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Modernisation of Indian stock exchanges: A regulatory perspective

Indian stock exchanges must undergo a substantial programme of regulatory reform if they are to keep pace with the country's fast-growing economy. Despite the efforts of regulators during the past few years to modernise the regulation of stock exchanges, a significant gap remains between what has so far been achieved and what is still required to enable these stock exchanges to truly support India's long-term economic goals.

In broad terms, the route to modernisation starts with demutualisation and effective governance and in some cases it can lead to listing. These issues require a delicate balance of judgments and actions from policy makers, regulators and entrepreneurs.

Although various stock exchanges operate in India, the National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE) are the two dominant market participants. An improvement in the competitive landscape in which Indian exchanges operate and an improvement in their performance can be facilitated with further reform of the rules for ownership, governance and listing.

In order for exchanges to contribute to the growth of Indian economy, regulators must put these three issues at the centre of a carefully-managed programme to modernise the regulation of India's stock exchanges.

Control of an exchange

Regulators have imposed tight restrictions on the ownership structures of Indian stock exchanges. These restrictions place a five per cent limit on the shareholding of a single shareholder. The regulatory rationale for limiting ownership is not a concept that is unique to India. The topic has been extensively debated across the world's leading markets as policymakers and regulators have tried to find the ideal ownership model for a stock exchange. Although a variety of approaches have been adopted by different countries, the ultimate aims of controlling ownership are common to all of them: stopping special interests gaining control of an exchange, and improving corporate governance to avoid issues such as conflicts of interests.

These same aims have also shaped India's approach. The intention behind the decision to place a five per cent limit on an investor's shareholding is to prevent a dominant shareholder or interest group from controlling an exchange and to ensure that the past dominance of exchanges by brokers did not continue after demutualisation.

By contrast, other countries have gradually relaxed the ownership

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restrictions of stock exchanges to encourage more competition and greater efficiency. In the US, the UK and Singapore, for example, an individual shareholder can hold up to 100% shareholding in a stock exchange, subject to prior approval by each country's respective regulator.

Despite a five per cent cap on an individual investor's shareholding, the position is slightly better for financial firms in India. If a financial firm is considered to be "fit and proper", it can increase its shareholding to a maximum of 15% so long as it receives prior approval from the Securities and Exchange Board of India (SEBI). A fit and proper person is expected to have a general reputation and record of fairness and integrity, including but not limited to financial integrity, good reputation and character and honesty. Further, the total foreign ownership of an Indian exchange cannot exceed 49%, with constituent sub-limits of 26% for foreign direct investment and 23% for investment by foreign institutional investors.

The Jalan Committee

SEBI set up a committee in January 2010 to review the ownership and governance of Indian stock exchanges in light of their evolving role as regulatory bodies that are also vested with commercial objectives. The committee, headed by Bimal Jalan, the former governor of the Reserve Bank of India, published its report in November 2010. Among its recommendations, the Jalan Committee called for the dispersed ownership of stock exchanges because of their vital economic and regulatory functions. However, the Jalan Committee also recommended loosening the shareholding limit for "anchor institutional investors" (AIIs), such as well capitalised banks and financial institutions, to allow them to hold, in total, up to 49% shareholding. In addition, the committee said a single AII's shareholding should be capped at 24%.

An interesting parallel to the Jalan Committee's recommendations can be found in the regulations that govern Indian commodity exchanges which permit a shareholder to hold up to 26% of the equity. One of the effects of these more liberal ownership rules has been to encourage strategic investment in commodity exchanges. There are currently five national exchanges in India and another three new exchanges have been granted operating licences.

Although loosening the ownership limit for AIIs would be a welcome move, the recommendation that only well

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capitalised banks and financial institutions be considered as anchor investors may not be the ideal solution.

The central issue that needs to be considered is how an exchange's operations can be made more transparent in relation to its functions. Perhaps the regulatory function of a stock exchange could be housed within SEBI, or in a separate self-regulatory authority, thereby enhancing the economic role of the exchange and reducing the regulatory role in nature. Such a change could pave the way for equity in these exchanges to be held by entities that wish to see the exchanges operate as commercial businesses. Separating the regulatory and economic functions of exchanges could also make it possible for foreign exchanges to be allowed to take a controlling stake. As the recent spate of cross-border acquisitions, mergers and consolidations of exchanges has illustrated, the business of stock exchanges is no longer country specific. If the five per cent limit on ownership is not relaxed, India may miss the wave of stock exchange mergers that are leading to the formation of global and regional stock exchanges.

Listing

At present, none of the stock exchanges in India are listed. SEBI has only recently given permission to the Multi Commodities Exchange (MCX) to undertake an initial public offering. When MCS completes this transaction, it will become the first exchange to be listed in India. However, MCX is unlikely to provide an effective template for India's other stock exchanges that may want to be publicly traded as the structure of promoter-run MCX is very different to the exchanges that have been created through demutualisation.

A more significant barrier is the Jalan Committee's recommendation that stock exchanges in India should not be listed. The committee noted in its report that listing would usher in more conflicts of interest for the stock exchanges in relation to their commercial and regulatory responsibilities as they would have to monitor their own listing-related compliances as well as those of related or competing stock exchanges.

Safeguarding the reputation of the exchanges is another issue highlighted by the Jalan Committee. According to the report, stock exchanges should not become a vehicle for attracting speculative investments. As stock exchanges are public institutions, any downward movement of their share prices might lead to a loss of credibility and might have a detrimental effect on the market as a whole. Separating out the regulatory function of the exchanges would reduce the perceived or real conflicts that might arise with self-listing.

Despite these concerns, the self-listing of exchanges is a widely accepted practice in many countries. In a self-listing scenario, a self-regulating organisation (SRO), such as an exchange, has to assess whether it meets its own listing requirements. It also has to monitor the trading in its own stock and has to decide whether there is any reason for it to review or investigate this trading activity. As a result, there is potential for conflict between the SRO's self-interest and its self-regulation mechanism. In order to avoid such a conflict, stock exchanges in some other countries have transferred their self-regulation mechanism to a third party such as the market regulator. The Australian Stock Exchange and London Stock Exchange, which are two self-listed exchanges, have ceded the authority to supervise their own

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compliance with the listing rules to the Australian Securities and Investment Commission and the Financial Services Authority respectively.

Cross-listing, on the other hand, seeks to resolve any conflict of interest arising out of self-listing, by diversifying the investor base of listed stock exchanges and avoiding any scope for price manipulation. However, one of the consequences of cross-listing is that sufficient commercial freedom is taken away from the stock exchange for it to be able to operate efficiently. Rival exchanges and severity of competition among them may result in conflicts. This may be particularly true in India where the exchanges are effectively competing in the same geography and looking to increase revenue and market share from the same sources. On balance, it seems prudent not to make cross-listing mandatory. Instead, proper supervisory arrangement by SEBI should be put in place for self-listing which would match similar arrangements in other countries.

Governance of stock exchanges

Prior to demutualisation, strong broker control over exchanges had led to the protection of the rights of the brokers over those of the investors. In order to resolve this conflict, demutualisation segregated ownership, trading and managerial rights of exchanges. Further, corporatisation of stock exchanges has improved the standards of governance by making them more transparent and reliable. However, this new ownership structure has failed to eliminate the continuing dominance of trading members as well as undue influence of dominant shareholders.

These types of problems have been tackled in other markets by allowing stock exchanges to list. Listing diversifies ownership of the stock exchange and reduces the dominance of trading members. It also enhances the governance standards of the stock exchanges.

In a similar way to India, other countries have imposed criteria to define “fit and proper” and introduced regulatory notification and/or public disclosure requirements when shareholding exceeds certain thresholds. For instance, in the UK, while there is no ceiling on the percentage of shareholding that a single shareholder can own in a stock exchange, a controlling shareholder must be “fit and proper”, and acquisition beyond three per cent shareholding requires the acquirer to make disclosures. In Singapore, a person shall notify and obtain the approval of the regulator before acquiring five per cent or more of the voting shares in an exchange. A person must also obtain prior approval from the regulator before becoming a 12% controller or a 20% controller of the stock exchange.

In the case of India, not more than 25% of the board of directors of a stock exchange can be composed of trading member directors, and at least 25% of the board has to be made up of public interest directors (or independent directors) and the balance should consist of shareholder directors.

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Listing would force Indian stock exchanges to comply with the corporate governance requirements that apply to all companies that are admitted to trade on the exchanges. The requirements for composition of committees, reporting, independent directors and disclosures by a listed company in India are particularly stringent and would help the stock exchanges to tackle conflict issues.

Conclusion

The Indian stock market cannot survive in isolation. At a time when stock exchanges around the world are merging with one another to form global and regional stock exchanges, India runs the risk of being left behind if the stringent ownership norms are not relaxed and the path to listing for these exchanges are not properly explored and opened up.

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