3

Regulation in Corporate Governance and Elsewhere: The Continuing Debate

Chiranjib Sen, N. Balasubramanian

1. Introduction

Ever since the beginning of civilisation and the general acceptance of the concept of an orderly and relatively fair society, the nature and extent of the regulatory role of the government have been in a state of constant flux, ranging from the peremptory and the detailed to the permissive and the persuasive. A plethora of variations (mostly dictated by the nature of the times and the stages of cultural and libertarian development of societies) have been tried with different degrees of success. Given that there is (and can be) no one-size-fits-all prescription in this regard, this paper traces in part this journey over the years and around the world, and is organised as follows. Section 2 sets out some of the general principles that form the basis of regulation in terms of a covenant between the regulator and the regulated; Section 3 traces some of the key trends preceding and following the 2008 financial meltdown that shook (and continues to affect) the interdependent world economies. Section 4 discusses the developments in the arena of corporate governance regulation in recent times, and Section 5 concludes the discussion with some prescriptive suggestions relevant to emerging economies like India.

2. Underlying Principles of Regulatory Acceptance and Empowerment

While a comprehensive discussion of the sovereign authority of the state to govern through legislation and regulation—directly or through duly empowered regulatory agencies—is beyond the scope of this paper, it would be useful for our purposes to identify the general principles by which the State derives such authority and the people (including legal entities such as incorporated bodies) agree to be subjected to such regulations. Locke (1892) describes the right of one over another, especially the state over its subjects, as an instrument to protect the liberty and freedom of all, such that in the exercise of one's own right to freedom, one does not encroach on and/or impair another's equal right to similar freedom. The state is empowered to undertake this right so long as the community or nation exists. But why should or would an individual with inherent freedom surrender and be subjected to the dominion of the state unless the individual sees some value for himself in doing so? Mill (1859) (and Rousseau, 1762 before him) discusses the inherent advantages an individual enjoys by joining such a society and subjecting himself to certain sacrifices of individual liberty in return for the safety and security that he would gain against external or internal threats to his life and property, which could be better handled as a group rather than as an individual. But having taken that decision (or being forced into accepting such a decision by an attacking and victorious marauder) the power so vested in the ruler seldom reverts to the individuals except in extreme cases of revolt or secession from the community due to the patent abuse of authority.

State regulation and exemplary punishment in the event of non-compliance have been documented in the Indian scriptural tradition. For instance, the *Mahabharata*[1] (Ganguli, 2000) describes how in the beginning there were no rulers and no concept of punishment since everyone understood and followed those ways of life that were fulfilling to them without interfering with others, and how men later strayed away from the path of common mutual good and wellbeing, and how laws then had to be codified and enforced to ensure that the weak were not overpowered by the strong, and so on.

The power to legislate and regulate, even with force if warranted, is thus derived by the State over its subjects and is expected to be used for the welfare of all. “There remains, however, the problem that a ruthless majority that has no compunction in eliminating minority rights would tend to make the society face a hard choice between honouring majority rule and guaranteeing minority rights” (Sen, 2009, p. 352). This is also the possibility which regrettably is a frequently observed reality that led Gandhi to comment on the inherently violent traits of a democracy based on majority rule.

Analogously, managers and owners of corporations often with a multitude of shareholders without any active role in the day to day operations of their companies are also prone to the excesses that come with their relative positions of *de facto* power attributable to their operational control and dominance in ownership arising from their stock ownership (which is not necessarily always a majority). By incorporating themselves into a legal entity under the provisions of a state charter or statute, they sacrifice their freedom to a certain extent in return for the benefits of perpetual succession and most often limited liability; publicly traded companies undergo a similar curtailment of their unfettered freedom when they choose to get listed on a stock exchange in return for the concomitant benefits of market access to capital, and relatively increased liquidity, and flexibility of exit when desired.

There is thus always a continuing tension between the governing and the governed with regard to the extent and rigour of regulation that their subjects are to suffer; in practice the flexible equilibrium is reached as a trade-off between the needs of society in public interest and the freedom of operation that would attract and retain investment (in a corporate context). Consultation processes and political debates often reflect an effort (on both sides) to obtain an acceptable compromise. Developments in regulatory regimes have to be viewed in this backdrop as well as in the context of the growing globalisation of business that often necessitates a similar set of considerations between different geographies that push for some measure of convergence of corporate governance regimes in countries.

We first review the market regulation scenario, queered as it is by the global financial meltdown in 2008 originating in the United States and subsequently spilling over to other inter-dependent economies of the world, not so much for the specifics of the breakdown of the financial sector as for the conflicting regulatory philosophies advocated and practised over the years that eventually contributed to the virtual collapse of the world financial order. We then turn to a consideration of the regulatory scenario in the corporate arena, with particular reference to India.

3. Global Financial Meltdown and Market Regulation

The exact beginnings of protracted systemic failures are not easy to pinpoint. Usually it is a specific event that the triggers recognition of the problem long after it may have commenced its incubation. Soros (2008) fixes the outbreak of the crisis to August 2007 (based on a BBC report)[2] when central banks had to intervene to provide liquidity to the banking system. To understand the role of regulation—or more precisely the lack of adequate regulation—it is necessary to recall the developments in this field, a study to which we now turn.

The state-market context

Institutional dimensions of market economies have been undergoing significant changes over the past decade. The global financial crisis has further accentuated the importance of such institutions and their reform. American and European policy makers and regulators are even now engaged in drafting new legislations and rules that are aimed at creating a more robust regulatory framework for the financial industry and for corporate governance, so that the chances of a repetition of the financial meltdown are minimised. These recent trends in regulation may be viewed as the latest chapter in the unfolding transformation of modern capitalism. The market liberalisation movement had swept the world beginning in the late 1980s. Policy reforms that began as a paradigm shift towards *laissez-faire* and away from government intervention in markets now seem to have come full circle with a new trend toward stronger regulatory governance over financial markets. Despite strong resistance from the powerful finance industry and their political allies in the USA, it is most likely that stronger regulation will receive legislative backing through the bills that are being discussed by the US Congress (at the time of writing).[3] Globally, regulatory reforms are very likely to extend beyond financial markets, because market failures in the fields of environmental sustainability, climate change, allocation of land and mining rights, and inclusive growth are increasingly evident. Indeed, these failures are at the root of intensifying social unrest and violence in many parts of the world, including India. These problems and their economic underpinnings are addressed through appropriate regulation and supporting institutions. Otherwise, it will be difficult to maintain a social and economic environment that would sustain rapid and harmonious growth.

The state-market dynamic during the globalisation phase has been different for the advanced and the developing countries. In the latter, market reform design was influenced strongly by the "Washington Consensus" policy template.[4] Most of the newly industrialising countries (including the highly successful Asian Tigers) had earlier followed variants of state-led developmental models during the four decades between the Bretton Woods Conference and the oil crises of the 1970s. Backed by the major multilateral institutions, and spurred on by the conservative and influential financial media, the Washington Consensus fundamentally reshaped the economic policies of developing countries, particularly those which experienced economic crises and needed some form of assistance in adjustment. In fact, each national macro-economic and/or balance of payments crisis was an opportunity for the World Bank and the IMF to package their policy reform template along with structural adjustment loans (Stiglitz, 2002). India's reform policies closely conformed to the Washington Consensus when they were launched in 1991. The reforms swept away most of the controls, planning, and closed economy policies that had dominated its economy since the 1950s.

The Washington Consensus policies, in their original form, did not give much emphasis to institutions. Instead the focus was on rolling back the government in both macro- and micro-economic arenas. Within a decade however, it became apparent that these policies were failing in many countries on several counts. For example, income inequality worsened along most dimensions (personal, regional, and urban-rural). Macro-economic instability continued with a string of financial crises that emerged in Latin America (Mexico, Brazil, Argentina), several former socialist "transition economies" (Russia), and the devastating East Asian crisis of 1997 (with contagion effects that started in Thailand, and spread to Indonesia, Malaysia and South Korea). Even Wall Street was not spared from crisis, as the failure of the leading hedge fund LTCM shook the confidence of the most powerful financial market in the world, and a meltdown was narrowly averted through a rescue package financed by a group of private banks. These recurrent episodes show that unfettered markets and increased competition by themselves are not sufficient to maintain stable growth. The lack of appropriate institutional frameworks also became evident in relation to privatisation. The process was marred by political controversy regarding the design of the bidding mechanism, and charges of corruption and "crony capitalism". Thus it became obvious to most observers that markets needed to be controlled through appropriate regulatory institutions, rules, laws, and policies.

This experience led to the reconsideration of the importance of the institutional framework that is required for markets to function effectively. Recognising this, the market fundamentalist thrust of Washington Consensus policies was augmented to include a number of new institutional dimensions in market reform policies. Thus policy attention began to be given to reforms in corporate governance, anti-corruption measures, prudence in liberalisation of the capital account in international transactions, rules-based trade liberalisation via the WTO, and creation of social safety nets. These new policy goals clearly targeted those areas where systemic failures were evident. By addressing them, the intention was to "get the institutions right" so that markets could work better. While the new approach was an improvement compared to the original Washington Consensus in that it acknowledged the key role of institutions, it still did not accord a high priority to regulation per se. The approach implicitly was for creating better rules and norms for market conduct, supplemented by a limited number of cautious discretionary policies.

In the developed countries, the pattern was different. Regulatory institutions in the US were well established (dating back to the Depression era when President Franklin D. Roosevelt established them to control unstable markets) (McCraw, 1984). Over time however, regulation came to be viewed as dysfunctional. Critics decried the "capture" of regulatory institutions by powerful business interests, and argued that regulation throttled competition, and bred inefficiency. The period of globalisation was therefore marked by a wave of deregulation initiated by Reagan and Thatcher. In many industries (such as air transportation and public utilities), deregulation succeeded in bringing about greater competition and efficiency (Kahn, 1995). This trend received support from the radical ideology of market fundamentalism, which held that competitive markets knew best, and hence *laissez-faire* was the best policy. These classical economic ideas, championed by Milton Friedman and Friedrich Hayek[5] in the modern era, had been edged out by Keynesian economics. But they gained ascendency when the advanced economies floundered in stagflation. The *laissez-faire* ideology was embraced by a resurgent financial sector which replaced manufacturing as the dominant industry. In particular, it found policy support from Alan Greenspan, the long time Chairman of the US Federal Reserve Board. This combination of a rising financial industry and the Greenspan-led Fed set the stage for a long phase of non-interventionist, easy monetary policy, and far-reaching deregulation of the financial sector. Greenspan was reluctant to tighten money supply in response to asset price inflation. He was also unwilling to take other restraining steps (such as higher margin requirements) to curb financial investors even when asset market prices rose sharply, and many people began to wonder if a speculative bubble might be forming (Stiglitz, 2003, p. 56).

The failure of macro-economic policy to act early is one element which can allow an asset bubble to develop. Another element is rapid deregulation. Much of the turbulence in American markets in recent decades is associated with deregulation. For example, the deregulation of telecommunications is linked to the technology bubble that burst in 2001; the deregulation of electricity markets led to the crisis in California; the deregulation of banking (repeal of the Glass-Steagall Act) created conflicts of interest in banks; and the weak regulation of the accounting sector underlay the subsequent accounting scandals and failures of leading accounting firms (Stiglitz, 2003). Despite these problems, the overall policy direction in the USA remained oriented towards deregulation throughout the 1990s and well into the first decade of the new millennium, as far as regulation by the government was concerned. The story was broadly similar in the UK and in other OECD countries. The main thrust of regulatory reform was to reduce the regulatory burden and administrative burden on private firms (Frick & Ernst, 2008).

The trend favouring deregulation was halted abruptly by the onset of the global financial crisis that shook the world beginning in 2008. There was little doubt that the crisis was the result of the comprehensive failure of financial markets that began in Wall Street, the very heart of global financial system. The crisis spread quickly to most major markets because of the pre-eminent position of the US economy, and the connectedness of global markets. It was triggered by the collapse of the US housing mortgage market. The real estate bubble had formed over a long time. It was aided by two factors—aggressive lending practices at the primary level that targeted sub-prime borrowers, and financial innovations in the creation of complex asset-backed securities that were essentially bundles of underlying mortgages. The asset-backed securities were then rated by leading rating agencies, and sold. These factors allowed the mortgage market to expand very rapidly. The originators of the mortgages could thereby shift the risk to other investors. The collapse of the market occurred when some of the sub-prime borrowers began to default on their mortgages, which in turn created a chain reaction of panic. Holders of the asset-backed securities found that they could not estimate the risk they were actually carrying, and prices plummeted when they tried to sell. The crisis revealed beyond doubt the disastrous consequences of the lack of an appropriate regulatory framework.

Apart from the structural and institutional factors associated with the crisis, there was also the related issue of corporate behaviour. Did the financial firms behave responsibly towards their clients and customers? Did they behave ethically in creating a situation in which they could spread risk to others without fully disclosing the risk to their customers? Were they truthful in disclosing information about their own financial condition? These issues are the topics of most public discussions currently. Thus the stage has been set for a new round of regulation as well as associated legal and policy initiatives. These will impact both the functioning of regulatory institutions and the governance of corporations.

Lessons are still being learned from the experience of the financial meltdown. Several sources of financial market failure that contributed to the crisis have been identified, including the ability of banks which originate the loans to pass on the entire risk through securitisation and sale (the originate-and-distribute model). This system created a strong incentive to create more risky loans. Moreover banks which funded the home loans did not have direct contact with the borrowers. Instead they outsourced the activity to independent mortgage brokers who received fees. These brokers had little incentive to be careful in collecting information about the borrowers. The use of structured investment vehicles created off-balance sheet entities that enabled banks to act non-transparently and to show a lower risk to regulators, and thereby to carry inadequate amounts of capital. These features illustrate how a system based on misaligned incentives had developed. Regulatory action is needed to address the propensity of firms to pursue immediate profits at the cost of creating high risk to the financial system as a whole. The scope and speed of changes that will be introduced will depend, however, on the outcome of the political battles that are already being fought in the major countries. The influence of conservative *laissez-faire* ideology on the US public is still considerable, and the lobbying power of financial business interests will no doubt be utilised to block significant legislation.

Regulatory ideas and institutions

From the viewpoint of society, regulation is needed to improve market outcomes when markets fail. Market failures can originate from several sources (Stiglitz, 2010). The conventional understanding is that markets fail in the case of public goods, and when there are externalities.[6] There is however, another source of market failure—imperfect information—which has assumed great importance recently. Addressing information failure is at the core of ongoing regulatory initiatives. This is due to its relevance in the context of financial market failures, when information regarding the quality of the product or the riskiness of a financial asset is asymmetrically distributed between the market participants. Market outcomes in such cases will be biased against the party with deficient information.

Regulation of financial markets may also be needed to protect against "irrational behaviour" by market participants. One of the lessons that can be learned from recent financial crises is that irrational behaviour plays a key role in creating and exacerbating asset market boom and bust cycles. Financial markets are prone to volatility because of sharp swings of optimism and pessimism in expectations. Intervention is justified in such cases because the irrational behaviour of a few market participants can destabilise the entire economic system, and thereby hurt others. Precautionary or defensive regulations are therefore necessary to curb such volatility. These ideas go against the grain of conventional economic theory, but they have influential adherents whose views are gaining ground. Standard economic theory is founded on the axiom of the rationality of market participants. However, market practitioners like Soros (2008) and academic experts like Akerlof and Shiller (2009) have challenged the relevance of these rationality assumptions on behavioural grounds.

Soros has long argued that financial markets are inherently prone to boom-bust sequences because the market participants (as well as regulators) act based on imperfect knowledge and under uncertainty. Market *fundamentals* do not have an existence *independent of the expectations of the market participants.* The expectations of market participants play a crucial role in their demand and supply decisions. However, *their actions themselves influence the events on which their expectations are based.* The market participants' cognition of reality is inextricably intertwined with their market buy-and-sell actions. Hence, there is a circularity in the process—what Soros terms "reflexivity" (2010, pp. 12–15). Rational economic decision-making in the traditional sense is simply not possible under these circumstances. Financial asset prices therefore do not move towards any equilibrium, but continually oscillate. Sometimes a trend develops, and this influences expectations in a self-fulfilling manner. This process, when based on leveraging, can lay the foundation for a boom-bust sequence. Sometimes the boom can be sustained, and this could be followed by a serious bust, when exaggerated expectations can no longer be sustained. Akerlof and Shiller (2009) make a similar argument, noting the wide divergence between actual stock prices and fundamentals. According to them, investment decisions are made under conditions of "fundamental uncertainty" and "straight from the gut", rather than rational calculation. They focus on feedbacks that underlie speculative bubbles—such as "price-to-price feedback" (emphasised by Soros), and also the feedback from asset prices to the real economy. Thus, precautionary regulation is needed to curb irrational exuberance or pessimism.

Finally, regulation is needed to ensure that inequalities of distribution that may be inherent in market outcomes are moderated, and brought in line with society's political preferences. These issues are more urgent in the context of developing countries. For example, efforts are needed to ensure that private sector providers of telecommunication services reach out to the rural areas, and that the poor have access to credit.

Regulatory strategies can help mitigate market failures. Their appropriate design is an important challenge for policy. The goal is to find the right balance between the benefits of market efficiency and dynamism on the one hand, and the costs of market failure on the other. Regulation, in order to remain relevant and effective, must also be able to cope with the fact that technological and business environments can change rapidly. These changes can strain the regulatory capacity of government regulators. To mitigate this problem, there has been a significant trend towards different varieties of self-regulation as well as towards certification by external expert bodies such rating agencies (Baldwin & Cave, 1999).

There are three basic instruments that are normally used in regulation (Stiglitz, 2010). These are Information Requirements, Proscriptions (specifications of what firms may not do), and Mandates (actions that firms must take). In the case of conventional market failures involving externalities and public goods, regulation typically involves tax and/or subsidy to correct the incentive embedded in the price. In some cases, there may be physical or quantitative restrictions on what the firms may do. In the case of information failure, regulation requires firms to truthfully disclose relevant information. The issues concerning disclosure are complex. In principle, information relating to conflicts of interest, ownership, and remuneration should be disclosed, as these enable customers or investors to exercise better judgment. Sometimes firms deliberately seek to evade disclosure requirements by giving information in a form that deceives or confuses the user of the information. Hence the form of disclosure needs to be regulated as well.

Moreover it is often necessary to go beyond disclosure. Market participants may not be able to process the information provided by firms, and some firms may not change their bad behaviour despite disclosure, in the hope that some participants will remain uninformed. For example, apart from disclosing information to customers, financial institutions may be required to comply with certain risk-mitigating standards to discourage moral hazard. In addition, certification by rating and audit agencies may be required to provide additional comfort.[7]

Restrictions on firm behaviour are needed, but merely proscribing particular actions may not be effective. It is difficult to control bad behaviour directly. However the probability of such behaviour can be reduced by focusing on the removal or reduction of wrong incentives that lead to bad behaviour. Hence regulators require banks to maintain sufficient risk capital to curb reckless lending, and also do not allow insider lending. Because business conditions can change, restrictions should not be too specific. Regulators may require a legislative mandate to enable them to have a broad scope of action. This may involve breaking up firms, or imposing ownership restrictions (as in the case of the Glass-Steagall Act which debarred commercial banks from owning investment banks).

The third category of regulatory instruments comprises Mandates. Through this means, regulators seek to achieve a public purpose without committing public funds. Mandates are a form of hidden tax on the firms. An example is the mandate on banks to provide “financial inclusion” and lend to “underserved” segments including small farmers and the poor.

In both developing and advanced countries, regulatory institutions have undergone significant changes. In India, independent regulatory institutions are being created particularly in the infrastructure and financial sectors where the roles of markets and private enterprise are increasing, alongside the incumbent public sector firms (which typically functioned as monopolies earlier). These new regulators are expected to replace direct control of markets with government ministries, and ensure a level playing field for private firms and the public sector firms. The initial experience of these regulatory bodies has not been easy or particularly successful (Bhattacharya & Patel, 2005; Rao & Gupta, 2008).[8] These institutions have had to function with inadequate enforcement powers, poor compliance, contend with opposition from incumbent public sector firms, and turf battles with the parent ministries as policymakers. It is clear from this experience that even when the need for regulation is well recognised, the effectiveness of regulatory institutions cannot be taken for granted. Their design must be appropriate for the political, legal, technological, and business contexts in which they operate.[9] To spell out design principles does not of course ensure that these will be adopted. How do regulatory institutions actually evolve? Sen and Suraj (2009) have analysed this question in the Indian context (with special reference to the regulation of competition) in the telecommunications industry. Their explanation is based on a process of political economy in which there are conflicts, negotiations, and manoeuvres by major actors. They identify two key mechanisms for balancing conflicting interests—the political/policy process and the legal process. They show how the regulatory institutions evolve through a series of iterations. They explain how the concept of *public interest* gets periodically redefined as policies change. The legal process plays a crucial role in enabling the regulatory institution’s role and jurisdiction to adjust to the new policy and business context. Therefore the emergence of an effective regulatory institutional framework ultimately depends on the resilience and robustness of the democratic framework and the legal system.

In advanced countries during the globalisation era, despite the strong anti-regulation rhetoric of politicians and the deregulation of the financial sector, the overall actual experience has not been one of unalloyed deregulation. On the contrary, there is evidence that the number of regulatory institutions (both state as well as non-state) have actually increased (Levi-Faur, 2008). Braithwaite (2008) has argued that instead of *laissez-faire* and unfettered markets, the broad trend has been a shift towards "regulatory capitalism" in advanced market economies. There is a symbiotic relationship between the modern mega-corporations and regulation, rather than being completely antagonistic (Braithwaite, 2008). Regulations often strengthen the market power of large corporations vis-à-vis small firms because they are better able to bear the costs of complying with regulations. Large corporations have in fact demanded certain types of regulation that are in their interest. The emergence of regulatory capitalism has been accompanied by innovations in regulation, including the growth of non-state regulatory bodies. For example, in chemical industries where there is danger of serious accidents, self-regulation can be observed. Also, as seen in the Indian case, regulatory institutions need to be (and are) set up by the government in newly privatised industries independent.

"Self-regulation" is particularly interesting from the perspective of corporate governance because of the enhanced role that firms have in these regulatory systems. Self-regulation refers to a regime in which "a group of firms or individuals exerts control over its own membership and their behaviour" (Baldwin & Cave, 1999, p. 125). The advantages of self-regulatory regimes arise from their ability to mobilise specialised knowledge and expertise about the regulated industry. In doing so, they can be relatively more cost-efficient compared to government regulators in formulating rules and standards. Also, they may be better able to secure voluntary compliance from their member firms. There are however, concerns about the accountability of self-regulatory systems, and sceptics fear that they may be easily "captured" by the firms that they are supposed to regulate.[10] There is a great amount of variability within self-regulation across the public-private spectrum. Institutions can differ depending on the degree to which they fulfil governmental functions—some self-regulatory bodies may pursue mainly the private ends of their members, or they may be fulfilling public policy tasks. The activities of self-regulatory bodies need not be entirely independent of the government. They may be guided and restricted by rules, statutes, and oversight by government agencies. There may also be processes for public enforcement of regulatory rules that have been developed by self-regulatory bodies.

Overall, there thus appears to be a greater degree of recognition and acceptance that regulatory discipline is not something that can be totally or even substantially relaxed if the interests of societies and peoples at large are to shielded from the disastrous consequences even of a partial collapse of economic and financial systems. Not only specific countries but also large parts of the inter-dependent global economies suffer from such fallouts, and hence they cannot be silent spectators to any such breakdowns. We are currently in a period of institutional transition with respect to regulation in many parts of the world. The process is characterised by political and intellectual contestation, as well as legislative action. At the same time, a substantial degree of innovation and experimentation in regulation has occurred. Non-state stakeholders are playing a larger role in this process.

4. Evolution of regulatory regimes in corporate governance

The corporate sector in a country forms an ever increasing component of its economy. It contributes large proportions of the country's national output and employment, and thereby it significantly impacts the society and its environment through its activities and operations. And yet, corporate regulation was virtually non-existent in the early decades of corporatisation. The earliest corporations, such as the British East India Company, were all chartered by royal assent. Apart from the covenants that the charter imposed—which were minimal with regard to public interest and more focused on the benefits to the crown—there were few regulatory restraints on their behaviour. In the nineteenth and early twentieth century, US corporations were allowed to operate with little restraint. Monks (2010) observes that at the beginning of the "glorious thirty years" from the late 1970s to the final years of the first decade of the new millennium, "It seemed possible that private enterprise could operate on a global stage, free from the constraints of governmental regulation and oversight. The vision was simple and stirring, and in many ways irresistible: Corporate efficiency could co-exist with democracy...Today, we are surrounded by the wreckage of this seemingly noble experiment. 'Self-restraint' proved largely to be no restraint. Rather than legitimatise the power handed them, corporations have ensured the ultimate need for involvement of government and the end of the dream" (p. 1). The scars of the early days of unrestrained capitalism that gave rise to the *robber barons* had been re-inflicted on an exuberant modern society that was gullible all over again. Regulation had to be brought in almost with a vengeance in the USA. In the early twentieth century it was ably conceptualised by Brandeis (1913) to put an end to the "money trust" of investment bankers and the interlocking directorates that led to monopolistic excesses. This was followed by Franklin D. Roosevelt's regulatory efforts after the Great Depression, and in the late twentieth and early twenty first centuries, there was a plethora of restrictive legislation including the Sarbanes-Oxley enactment in 2002, and the much stricter listing covenants ordained by the Securities Exchange Commission and the leading Stock Exchanges. The pendulum had swung decisively in favour of stricter control and regulation of the publicly traded corporate sector.

In the United Kingdom, corporate governance guidelines were strengthened by successive committees headed by Adrian Cadbury, Ronnie Hampel, Richard Greenbury, Derek Higgs and Chris Smith (and David Walker in November 2009 specifically on governance in banks). The UK company law was refurbished and revised in 2006 after a decade of consultations and discussions.

In India, the legislative governance of companies had always followed corresponding developments in the UK at least till the country's political independence in 1947. Since then, a major overhaul in 1956 and a series of amendments in subsequent years have tightened control over corporate behaviour. A Companies Bill was introduced in parliament in 2009 and is awaiting approval. Listed company governance has similarly undergone a quantum change—since 2000, the listing agreements have been strengthened to seek better governance, transparency, and disclosure among publicly traded companies.

While designing a model of regulation appropriate to the stage of development of the country, it is important to bear in view the twin regulatory objectives of protecting the interests of shareholders (through improved value creation and its equitable distribution) while promoting investment and encouragement entrepreneurial leadership.

Regulatory models and issues in corporate governance

There are several ways to apply regulation to subject entities and ensure their compliance, where necessary by adequate, and even exemplary, punishment. We review three such key themes that appear to be currently in contention, with little consensus on the most appropriate variant that would deliver the desired results. These may be grouped as follows (a) Principle-based vs. Rule-based Governance; (b) the Comply or Explain Approach; and (c) the Resolution of Multi-Regulator Conflicts.

Principle-based vs. rule-based systems approach

This debate concerns whether intended governance standards are better achieved by laying down broad principles or prescribing detailed requirements. Admittedly both the methods have their own advantages and disadvantages. The rule-based system would, for example, clarify precisely what is required. As Ford (2008) points out, "The classic example of the difference between rules and principles or 'standards' (to use another term) involves speed limits: a rule will say, 'Do not drive faster than 55 mph', whereas a principle will say, 'Do not drive faster than is reasonable and prudent in all the circumstances.' Put another way, a rule generally entails an advance determination of what conduct is permissible, leaving only factual issues to be determined by the frontline regulator or decisionmaker. A principle may entail leaving both specification of what conduct is permissible and factual issues for the frontline regulator." (p. 6).[11]

"Rule-based accounting standards provide extremely detailed rules that attempt to contemplate virtually every application of the standard. This encourages a check-the-box mentality to financial reporting that eliminates judgments from the application of the reporting…[but] rule-based standards make it more difficult for preparers and auditors to step back and evaluate whether the overall impact is consistent with the objectives of the standard" (Herdman, 2002, p. 5). They "promote precision, formal equality, predictability, certainty, uniformity, and judicial restraint...and reduce the likelihood of bias, arbitrariness, and abuse of power by decision makers" (Ford, 2008, p. 7, fn. 24).

Thus under certain circumstances that require precision such as in accounting or actuarial processes, defining the rule of the game in as much detail as possible may actually be helpful to avoid any unintended deviations in application, and consequently the results. On the other hand, Herdman (2002) goes on to say that "An ideal accounting standard is one that is principle-based and requires financial reporting to reflect the economic substance, not the form, of the transaction" (p. 5) and cites some Accounting Standards that combined a judicious mixture of principles and rules that he hoped would serve as a test of the level of specificity needed to strike a balance between rules and principles. Principle-based standards would yield a less complex financial reporting paradigm that is more responsive to emerging issues.

While there seems to be a growing appreciation of the superiority of principle-based approaches over their rule-based counterparts, two important issues need to be addressed—first, which of these approaches best subserves the objectives of corporate regulation; and second, what are the preconditions for their successful implementation.

The experience reported from the UK which has been predominantly following the principle-based approach in corporate governance seems to indicate that the country has benefited from its adoption. It must be noted though that most of these findings are based on the holistic status of corporate governance in the UK which would include the comply or explain approach and many other facets of applied governance practices in that country, and not just on the principles versus rules issue.

On the issue of the preconditions for the successful introduction of principles-based governance regimes, it is necessary that at least two criteria need to be satisfied. All the players in the corporate governance arena should be willing to go that extra mile to apply the principles in the fullness of their spirit; and secondly, the markets should be alive to the freedom of interpretation and choice provided by the principles to operating managements and should be in a position to evaluate their performance on an informed basis. Ideally, large block holders including institutional investors may take this role on themselves and evaluate company performance on this parameter. This would help in distinguishing the good performers and rewarding them with an appropriate market premium even while penalising those who unwittingly or otherwise fail this test.

There is a need to exercise caution before making a hasty transition to the principle-based approach. Currently in India, the rule-based component dominates the approach to corporate governance regulation, in the form of legislative or regulatory mandates. There is a need for the gradual diminution of these detailed check-box provisions with well thought out principles. The process has to be handled with extreme care and changes should only be made after due public discussion and with the buy-in from all the parties concerned. Even then, such a change can bring in the benefits of improved transparency and investor confidence on the one hand and a substantial reduction of compliance costs to the companies on the other, only if there is a substantial enhancement in the market's capacity to evaluate, and reward or punish the companies according to their performance on the governance scale. Otherwise such an experiment is unlikely to succeed.

The Comply or Explain Approach

The second issue in regulation has to do with the extent of compulsion as opposed to conviction with regard to governance practices. This also bears upon the extent of self-restraint on the part of the regulators with regard to the extent of freedom they wish to offer to their subjects, and also upon the trust and confidence that the subjects are able to command with regard to their capacity to utilise freedom without allowing it to degenerate into licence.

If the instruments for achieving regulatory objectives could be conceived of as a continuum ranging from inviolable mandates at one end of the spectrum and total volition at the other, comply or explain would be somewhere in the middle, where desired regulatory requirements are articulated but with an option granted to the regulated not to comply so long as the reasons for such non-compliance are explained to the satisfaction of those to whom the entity is accountable.

The UK is probably the one country that has practiced this comply or explain approach successfully for close to two decades.[12] It is recognised in a corporate governance context (FRC, 2006) that "The key relationship is between the company and its shareholders, not between the company and the regulator. Boards and shareholders are encouraged to engage in dialogue on corporate governance matters. Shareholders have voting rights and rights to information, set out in company law and the Listing Rules, which enable them to hold the board to account." (p. 3).

Viewed in this perspective, regulation was seen as a facilitator to ensure that the processes involved in the accountability framework between companies and their shareholders were properly (as laid down in the listing requirements) conducted. If the company chose not to fall in line with any specific requirement on the ground that complying would have jeopardised the competitive wealth-creating capacity of the company (which clearly will not be in the shareholders' interest), it was welcome to default so long as it publicly justified its actions (or inactions). If the shareholders did not agree with the company's decisions, they could punish the company by bringing down its stock prices, and in extreme cases resort to shareholder actions through courts or at members' meetings.

It is also possible to evaluate the comply or explain concept in a regulatory context from an ethical or libertarian viewpoint. The freedom granted to corporate boards and managements to deviate from the prescribed requirements is concurrently circumscribed by the requirement to "explain" to those affected by such decisions. It is not an unfettered licence to flout the regulation with impunity.

To be effective though, the markets must be sufficiently developed and enlightened enough to see through unworthy defaults and to inflict appropriate retribution. The European Corporate Governance Forum (2006)[13] highlights the preconditions that must exist for the success of this approach as follows. There should be a real obligation to comply or explain; a high level of transparency, with coherent and focused disclosures; and a way for shareholders to hold company boards (unitary or dual) accountable for their decisions to comply or explain and the quality of their disclosures.

A number of countries have embraced the comply or explain concept in varying degrees, including Canada and Australia, but the progress in Europe itself is somewhat slow. In India, the elements of the concept are present in the listing agreements which lay down non-mandatory best practices in addition to mandated requirements *but there is no obligation on the part of companies to publicly explain why they are not following them.* The most recent instance of such efforts on the part of the government was the voluntary National Guidelines On Corporate Governance (2009), again with no requirement for the companies to explain their non-adoption. The value of such initiatives is unlikely to be substantial; in any case, companies which believe in such good practices are likely to be following them, those not interested couldn't be bothered, and the rest are likely to view them as good practices that they would put into place at a convenient time since there were no obligations whatsoever either to implement or to explain why they were not followed.

How does the market react to non-compliance of requirements even in countries like the UK where the comply-or-explain principle has been in place? Recent research (MacNeil & Li, 2005) suggests that despite a substantial proportion of listed companies in the UK (around half the population in 2004) defaulting and in most cases "explaining", investors did not seem to be unduly concerned so long as their financial performance was good. The central point is that investors seem willing to accept a company's judgement as regards substance (the optimal governance structure) when times are good, but are less (or not) willing to accept it when financial performance is poor (i.e. there is reversion to process). This is all the more disturbing especially in a country like the UK where ownership is generally dispersed, and institutional investors (who reputedly should have the wherewithal to judge governance performance) predominate. One can only speculate what would be the approach of the non-promoter investors in a country like India with predominantly concentrated or dominant ownership and control patterns, further compounded by virtually passive institutional investors with substantial block holdings. If the pace and extent of compliance even with the mandated requirements ever since 2000 when listing agreements were modified to prescribe corporate governance provisions are any indication,[14] the prospects of any successful implementation of the comply or explain model must indeed be quite gloomy.

Multiple regulators

The third issue that impacts the successful operation of the chosen regulatory model concerns the apparently unavoidable presence of multiple regulators with overlapping jurisdictions, often engaging in turf wars among themselves.[15] As economies develop, often in a haphazard manner over decades, it is inevitable that an equally complex web of regulation and supervision gets built over time. Some segments of the economy, such as the financial sector, are more prone than others to the rigours of multiple regulations. Whenever regulations framed by one regulator are directly in conflict (or not fully in conformity) with the regulations of another, difficulties in satisfactory compliance can arise. No country is immune to this continuing phenomenon. Disparate models to address these issues have been tried out around the world with varying degrees of success, and this is indicative of the problems defying satisfactory resolution.

Even for entities operating in just one segment of business, problems can sometimes arise. For example, a listed company engaged only in the generation and distribution of electricity may have to comply with the regulatory regimes of not only legislation and regulation relating to the industry segment but also with the requirements of SEBI and the stock exchanges, besides those laid down in corporate legislation. The situation is similar in many other cases like banking, insurance, telecommunications, and so on. The complexities do not affect the companies alone, but the regulators as well. Often, especially in emergency situations, the regulators themselves find it hard to hammer out solutions and sometimes have to be arbitrated upon. Paulson (2010) highlights the excruciating and often frustrating confabulations between and among the various regulators and legislative institutions during the sub-prime crisis and the subsequent near-collapse of the financial system in the US in 2008. Besides the Treasury, the regulators involved included the Federal Reserve Board, the Securities and Exchange Commission, the Federal Reserve Bank of New York, and the Federal Housing Finance Agency. In addition, various House and Senate Committees on Finance, Banking, Housing and Urban Affairs, Financial Services, and so on were also involved. Given the overriding need to respect and accord with the independence of the regulators in the US, Paulson (2010) highlights the extreme caution and tact with which the efforts to coordinate the pre-emptive and corrective measures had to be tackled, even while maintaining utmost secrecy to ensure no price sensitive information was leaked out that may have major impact on the stock markets.

Longer term reforms proposed in the US (Paulson 2010, pp. 126–127) comprised three new regulators—a business conduct regulator solely focusing on consumer protection; a prudential regulator overseeing the safety and soundness of financial firms operating with explicit government guarantees or support such as banks; and an omnibus regulator (eventually the Federal Reserve) with wide ranging powers and authorities to deal with any situation threatening the country's financial stability. A separate regulator for government sponsored enterprises (such as Fanny Mae and Freddie Mac) was also to be set up operating under the Federal Reserve.[16] Shorter term measures included (among others) the merger of the Securities and Exchange Commission with the Commodity Futures Trading Commission.

While opting for a single or super regulator even on a business segment basis may look attractive at first sight, there are inherent problems associated with such concentration of power as well. Such a super regulator, if subjected to political intervention and pressures, may well impact the entire economy and the markets while a system of multiple sectoral regulators may be less prone to such wholesale abuse of power, besides of course bringing to bear upon their work the specialised knowledge and experience of their particular domain. And the experience of countries which had embarked upon a single financial regulator system does not offer any major comfort of success or protection against the kind of problems that gave rise to the 2008 global meltdown.

The UK, which had all along been cited as the prime example of successful single supervisor system country for its financial industry, has now formally decided to wind down and abolish the FSA in 2012, replacing it with three supervisory bodies—a Prudential Regulatory Authority created as a subsidiary of the central bank, a Financial Policy Committee at the bank, and a Consumer Protection and Markets Agency—and strengthening Bank of England's supervisory role.

In the Indian context where a Financial Stability Development Council has been proposed by the government, doubts have been expressed (Patil, 2010) as to the potential erosion of constituent regulators such as the Reserve Bank of India and the possibility of consequential dilution in their accountability.

Even as reservations on the institution of a single super regulator for the financial sector are voiced, its extension to include capital market regulations is a non-starter. Regulators and the regulated need to reconcile to such multiple-domain suzerainty and learn to consult, cooperate, and coexist in a harmonious manner such that while achieving their individual objectives, no unsolvable inconsistencies creep in, thereby placing the regulated entities under strain for compliance. As it is there is a strong interlocking of regulatory membership on boards and other decision making bodies; it may be worthwhile to develop practical conventions regarding which of the regulators in particular circumstances is the first among equals and defer to their wisdom and domain. Having laid down the domain objectives of the regulators, the government of the day should ensure that no political pressures are brought to bear upon the regulators in day to day implementation and interpretation of laid down policies and procedures. The time-tested method of diffusion of authority and a well-functioning system of checks and balances overseen by an independent judiciary is probably the best bet to ensure regulatory maturity, independence, and constraint.

The success of regulation depends on compliance, but firms obviously have strong short term incentives to avoid and even evade regulation, and to limit the application of regulatory rules that threaten their profits. The recalcitrant attitude of US banks and other financial firms towards regulatory initiatives, even after the 2008 financial crash and taxpayer funded bailouts[17] of unprecedented magnitude is a sharp reminder of this fact. Even as the oil spill from BP's leaking deep sea wells in the Gulf of Mexico threaten to become the worst environmental disaster in history, oil firms have begun strategising against possible future regulation.[18] Thus the preparedness of private firms to fulfil public responsibilities lags behind what might be desirable from a societal standpoint. The question is "Can corporate governance play a useful role in this regard, and if so, how?".

Corporate governance and regulation intersect because both are intended to influence the behaviour of corporate managers. During recent decades, there has been a great deal of debate in response to major corporate failures and scandals of the 1990s. These episodes have frequently been interpreted as evidence of the failure of corporate governance to exercise adequate internal oversight. In the US, important legislation (such as the Sarbanes-Oxley Act 2002) was enacted, and the Securities and Exchange Commission tightened up the rules in relation to listing requirements (Balasubramanian, 2010).[19] Global trends in corporate governance in recent decades have been strongly influenced by the US experience

(Sullivan, 2010). The main aim of corporate governance regulation has been to ensure the adequacy and integrity of corporate disclosure, so that shareholders and investors could make better decisions. Diagnoses of what went wrong in the corporate failures (like Enron or World Com) also highlighted the failure of "gate keepers" (auditors, analysts, and rating agencies). Hence, changes such as greater oversight of accounting firms, strengthening the audit committees of corporate board, and of internal controls (such as CEO certification of financial reports) were introduced. The underlying principles of these reforms are based on the "shareholder theory of the firm" (and a principal-agent relationship between the owners and managers), according to which managers must perform exclusively in the interests of shareholders. Although corporate capitalism especially in the US and the UK have been based on shareholder primacy right from inception, during the 1960s and 1970s the relative power of professional managers had increased markedly. Structural changes within capitalism contributed to this trend towards reassertion of shareholder rights in the late twentieth century. In particular, there was a rise in importance of the finance industry, accompanied by the increasing asset preference of households to hold savings in stocks and bonds. This gave a fillip to the growth of institutional investors such as pension and mutual funds. Powerful networks of investment and other bankers,[20] private equity executives and institutional investors were forged. A struggle ensued between shareholder groups wanting to exercise rights of ownership and the top managements seeking the professional right to manage. In this context, a more active market for corporate control emerged. At the same time, the compensation of senior executives became linked to the market valuation of the company's stocks. These trends were important in entrenching and advancing the principle that 'maximisation of shareholder value' was the primary role of management. This formulation constituted a compromise that was acceptable to shareholders as well as to the top management of firms. However, it did not address the larger issues concerning the relationship between the firms and other stakeholders, including society as a whole.

The 2008 financial crash and the environmental disaster in the Gulf of Mexico have dramatically highlighted this weakness. Not only has regulation failed, such events also show that corporate governance structures and processes cannot ensure that firms act more consistently in the larger public interest. In the pursuit of profits, shareholder value maximisation and executive compensation, firms have been taking high risks, particularly of a kind that affects not only shareholders but also other stakeholders. Companies which have become "too big to fail" because this can create massive financial or environmental disasters, assume high risk because they know that governments will step in to bail them out if things go wrong.[21] As shown by the 2008 sub-prime home mortgage crisis, the risk may be shifted not only to governments, but to other market participants to an extent that can have disastrous consequences for the financial system. Firms appear unwilling or unable to act in a manner consistent with their own long term interests, and indeed have endangered the health of the market system as a whole. Thus, a major lacuna exists with regard to systemic risk that present systems of oversight and incentives are not able to reduce sufficiently.

5. Finding the golden mean: To regulate or not to regulate?

The answer lies in a better alignment of self-regulation mechanisms with corporate governance. This would mutually reinforce their strengths and would provide a more sound institutional foundation for market systems. For this alignment to occur, two types of institutional changes are desirable. First, the paradigm of corporate governance should shift towards the *stakeholder model* from the shareholder model. Second, the design of regulation should shift towards a hybrid form that combines *self-regulation* with *co-regulation*. This implies a combination of self-regulation (which includes the participation of other non-governmental bodies) combined with the participation of the government particularly in enforcement (Balleisen, 2010). There should also be a change in *regulatory strategy.* It should move from "ex-post regulation" towards "ex-ante regulation". In other words, *pre-emption* and *prevention of bad outcomes* should get more attention rather than the punishment of bad behaviour by firms after it has occurred (although the latter is also important). The key challenge of regulatory design is to find the right balance.[22] A co-regulation model opens the possibility of a golden mean that would be able to pursue this objective more effectively because of its participatory character. These institutional elements are not new. Co-regulation models of regulatory design have been developed extensively in Australia. Stakeholder models of corporate governance have historically existed in continental Europe and Japan (the so-called "Coordinated Market Economies"), whereas the Anglo-American model of capitalism ("Liberal Market Economies") has tended towards the shareholder model (Hall & Soskice, 2001). In India, corporate governance initiatives have evolved in parallel with market reforms. A key objective has been to align financial markets with practices followed elsewhere, so that foreign institutional investors are better able to judge Indian companies.[23]

Self-regulation initiatives in the past have not been effective because many corporations have used them as "smokescreens" to deflect serious regulatory oversight (Balleisen, 2010). Corporations too often treat regulations cynically as constraints and irritants that have to be managed and overcome along the route to realising shareholder value maximisation. The outcome of such conduct has not been happy—the social standing and image of corporations in the advanced countries today is very low. The important question therefore is whether corporate governance can help change the short-sighted attitude and narrow mindset of corporations. Balasubramanian (2010) has proposed a stakeholder governance framework that recognizes the broader social context in which a firm functions and the related responsibilities of the firm. Corporate boards and executives are answerable to and/or guided by government legislation, market regulators, lenders and creditors, institutional investors, stock exchanges, shareholders/stakeholders, as well as the press and media. Balasubramanian (2010) has argued in favour of a re-orientation of corporate goals away from the narrow goal of *profit maximisation* toward *profit optimisation* through a process of building *corporate reputation*. Such a corporate vision would provide a stronger motivation for firms to define their relationship with the wider network of stakeholders. A strong reputation would better serve the long term interests of corporations. Drawing on stated corporate principles proposed by respected business conclaves and followed by some leading firms, Balasubramanian (2010) explains how firms could build their reputation on the following "pillars"—integrity, trust, ethics, social responsibility, philanthropy, transparency and communication, and citizenship.[24] If such principles are adopted widely and become accepted norms of corporate conduct, the world would be a better place and the task of regulation would certainly become much easier. The challenge lies in creating governance processes and systems that offer sufficient motivation and incentives for the firm's decision-makers to act responsively to wider stakeholder concerns.

Stakeholder-oriented reputation building values would make it easier to *align the internal governance of firms with regulatory governance.* In particular, the effectiveness of co-regulation would be enhanced. As noted earlier, different variants of nongovernmental regulation have been attempted in many countries. Nongovernmental regulation has several potential advantages. These include greater flexibility and precision because of the greater access to relevant knowledge of the particular business, greater coverage, better cooperation between regulators and regulated firms, and consequently a greater "buy-in" by the regulated firms. However, the experience has not always been successful. Private regulation works relatively well under certain conditions (Balleisen, 2010). These include situations in which firms within an industry have an economic interest in having regulation. The potential benefits may include reduction of economic uncertainty, efficiency increases through having common standards or by enhancing the ability of the industry to protect its reputation. Private regulation also works well when there is a high degree of heterogeneity among firms in the industry, so that universal standards are not feasible. In such cases, mechanisms that permit collaboration between managers and regulators are efficacious.

For private regulation to be effective, transparency and accountability are very important. In this context corporate governance systems can be highly supportive. The firms can, for example, collect data required for monitoring regulatory compliance, and disseminate them throughout the organisation, and the entire industry. Firms can strengthen internal regulatory systems in several ways. Formation of monitoring teams that include workers' representatives is a useful step in effective self-regulation. The clout of internal regulators within the corporate organisation needs to be enhanced. This can be done by allocating sufficient budgets for their information collection and monitoring functions, and by providing them direct access to topmost levels of management and boards of directors. Similarly, the achievement of regulatory goals by employees should be measured, and this should be part of their performance evaluation. Third party rule-making and monitoring can provide additional accountability and rigour to compliance. These third parties could be industry associations and well as public interest groups. Finally, the direct participation of government is needed to bolster the enforcement of regulatory rules.

An impressive body of analysis and experience has developed reflecting the renewed interest in co-regulation. Drawing on this, Balleisen (2010) has proposed a useful list of actions that government regulators could undertake within a "co-regulation" framework. Government regulators could (1) mandate appropriate reporting requirements for internal regulatory plans of firms, and ensure that non-state regulators carry out specific assessments; (2) publicise the regulatory performance of firms, thereby linking regulatory compliance with corporate reputations;[25] (3) create a professional body of nongovernmental regulators;[26] (4) enhance the capacity of government regulators to analyse and evaluate the impact of private regulatory governance;[27] (5) periodically inspect self-regulated firms in depth and ensure that standards are actually met; (6) ensure that certain "regulatory floors" are maintained, and that violators punished along a graded schedule in keeping with the extent of violation; (7) empower supplemental nongovernmental watchdogs to leverage greater expertise and information; and (8) maintain a credible threat that administrative regulation will follow if self-regulation fails.

To sum up these arguments, an effective co-regulation framework can be developed on the basis of the above principles which will provide an overarching framework of policy and credible incentives that support self-regulation. Thus the weaknesses of stand-alone self-regulation (that have rendered them ineffective in the past) could be avoided, and its useful features harnessed. In addition, this type of regulatory framework would be synergistic with stakeholder oriented corporate governance that aims at building a reputation for the firm.

Regulatory compliance depends on the willingness of the regulated firms to cooperate. We have proposed a particular institutional framework that combines corporate governance and regulation in a synergistic manner. These two institutions of governance—regulation in general and corporate governance (one a subset of the other)—in particular need to be considered together because they impinge on each other. The corporate governance model influences the firm's motivation and hence regulatory compliance. The dominant paradigm of shareholder-linked corporate governance is not very conducive to regulatory compliance due to its narrow concern. The adoption of a stakeholder model of corporate governance would be more amenable to generating internal incentives for regulatory cooperation, and hence compliance. In particular, the corporation's reputation building model as proposed by Balasubramanian (2010) has the potential for legitimising within the firm, a synergistic relationship between wealth creation and regulatory compliance, leading to improved investor trust and stakeholder approbation. On regulation *per se*, a hybrid model of regulation is best in this context. In particular, a model that combines nongovernmental regulation with governmental participation (co-regulation) would be the most effective, avoiding as it does the motivational pitfalls of pure self-regulation. Moreover, this regulatory framework would provide the institutional foundation for the seamless integration of corporate reputation-building plans with achieving the public goals identified by regulation. Firms, alongside other actors such as industry associations, citizen groups and professional societies, could develop appropriate regulatory rules within a transparent and accountable framework. The firm's internal processes for data collection and monitoring could be strengthened. Firms could ensure adequate incentives within the firm for regulatory compliance by linking relevant parameters to measures of employee performance. Government policy makers and regulators on their part could put in place a set of processes (mentioned above) for credible enforcement, including systems for rewarding firms based on their performance on selected indicators of regulatory compliance.

We have sketched very briefly the essential contours of a corporate governance cum regulatory framework. While not universally applicable, it has relevance in industries where there are problems of information asymmetry, technological complexity and rapidly changing business and technology conditions, and potential for high systemic risk. In these contexts, collaborative and participatory approaches allow for collectively developed, jointly monitored and pre-emptive (*ex-ante*) types of governance. The actual form of regulatory organisation and the mix of instruments and incentives would be context-specific and should emerge from a process of trial and experimentation.

References

Akerlof, G. A., & R. J. Shiller. (2009). *Animal spirits: How human psychology drives the economy and why it matters for global capitalism*. Princeton University Press.

Balasubramanian, N. (2010). *Corporate governance and stewardship: The emerging role and responsibilities of corporate boards and directors*. Tata McGraw-Hill.

Baldwin, R., & M. Cave. (1999). *Understanding regulation: Theory, strategy and practice*. Oxford University Press.

Balleisen, E. J. (2010). "The prospects for effective coregulation in the United States: A historian's view from the early twenty-first century". In E. J. Balleisen, & D. A. Moss (Eds.), *Governments and markets: Toward a new theory of regulation* (pp. 443–481). Cambridge University Press.

Bhattacharya, S., & U. R. Patel. (2005). "New regulatory institutions in India: White knights or Trojan horses?". In D. Kapur, & P. B. Mehta (Eds.), *Public Institutions in India* (pp. 406–456). Oxford University Press.

Braithwaite, J. (2008). *Regulatory capitalism: How it works, ideas for making it work better*. Edward Elgar.

Brandeis, L. D. (1995). *Other people's money and how bankers use it*. Bedford: St Martin. (Originally published in 1914).

Das, G. (2009). *The difficulty of being good: On the subtle art of dharma*. Penguin-Allen Lane.

Doniger, W. (2009), *The Hindus: An alternative history*. Penguin-Viking.

European Corporate Governance Forum. (2006). *Statement on the comply-or-explain principle*.

FRC. (2006). *The UK Approach to Corporate Governance*. Financial Reporting Council.

Ford, C. L. (2008). "New governance, compliance, and principles-based securities regulation". *American Business Law Journal*, 45(1), pp. 1–60.

Frick, F., & T. Ernst (Eds.). (2008). *International regulatory reform report 2008*. Verlag Bertelsmann Stiftung.

Friedman, M. (1982). *Capitalism and freedom*. University of Chicago Press.

Ganguli, K. M. (2000). *The Mahabharata of Krishna-Dwaipayana Vyasa*. Munshiram Manoharlal Publishers.

Goswami, O. (2010). "Corporate governance". In K. Basu, & A. Maertens (Eds.), *The Concise Oxford Companion to Economics in India*. Oxford University Press.

Hall, P.A., & D. Soskice (Eds.). (2001). *Varieties of capitalism: The institutional foundations of comparative advantage*. Oxford University Press.

Hayek, F.A. (1994). *The road to serfdom*. University of Chicago Press.

Herdman, R. K. (2002), Testimony concerning *The Roles of the SEC and the FASB in Establishing GAAP,* Before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, US Securities and Exchange Commission.

Kahn, A. E. (1995). *The Economics of regulation*. The MIT Press.

Kaplow, L. (1992). "Rules versus principles: An economic analysis". 42 *Duke L. J.*, 557, pp. 559–560.

Levi-Faur, D. (2008). *Foreword*. In J. Braithwaite (Ed.), *Regulatory Capitalism: How it Works, Ideas for Making it Work Better*. Edward Elgar.

Locke, J. (1690). *The second treatise on government*. Accessed on 25 August, 2010 (http://books.google.com).

Macneil, I., & X. Li. (2005). "Comply or explain: Market discipline and non-compliance with the combined code". University Of Glasgow.

McCraw, T. K. (1984). *Prophets of regulation.* The Belknap Press, Harvard University Press.

Mill, J. S. (1859). *On Liberty*. Accessed on 25 August, 2010 (www.forgottenbooks.org).

Monks, R. (2010). *Corporate governance: Past, present, & future*. Center for Corporate Governance and Financial Regulation, Harvard Law School.

Patil, R.H. (2010). "Financial sector reforms: Realities and myths". *Economic and Political Weekly* (8 May, 2010), 45(19), pp. 48–61.

Paulson, H. (2010). *On the brink*. London: Headline-Business Plus.

Rao, D. N., & S. Gupta. (2008). "Recent developments in the regulatory framework for the private sector in infrastructure". In *Trade policy, industrial performance and private sector development in India* (pp. 189–245), Asian Development Bank, Oxford University Press.

Rodrik, D. (2004). "Growth strategies". Harvard University. (A paper for *Handbook of Economic* Growth). Accessed on 25 August, 2010 (www.hks.harvard.edu/fs/drodrik/Research%20papers/GrowthStrategies.pdf).

Rosseau, J. J. (1762). *The social contract*. Accessed on 25 August, 2010 (http://books.google.com).

Sen, A. (2009). *The idea of justice*. Penguin-Allen Lane.

Sen, C., & A. Suraj. (2009). *The role of legal process in the redesign of government-business relations*. Working Paper Number 102, Stanford University Center for Democracy, Development and the Rule of Law.

Soros, G. (2008). *The new paradigm for financial markets: The credit crisis of 2008 and what it means*. Public Affairs-Perseus Books.

Soros, G. (2010). "The Human Uncertainty Principle". In *The Soros Lectures at the Central European University*. Public Affairs-Perseus Books.

Stiglitz, J. E. (2003). *The roaring nineties*. Penguin.

Stiglitz, J. E.(2002). *Globalization and its discontents*. W.W. Norton and Company.

Stiglitz, J..E. (2010). "Government failure vs. market failure: Principles of regulation". In E. J. Balleisen, & D. A. Moss (Eds.), *Governments and markets: Toward a new theory of regulation* (pp. 13–51). Cambridge University Press.

Sullivan, M. A. (2010). "What opportunity is knocking? Regulating corporate governance in the United States". In E. J. Balleisen, & D. A. Moss (Eds.), *Governments and markets: Toward a new theory of regulation* (pp. 335–362). Cambridge University Press.

Williamson, J. (2004). "The Washington Consensus as a policy prescription for development". (Lecture delivered at the World Bank on 13 January, 2004). Institution for International Economics. Accessed on 25 August, 2010 (http://www.piie.com/publications/papers/williamson0204.pdf).

Notes

[1] This massive epic dated at around 500 BCE documents the origins, conduct and consequences of a massive fratricidal war between two branches of the Bharata clan, and is a mine of good counsel and political stratagems which are of continuing value. For a secular and modern interpretation, see Doniger (2009) and Das (2009).

[2] See "Timeline: Sub-Prime Losses: How Did the Sub-Prime Crisis Unfold?", BBC News. Accessed on 25 august, 2010 (http://news.bbc.co.uk/1/hi/business/7096845.stm). Soros (2008) also sets out the detailed listing of events and interventions commencing on 6 August 2007.

[3] For a report on the current political activity concerning financial reform bill in the USA, see "Maul Street: Bit by bit, things worsen for the financial industry", The Economist, May 15-21, 2010, pp 84-85. Some of the proposals in the Senate legislation are "draconian", and include for example a ban on banks operating a derivatives swaps desk.

[4] The Washington Consensus (a term coined by J. Williamson) was not based on any formal accord; it was rather the intellectual distillation of a set of policy prescriptions for freeing markets from discretionary government intervention. The main elements of the Washington Consensus market liberalisation policy agenda were the following: fiscal discipline, reallocation of public expenditures towards areas where private markets typically failed (health, education, infrastructure), tax reform towards lower marginal direct rates and simplification of indirect taxes, liberalisation of interest rates, competitive exchange rates, liberalisation of international trade and foreign investment, privatisation, deregulation, and secure property rights (Rodrik, 2004; Williamson, 2004).

[5] See Friedman (1982) and Hayek (1994).

[6] In the former case, the price mechanism cannot allocate resources efficiently because it is difficult to exclude those who do not pay from consuming the public goods. Those who pay and those who do not pay for the good can derive the same benefit from its supply. Thus the incentive to reveal one's preference is distorted. In the latter case, private and social benefits and/or costs diverge. The market outcome based on the maximisation of private net benefits leads to either undersupply or oversupply of the good compared to the social optimum. The standard example of negative externality is when pollution occurs but the polluter does not bear the cost.

[7] However, the repeated failure of credit rating agencies and accounting audit firms in recent crises has shown that their effectiveness cannot be taken for granted. Poor judgement by these agencies needs to be prevented by regulation blocking relationships (between the rating agency and the firm being rated) when there is conflict of interest.

[8] The new regulatory institutions include the Securities and Exchange Board of India (SEBI), the Telecommunications Regulatory Authority of India (TRAI), the Insurance Regulatory and Development Authority (IRDA), the Central Electricity and Regulatory

Commission (CERC), the State Electricity Regulatory Commissions (SERCs), the Petroleum and Natural Gas Regulatory Board (PNGRB), and the Tariff Authority for Major Ports (TAMP).

[9] The Planning Commission's Approach Paper on Regulation spells out some of these design principles. (*Approach to Regulation of Infrastructure,* http://infrastructure.gov.in/pdf/approach_to_regulation_of_infrastructure.pdf).There should be a separation of functions between the regulator and other authorities (legislature, executive and judiciary), and market participants with regard to policy making, framing legislation, rule making and ownership of the enterprises. There should also be adequate democratic accountability for the regulator (to Parliament and to citizens). *The 13th Report of the Second Administrative Reforms Commission* has also made similar and more specific recommendations. Notable among them are the guidelines for improving the interface between the government and the regulator, and for greater transparency and involvement of citizen groups and professional organisations in regulation. They have also called for periodic regulatory impact assessments, and for parliamentary oversight and external review mechanisms to ensure that regulators are accountable.

[10] Stiglitz (2010) for example, states "There is peculiar variant of regulation that has become popular in the United States, self-regulation, which I view as an oxymoron" (p. 27). In the case of banks, they have proved ineffective.

[11] Ford (2008) draws upon Kaplow (1992).

[12] When the recommendations based on the 1992 Cadbury Report on the Financial Aspects of Corporate Governance were incorporated in the listing agreements between London Stock Exchange and the listed companies, a provision was inserted in the agreements stipulating that companies should report whether they had followed the recommendations, or if not explain why they had not done so; this eventually became known as the 'comply or explain' approach.

[13] The European Corporate Governance Forum was set up by the European Commission in October 2004 to examine best practices in Member States with a view to enhancing the convergence of national corporate governance codes and providing advice to the Commission.

[14] For example, several companies (including many state-owned enterprises) are still non-compliant with the mandates requiring induction of independent directors on their boards, and business lobbies successfully delayed the implementation of requirements based on the recommendations of the Narayana Murthy Committee.

[15] The stand-off in 2010 between the Securities and Exchange Board of India and the Insurance Regulation and Development Authority on jurisdictional domain over Unit-linked Insurance plans with significant equity content, issued by insurance companies is a case in point.

[16] These recommendations were made in a 31 March 2008 document titled, *Blueprint for a Modernized Financial Regulatory System,* brought out by the US Treasury. A Bill largely incorporating these recommendations was going through Congressional approval processes as of June 2010. A reconciled draft legislation incorporating consensus provisions of the earlier House and Senate versions was finalised in early July 2010 (Dodd-Frank Conference Report [H.R. 4173], 'Dodd-Frank Wall Street Reform and Consumer Protection Act), preparatory to the processes involved in its Presidential

approval. A fuller discussion of these recommendations and provisions is outside the scope of this paper.

[17] These actions were not widely supported by the American public. Paulson (2010, p. 234) counselled presidential candidate John McCain to refer to bailouts as "rescues" and "interventions" in his campaign speeches.

[18] See "Oil companies weigh strategies to fend off tougher regulations", New York Times (June 2, 2010). Accessed on 25 August, 2010 (http://www.nytimes.com/2010/06/03/us/03lobby.html).

[19] Balasubramanian (2010) also provides exhaustive references to the literature. Also see Goswami (2010) for a short narrative account of the Indian case.

[20] See Brandeis (1995) for a discussion of the earlier phase of their emergence. After the Great Depression however, the relative importance of the finance industry had declined as manufacturing drove the growth process for three decades. In the globalisation era post-1980, there has once again been a resurgence of the finance industry. The oil shocks of the 1970s triggered this process by bringing petrodollars into the multinational banks.

[21] This may not actually be the case as far as shareholders were concerned. For example, Paulson (2010, p. 170) asserts that "common shareholders had lost nearly everything" in the case of Fannie Mae and Freddie Mac, the two massive mortgage-infected, over-extended US Government Sponsored Corporations that were bailed out; and in case of BP, shareholders had to forego their dividends to enable the company to foot the $20 billion cleanup bill that the Obama administration had imposed ("BP agrees to $20 billion fund for gulf oil spill claims", Washington Post, (17 June, 2010)).

[22] Both types of regulatory strategies have their strengths and weaknesses. Too much of ex-post regulation can be intrusive and hinder dynamism, whereas too much of ex-ante regulation may be ineffective in containing systemic risk.

[23] The Confederation of Indian Industry has played a key proactive role, in cooperation with SEBI, and the Ministry of Corporate Affairs in promoting corporate governance reform.

[24] Balasubramanian (2010) refers to the Caux Round Table Principles, the Global Compact, the Sullivan Principles, the Tata Code of Business Conduct, as well as scriptural ethical principles (pp. 382–383).

[25] As Balleisen (2010) notes, such information would also be useful for insurance companies, and have an impact on the firm's insurance costs. This would be an additional pecuniary incentive for regulatory compliance.

[26] This has been done by the Australian Competition and Consumer Commission.

[27] Regulation must change with the changing context. It is essential for government regulators and policy makers to have the capacity to analyse the rapidly changing business and technology environments, so that adjustments in regulatory design can be made as required. It is possible that an industry that has been functioning under direct administrative regulation requires to be regulated through a co-regulation mechanism, and vice-versa.