at least 25%. The Ministry of Finance notified the Securities Contracts (Regulation)(Amendment) Rules, 2010 on June 4, 2010, amended on August 9, 2010, containing certain notable provisions, including:

- The minimum threshold level of public holding shall be 25% for all listed companies.

31 See http://www.finra.org/AboutFINRA/



- Existing listed companies having less than 25% public holding have to reach the minimum 25% level by an annual addition of not less than 5% to public holding, (where minimum 5% annual limit was later amended).
- If the public shareholding in a listed company falls below 25% at any time, such company shall bring the public shareholding to 25% within a maximum period of 12 months from the date of such decline, in a manner specified by SEBI.

55. While certain avenues have been provided through SEBI circulars for the dilution of promoter holding, a rigorous RIA by SEBI may have had a better outcome from the perspective of dilution of promoter holding rather than the overly straightjacketed means prescribed by SEBI. For instance, it is not clear why SEBI has not permitted a promoter of a company from selling shares in the stock exchanges, clearly a highly transparent and desirable means of reducing promoter percentage shareholding.

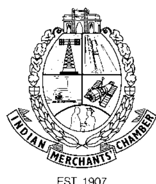
Dematerialisation of shares

56. It is, pertinent to note that one of the most remarkable impacts of the SEBI's regulatory mandate was felt in the dematerialization of shares, when it started in January, 1999.

57. In its circular dated February 10, 2004 (Reference: SEBI/MRD/Cir – 10/2004) SEBI introduced compulsory dematerialized trading in select shares for all investors and thereafter, an increasing number of shares were added to this list at regular intervals. During this time:

> *"the companies/transfer agents were under tremendous pressure on account of the large number of physical shares being received by them for transfer and/or demat. Moreover, transfer and demat were two separate processes and the investors were required to submit the transferred shares to the share transfer agent, through their DPs, for dematerialization. This entire process involved anywhere from 1-3 months and the investors could not sell the shares during this period.*
>
> *Accordingly, the transfer-cum-demat scheme was introduced by the depositories to counter the problems faced by the investors in the transition phase of moving from physical to demat trading mode, to decrease the time period involved in transfer and demat. However, as on date, a large number of stocks have already been dematerialized, almost 100% trading takes place in dematerialized form and hence, there is far less pressure on the companies/the share transfer agents*."

58. Though the initial costs imposed by the regulation was very high, SEBI kept in mind the scale of the changes it was bringing about and phased



the implementation of its proposal. The cost included the conversion of physical security certificates into dematerialized/electronic form, enhanced compliance costs by brokers and other intermediaries, direct costs of setting up computerised trading terminals, networks with the stock exchanges and depositories and software development expenses, training of personnel etc. But as history stands testament, the benefits in the long-term have far outweighed the short-term costs (which was protested at that time).

59. Apart from the obvious benefits that have accrued to the investors/shareholders/traders, larger positives have emerged out of this move by SEBI:

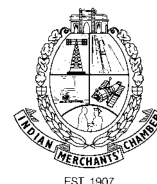
    - Increased liquidity in the market, attracting foreign investors and is in compliance with international standards by creating efficient and risk-free trading environment;
    - Minimisation of settlement risks and frauds in transactions, thereby restoring faith of investors/traders;
    - Reduction of delay in trading practices;
    - Reduction of capital issuance costs and streamlining of share allocation procedures;
    - Better facilities to shareholders/investors regarding grievance redressal;
    - Shortened timelines for settlement of trades, negligible risk of bad delivery of securities and much higher volume of trading.

Mutual Funds

60. SEBI, in a balance between its regulatory and development role, has had to take some tough, yet crucial decisions, in an attempt to shore up the mutual fund industry. While the latest decision in the last quarter of 2012 was in the tenor of being a concession in terms of relaxation of the limits on the expense ratio which the AMC charges to the fund, other decisions have led to a major impact on the distributors of mutual funds.

61. Until a few years ago, mutual funds thrived on the salesmanship of independent distributors who canvassed investors for a commission, which was paid by the funds from an entry fee charged to new investors. In 2009, when SEBI did away with entry loads[32], it significantly curbed the funds' ability to pay huge commissions to the distributors. This, in turn, affected sales. Listless stock

32 See Circular: SEBI/IMD/Cir. No. 4/168230/09, dated June 30, 2009.



markets have not helped matters either. Noticing this decline, fund houses have been requesting SEBI for a change in regulations, maintaining that the regulatory moves were slowly choking the industry. Since funds are sold rather than bought, i.e. people buy funds based on the marketing effort of distributors rather than purchase it otherwise, this led investors to decline investment in mutual fund products.

62. On the other hand, because of the rather dismal equity markets which were in turn reflected in the mutual fund performance, investors who had lost money because of an adverse market chose to abandon the mutual fund route besides other equity investments. The result has been a decline in the assets managed by the mutual fund industry in India in the recent past. This has, as research has shown, also been evidenced by a decrease in the aggregate number of retail investor mutual fund accounts by almost 45 lakhs between 2009 and 2012[33].

63. It is said that equity mutual funds are the only set of funds where the commissions have motivated the distributors to indulge in sales, using tactics that would sometimes be construed as misselling. Data has also pointed to the fact that capping the commissions to distributors has led to a fall in the assets under management/overall fund flows. For example, it is possible that the policy has had large benefits by reducing how much the investors churn their investments, as brokers no longer have an incentive to encourage investors to enter and exit funds frequently to maximize entry load earnings. Research has also shown that the period between 2009 and 2012 was when investors started moving from financial assets to real assets[34].

64. It has been pointed out a possible reason for the fall in the inflows was due to much lower incentives, due to the ban on entry loads, being offered to distributors to push sales, which ranged to 0.75-1% as opposed to 3-4% on new fund offers in the pre-entry load ban regime. This, it is said, often meant that the distributor ended up selling the product that had the juiciest margins rather than the most appropriate one for the investor in question. Due to the investment goals of the investors not being met of a lot of churning which

---

33 See S. Anagol, et al, *Distribution fees and Mutual Fund flows: Evidence from a natural experiment in the Indian Mutual Funds Market*, at page 36, February 2013, Indira Gandhi Institute of Development Research, Mumbai, last viewed on March 18, 2013; Available at http://www.igidr.ac.in/pdf/publication/WP-2013-004.pdf

34 See S. Anagol, et al, *Distribution fees and Mutual Fund flows: Evidence from a natural experiment in the Indian Mutual Funds Market*, at page 30, February 2013, Indira Gandhi Institute of Development Research, Mumbai, last viewed on March 18, 2013; Available at http://www.igidr.ac.in/pdf/publication/WP-2013-004.pdf

occurred i.e. buy, sell and again buy, sell transactions in quick succession, the purpose of which was to make the most commission out of the investor, SEBI began cracking down on both the mutual fund industry and on the distributors.

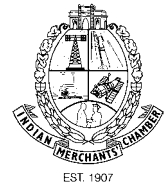
65. However, in the SEBI (Mutual Funds) (Second Amendment) Regulations, 2012, issued on September 26, 2012, the AMCs have been allowed to recover some of their costs through an imposition of an enhanced expense ratio, up to 30 basis points if at least 30% of the fund inflows are from beyond the top 15 cities. Though the impact of such a move is not entirely clear, it assumes that mutual fund penetration has reached saturation in the top 15 cities. Additionally, by incentivising AMCs, by charging higher expense ratio, to push its reach beyond the traditional operating centres of large towns, SEBI has seemingly relocated the issue of misselling, wherein it may result in distributors trying to push products on investors in smaller towns. As a safeguard, SEBI has provided that a claw-back would be provided on the enhanced expense ratio, to the extent that the portfolio from the smaller towns is redeemed within one year, yet fails to address the issue on AMCs earnings through exit loads in the same situation, which may be imposed by the fund.

66. Thus, the impact of SEBI's regulatory move, of entry load banning, and later conceding to some demands of the mutual funds by allowing some charges to be reversed somewhat could be termed an experiment in regulatory impact assessment, some not so successful, some more successful. The most recent change to the Mutual Fund regulation has brought cheer in neither the investors' camp, nor the fund houses' – but may well be a good equilibrium in terms of development and regulation.

X. Summary and Conclusion

67. In summary, it is evident that conducting an impact analysis is not a novel concept, or one whose importance may ebb with the passage of time. The calls for conducting such exercises on the larger regulatory environment, rather than just for securities regulations, have been growing for a while and may soon find their way into institutional discourse and become *de rigeur.* [35]

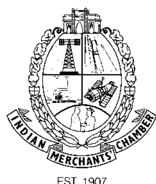
35 See, for example: Pradeep Mehta, *India needs to launch regulatory impact assessments to weed out laws that hurt business growth*, August 23, 2012, The Economic Times, last viewed on March 18, 2013; Available at: http://articles.economictimes.indiatimes.com/2012-08-23/news/33342429_1_red-tape-fiscal-deficit-business-growth



68. Some of the salient features of RIA that this paper draws attention to are:

- Globally, policy makers are increasingly valuing regulation that produces desired results as cost-effectively as possible and one of the best tools available for such business-friendly norms is conducting a participative-RIA;
- RIA can throw up results which show that “doing nothing” is a real option, particularly where action, or the cost of creation of regulation, can far outweigh the perceived benefits that may accrue;
- An RIA must be integrated with a public consultation process, as this provides better information to underpin the analyses;
- RIA is primarily a methodological approach that allows for the ex-ante or ex-post outcomes to be assessed against the goals set for the regulation;
- The costs of financial regulation can usefully be broken down into three broad categories: direct costs, compliance costs and indirect costs;
- A Regulatory Impact Statement (“RIS”) must be presented to decision makers so that the decision is informed by an assessment of best available information. After a decision has been made, the RIS needs to be made public in order to disclose the basis of such a decision;
- A cost-benefit analysis is expected to help regulators and the concerned decision-makers think through what each proposed rule intends to accomplish and what the acceptable costs of achieving those objectives might be;
- An RIA will be an efficient method of identifying long-term costs and benefits as opposed to the immediate costs and benefits that are visible without it. This assumes importance since regulations are drafted to serve its purpose for considerable periods of time.

69. RIA is not against regulation. It is not against a decrease of regulatory authority either. What it stands for is *smart regulation*, where the regulator can develop mechanisms for enforcement of its mandate, achieve its objectives in a manner which costs the least and investigate and repeal the provisions that place an unnecessary burden on entities without any justifiable benefit and reduce the larger economic costs, at the same time. Through an analysis that makes clear the benefit of any regulatory decision, it is expected that the market regulator may be able to keep track of the unexpected changes, if any, that its regulations may bring about at the operational level of the entities being proposed to be regulated.



70. It may also be worthwhile to take guidance from the Planning Commission of India[36], which points out that India's business regulations lack 'Periodic Review Clauses', prohibiting an automatic review of their functioning and efficacy from time to time. It further goes on to state that though these provisions get reviewed only on the basis of complaints/challenge or a clamour against them by the concerned stakeholders, it is neither comprehensive, systematic or of a structured nature. Calling for conducting of high-quality RIA, it draws significant lessons from the international experience with impact analysis and calls for its use as an innovative governance tool in the Indian context.

FSLRC Report

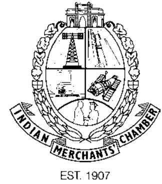
71. The Report of the Financial Sector Legislative Reforms Commission ("FSLRC"), released in public domain on March 28, 2013, makes certain critical recommendations consistent with this paper.

> *"An analysis of the costs and benefits of the proposed regulation. This is required because every regulatory intervention imposes certain costs on regulated entities and the system as a whole. The Commission recommends that regulations be drafted in a manner that minimises these compliance costs.*
>
> *In some cases where a pure numerical value based cost-benefit analysis is not possible, the regulator should provide the best possible analysis and reasoning for its choice of intervention.*
>
> *After publishing the above documents, the regulator will specify a designated time for receiving comments from the public on the regulations and the accompanying documents. The draft Code will ensure that the time period and the mode of participation specified by the regulator is appropriate to allow for widespread public participation."*

[Pages 31-32 of the Report]

---

36 See Towards Optimal Business Regulatory Governance in India, Report of the Working Group on Business Regulatory Framework, Steering Committee on Industry, Planning Commission, Government of India, 2011; last viewed on March 22, 2013; Available at: http://planningcommission.nic.in/aboutus/committee/wrkgrp12/wg_brf2103.pdf



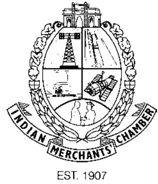
72. Chief amongst those recommendations, keeping in view the essence of this paper, is the requirement to institutionalise cost-benefit analysis and make it a vital part of the regulation-making and guideline-making process for the proposed unified regulator for India's financial system. It lays down the processes to be followed and most crucially, allows the invocation of the proposed Financial Sector Appellate Tribunal's jurisdiction to review any regulation or general guidance issued on the grounds of being contrary to the proposed Act, including on the following grounds:

    (a) in the case of regulations, there was a material and substantial error in the analysis of costs or the analysis of benefits; or,

    (b) the regulations were in gross disregard of the principles that the Financial Agency was required to follow while making the relevant regulations;

73. This provision is ground-breaking. Not so much as because as it mandates a cost-benefit analysis to be undertaken, but allows for a challenge to be mounted against the manner and methodology that may be adopted by a regulator while conducting an assessment. This will allow focused questioning, more oversight, positive accountability and most importantly, best-practices to be introduced into regulatory decision-making, after an in-depth consultation with stakeholders and legal experts.

74. The recommendations made by the FSLRC, with respect to mandatory cost-benefit analysis as a part of regulatory rule-making, is a positive development for the new generation of regulations that may follow the adoption of the bill.



Conclusion

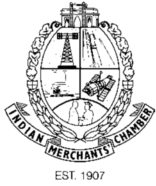
75. We conclude that a participative and consultative RIA mechanism also brings in a certain level of consistency in the regulatory framework while avoiding the possibility of overlap of regulatory reach, over-regulation of entities and distortion of competitive forces. By making clear the expected benefit, quantitative or qualitative, the costs to be incurred, we expect that the regulators will be better able to justify the imposition of rules and expect stronger, and possibly even voluntary, compliance by the entities it governs.

76. Finally, the use of RIA is not merely semantics or play with words but forces a strong analytical framework for judging and introspecting before new regulations are introduced. SEBI and every regulator should incorporate RIA along with the current public consultation process into every proposed regulation. This will create the seemingly impossible duality of better regulation with less regulation at the same time.

Deena Mehta
Chairperson
IMC Committee of Capital Markets

Sandeep Parekh
Founder
Finsec Law Advisors

Notes



Notes

The Practice Group

Sandeep Parekh has worked as an executive director at the Securities and Exchange Board of India, where he headed the Legal Affairs and Enforcement departments. Previously, he has worked for a law firm in Delhi, Mumbai and Washington, D.C. Sandeep has also been a faculty at the Indian Institute of Management, Ahmedabad. He is admitted to practice law in New York and is a member of Mensa. He is a World Economic Forum "Young Global Leader" and has been invited to speak at Davos. Sandeep has published op-eds in the Financial Times and the Economic Times.

The Firm also counts as a senior advisor, K D Zacharias, former legal head of the central bank, RBI. Mr. Zacharias has over 30 years of experience in the legal profession as an advocate and then at the central bank. He has been associated with various policy making committees appointed by the Reserve Bank and Government of India. Indrajit Mishra brings over a decade's experience in providing broad range of legal advice to clients on corporate transactional work. He specialises in private equity, M&A and joint ventures. Tejesh Chitlangi has assisted several domestic and offshore entities in establishing innovative domestic and offshore fund structures. Yash Bansal and Ankit Thakur are graduates of elite national law schools NALSAR and NUJS.

Indian Merchants' Chamber
IMC Building, IMC Marg, Churchgate, Mumbai 400 020.
T: +91 22 2204 6633 | F: +91 22 2204 8508
E: imcpresident@imcnet.org | W: www.imcnet.org