Role of Stock Exchange as an SRO

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India takes pride in having a long history of capital market with Exchanges over 100 years old. We also boasts of fairly well spread equity cult with 23 Stock Exchanges and Brokers penetrated in all the important cities across the Country. Further, we also take pride in having a market which is well developed and comparable to any other market in the world. Until 1994 all these Exchanges were treasured as nodal centers for development as they were the most important institution in the city of their location and they caused primary, secondary and tertiary development in that city and the state where they were located. Thereafter, while the Exchanges went online and there was greater transparency in trading, we still saw tremendous problems in paper related matters and also in the price formation.

Thus, we have seen that while technology and dematerialisation has brought in transparency into the system, it has also created various other risks. We can only conclude that risks will keep changing with changing environment and the Exchanges have to constantly keep changing its regulatory environment to manage these risks. The skewed trading statistics of Exchanges given below indicate the problem of smaller Exchanges and most of these Intermediaries are selling products and services of the two large Exchanges and, thereby, bringing in new regulatory risks.

Total Turnover and Market Share

Stock Exchange	2000-01		1999-00		1998-1999	1997-1998
	Rs. Crore	%	Rs. Crore	%	%	%
NSE	1339510.90	46.49	839052	40.59	40.49	40.71
Mumbai	1000031.55	34.71	685028	33.14	30.49	22.82
Calcutta	355035.35	12.32	357166	17.28	16.79	19.67
Delhi	83871.12	2.91	93289	4.51	5.06	7.47
ISE Exchanges*	42209.98	1.47	45255	2.20	3.53	4.98
Ahemedabad	54035.20	1.88	37565.61	1.82	2.91	3.39
Pune	6170.53	0.21	6086.81	0.29	0.73	0.95
OTCEI	125.90	0.01	3587.91	0.17	0.01	0.01
All India Value	2880990.53	100	2067030.56	100	100	100
All India % age	100	100	100	100	100	100

*** 15 Stock Exchanges that have promoted ISE.**

The turnover of last financial year 2001-02 would be even more disturbing as the two other large Exchanges of Calcutta and Delhi have also been reporting negligible turnover in the last year. While the Stock Exchange were not having any trading on their Exchange they continue to have regulatory responsibility of ensuring all compliance by the Companies, Brokers, Investors, Disputes resolution, reporting to SEBI, implementing all SEBI decisions, etc.

In such a dynamic environment, while the Exchanges carry out most of the regulatory function based on the directions of Securities and Exchange Board of India (SEBI), there are a host of function that they implement on their own as they guarantees the performance of a Trade. Therefore, based on its judgement and past track record of trading and settlement, the Stock Exchange take various risk management and regulatory decisions for the operations of a Exchange over and above those specified by SEBI. The, key responsibilities of a Stock Exchange as a Self Regulatory Organsiation (SRO) in a dynamic and modern capital market are indicated below;

Role of a Stock Exchanges as a SRO :

Exchanges have a multiple role to play in the current capital market regulatory scenario and some of the major ones are listed below;

1. Ensure efficient and fair price discovery process.
2. Implement the regulatory framework of SEBI for primary and secondary market.
3. Regulate companies in the primary and secondary market.
4. Regulate Broking intermediaries in the primary and secondary market.
5. Maintain market integrity, safety and fairness.
6. Ensure investor protection and education in primary and secondary market.
7. Ensure continuous compliance by the companies and Brokers.
8. Continue to be the industry body to fulfill the needs of the investors and intermediaries directly or through the Regulator.
9. Maintain efficient infrastructure with provision for all contingencies.
10. Inspection and Investigation of Brokers and Sub-brokers.
11. Prevent price manipulation and unfair trade practices.

These tasks become more onerous with diminishing number of Exchanges and increasing penetration of brokers across the country and multiple nature of relationship between Broker, Client and Sub-brokers. Besides, the cost of regulation is increasing with increasing regulation in the market and its widespread distribution. Apart from the fact that the volume of business has risen, better level of investor awareness on account of greater investor education and better delivery of investors protection services, the quantum of complaints, legal actions and arbitration cases have actually increased over the recent years. We expect some more changes to take place in the forthcoming period when the role of the Stock Exchange as an SRO would become further demanding due to following factors;

Changes expected and their impact on the Role of Stock Exchanges as a SRO :

We are now gradually heading towards an era of fewer Exchanges from the existing system of multiple Exchanges. It may be interesting to watch the impact of competition on issues, like, investor protection and self regulation. The debate about investor protection and self regulation would get further heated amidst the debate on demutualisation of Exchanges wherein it is being proposed that the members of the Exchanges and others could be shareholders in an Exchange and the Exchanges would be run for profit like any other commercial organisation so that it can raise resources for its infrastructure whenever needed. The argument put forward in favour of such demutualisation is that the regulatory and statutory function of the Exchange would be insulated into a separate body or department which would be independent. However, we will need to see such environment in which the profit motives of the Exchange would not conflict with the regulatory and investor protection related function of an Exchange.

Today, despite most exchanges being run as a charitable institution without the problem of tax liability, still possibly no Exchange is spending 20% of its listing income on Investor Services as desired by the circular of Ministry of Finance. Thus, to expect such expenditure as a SRO in an era of profit maximisation could be a tall order to achieve. However, having said this, it may be proper to also state that in an era of reduced competition from consolidation of Exchanges and greater regulation, it may not be easy for any Exchange to overlook their regulatory responsibility as the consequences of any lapse could be very serious for their image, continuation, credibility and resources.

Based on the current environment, reality of resource constraints with Exchanges to modernise and upgrade, need for the Exchanges to be better managed, etc, it appears that there would be tremendous pressure on the Exchanges to manage its resources and simultaneously to also deliver objective of self regulation to abide by the regulatory standards set before it by SEBI. However, it is expected that role of Stock Exchanges as a SRO would not be a non-starter as the current regulatory framework puts enormous pressure on the Management to run the Exchanges professionally and transparently as a system driven Exchange rather than as a closely held institution and this would only get further strengthened in an era of demutualisation.

Some of the major changes expected in the near future and their impact on the functioning of a Stock Exchange as an SRO are as follows;

1. **Professionalisation of Industry :**
   The industry would gradually become more professional with mandatory certification exams, registration requirements, risk management procedures, value added service demanded by clients, expansion of the product profile and shift in focus from trade execution to product creation and advisory services. Changes in the regulatory environment may act as a catalyst to expedite this process further. This would entail greater self regulation by the Exchanges to meet the industry requirement rapidly and not to expect every step to be carved out through a SEBI regulation. It is expected that the Exchange may automatically start putting in place a self regulatory regime around the basic SEBI regulations to make the system deliver at the same pace at which the system is used by an end user for trading or for completing his or her settlement and margin liabilities.

2. **Greater use of technology :**
   The Intermediaries are expected to use more and more technology for trade execution through internet, straight through processing across trading and post trading support institutions, online risk management, regulatory compliance, information dissemination, etc. The greater the technology usage, the more would be the expectation of the end users with respect to transparency, information requirement and the Exchanges would have to gear up to meet the changing environment of disputes and regulatory non-compliance. The Exchanges as an SRO will have to also shift their compliance required from the manual system to automated system to keep pace with the changes, to meet the expectations of Regulators and to take proactive measures.

3. **Changes expected in Products and Services:**
   Currently, most of the Brokers only provide automated order execution facility to the investors. Their focus is towards convenience in order execution and, therefore, people are depending more and more on the multi-terminal and multi-location Offices. The next level of growth would be from internet trading and from entities like, ICICI Direct who can cross subsidise the order execution and get more revenue

through value added services. Besides, there would also be portfolio Management services, advisory services, etc. Such complexities would throw open new challenges in protecting investors and also regulating the market. The Government Debt Market is still required to be made available to the retail investors in India whereas, the derivatives market has been just introduced in India. The derivatives and the debt market collectively account for four times of the total business in the cash market in equities. These are expected to throw up new challenges for the Stock Exchanges as an SRO and we still would be required to undergo a learning period before we can master the risks emerging from these markets and multiple regulators.

4. **Competition in the Industry :**

We expect that the industry would get extremely competitive and, therefore, on one hand the Brokers would be under pressure to keep cost low and simultaneously the regulatory pressure would require them to comply with a host of compliance. In case the Exchange supervision is not done appropriately then there could be chances of Brokers not doing the compliance properly and, therefore, disputes or possible problems emerging later which may impact the sanctity of the market. Therefore, the Exchanges as SRO would have to be more attentive to the performance of the Brokers to prevent problems surfacing collectively.

5. **Recent events and the changes expected in the regulatory system for greater investor protection :**

Considering the recent episodes that have happened in the capital market during the last 10 years in general and the last three years in particular, it appears that the law makers would focus on enforcement and exemplary disciplinary or punitive action. The focus would shift towards creating an environment conducive for investor protection and in improving their confidence in the system. It is expected that in such an environment, the Stock Exchanges would have to take lot of precaution to protect the investors and to take timely action.

The Government has already established a Investor protection Fund under the Department of Company Affairs and it shows the seriousness of the Government to look into the interest of the small investors. We are for the first time witnessing a scenario where the Government is appreciating the need for better governance of capital market as they are now realising that they are both, directly and indirectly getting affected if the market suffers due to any risk. Similarly, Exchanges apart from guaranteeing trades though a Trade Guarantee Fund, are also protect investors through an investor protection fund. Thus, the pressure on an Exchange to Guard the use of its own funds is immense which induces it to take all remedial and preventive measures to stem any chance of usage of these funds.

6. **Management Issues :**

Exchanges, until recently, were governed by Board headed by Members Directors who were also involved in routine activities. The Public Representatives, generally not very conversant with the market intricacies, dealt with policy issues only in a Board Meeting as against the regular presence of the elected directors after and during trading hours. Therefore, decision making in an Exchange, was largely member dependent and also varied with change in office bearers which indicated its short term nature. Thus, shifting from Mutual Bodies to Demutualised Exchanges should induce long term planning, investors centric services, reasonable profits for capital investments, realistic pricing of services, resource generation through multiple means, better risk management and independent surveillance. However, it would depend on the Management Structure and Operational System created for routine operations of an Exchange. Such an environment would cast a lot of responsibility on the on the Exchange as a SRO which could be performed satisfactorily by an Exchange only with good professionals and high degree of automation and supplemented with an operations audit on a continuous basis.

7. **Promoters conflict as investors :**

Internationally, Stock Exchange public offerings are normally subscribed by individuals and organsiations directly or indirectly interested in Stock Exchanges. However, the ownership by Traders and private sector also appears to be in conflict due to the objective of profit maximisation. Since, we have to achieve both the benefits of demutualisation, i.e., additional resources and independent and professional corporate governance simultaneously, it will depend largely on the regulatory structure which would fix the accountability of each entity.

8. **Corporate Governance :**

The listing agreement has been the tool with the Stock Exchanges to regulate companies for adequate disclosure and investor protection. With the continuous changes that have been done in the listing agreement over the period of last few years, it has become a very effective tool for regulating companies. One of the most significant changes in the recent times has been the clause on Corporate Governance and disclosures which have further strengthened the listing agreement. While these compliance are normally done by the well capitalised companies, ensuring the same across 10,000 listed companies is a task. We need greater use of technology and automated compliance for better monitoring and information dissemination. SEBI's launching of EDIFAR will go a long way in achieving the same. It is expected that by the end of next financial year all important companies would be in this mode of compliance. Considering the extent of misreporting, rumours, price maniupulation that takes place in the market, it is important to achieve this objective at the earliest to quell an early signal of market manipulation.

9. Price Manipulation :

One single factor that has always affected the sanctity of the market has been price manipulation which has caused a cascading impact on the entire market and the market sentiment with global ramification. The Exchange surveillance systems have been strengthened over years and it is now not easy to overlook any price manipulation. However, the only thing that could go wrong is the management's will to initiate action and for this demutualised management structure may provide the appropriate climate for taking necessary measures to protect the sanctity of the market. This is one area where Exchanges will have to work with focussed attention at all times.

10. Investor Protection and Education :

The efforts put in by the Exchange in managing the affairs of the Exchange as a SRO are judged by the extent of investor protection that is available to an investor. While there is no barometer to judge the investor protection by a given number but some of the yard sticks are extent of compliant received and resolved, arbitration handled and resolved, investor awareness meetings conducted, literature distributed and the perceptible demonstration of the fear of an Exchange in the minds of the Members, Sub-brokers and the Companies. etc. This would be the cornerstone of the entire function of the Exchange as an SRO.

11. Inspection and Investigation :

While all Exchanges are required to inspect about 10 per cent of their active Brokers each year, the post inspection scrutiny does not merit much attention as it is considered as a compliance of a number. Besides, the Exchanges also conduct special investigation of Brokers when there is concentration of trading done by them in any scrip or when they are involved in price manipulation or on account of any rumours. This area is now gaining importance as an early warning system for preventing potential defaults.

Until now the business of the conventional Exchanges was almost secured and any regulatory decision was never evaluated from the dimension of its impact on the share value of the Exchanges or the profitability or turnover of the Exchange. In the context of the current debate, if the shareholders in a demutualised Exchanges are also private shareholders of the Exchange then there is a possibility of slackness in regulatory action due to the fear of its impact on the business and profitability. Besides, mandatory services, like , investor protection, investor services, etc. may need to be protected in an environment of profit maximisation. It may, therefore, be necessary to identify all routine and exceptional situations which may require action or investigation, a detailed operational guidelines would have to be given to the Exchanges to prevent any lapse due to lack of clarity or conflict of interest. Besides, the Exchanges would have to do a tight rope walk of preventing unnecessary regulatory fear amongst the investors, Brokers and Companies on one hand and simultaneously ensuring that the sanctity of the system is not distorted due to any irresponsible Brokers, Investor or Company.

It may, therefore, be concluded that with all the changes taking place in the market, the dimensions of risk and regulatory compliance are getting complex and managing them would mean large resources, professional staff, technology infrastructure and transparent regulatory framework. In such a scenario, SEBI would only specify the essential minimum regulatory framework whereas the Exchange would have to ensure the infrastructure and compliance. This would be in the interest of all the stakeholders in the market.

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