Emerging Role of Stock Exchanges in Investor Protection

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This is an opportune time for this article when the country is facing most serious crisis of confidence in the capital market. Indian Market saw a transition from the low volume high paperwork environment until mid 1990's to a high volume paperless environment by the year 2000. During the last decade, the Indian markets saw more change than they ever saw since the market came under the purview of Securities Contracts (Regulations) Act, 1956. These regulations made the Indian Capital Market look like any other international market in terms of the infrastructure, trading and settlement system and regulations. However, the era of high regulation and rapid changes during the last decade has left a grim scenario in the capital market in the beginning of the new millennium. Therefore, it makes people wonder whether the objective of regulations have been beneficial or detrimental for the market and there are more takers for the latter.

The existing scenario indicates the sensitivity of the Government to the capital market. Out of 24 Exchanges in the country almost 15 -18 have reached a stage of closure. Out of 10,000 registered brokers less than 2000 operate directly on Exchanges as Brokers and others have either gone out of industry or started operating as a sub-broker. Out of 10,000 listed companies less than 100 companies account for almost 99 per cent of trading and over 9000 companies may not have been traded even once during the last year while many of them may have already closed down with no trace of their management or plant. The trading volume has now plummeted from over Rs. 15000 crore per day to about Rs. 2500 crore per day across Exchanges of which almost 95 per cent is accounted by NSE and BSE. The cost structure of Exchanges and intermediaries due to high degree of technology and compliance is very high and it may be economically feasible business for a Trader only at a high turnover and not at the present turnover. It is reported that since July 2, 2001 request has been made by more than 1000 users to deactivate their terminals. The market has fallen from a peak SENSEX of almost 6000 last year to less than 3500 now. While the optimists are saying its too early to judge, the pessimists are taking recourse in a different industry or a different form in the same industry.

The pain of this change has been felt most by the investors and equally by the intermediaries, issuers, Exchanges and others associated with the capital market. In this scenario, the Exchanges have a meaningful role to play in keeping the sanctity of the market and in providing early warning signals to the regulator for taking corrective actions whenever the market sanctity appears to be in danger. This will ensure that minor timely corrections would not result in a major catastrophic scam. Some of these measures can be directly implemented by any Exchange and in others the Exchanges should be assisting the regulator and the Government in creating the right climate for preserving the confidence of the investors.

The objective of the Securities Contracts (Regulations) Act, 1956 (SC(R)A) and the Securities and Exchange Board of Inida Act 1992 (SEBI Act) primarily is to protect the interest of the investors and development of the market through regulations. Until the SEBI Act came into effect, most of the investor protection system was primarily centralised with the Stock Exchanges. It would therefore be appropriate to evaluate all regulations against a common litmus test of whether or not it has investor protection and development of the market as its main focus. Stock Exchange could be re-strengthened to fulfill their regulatory responsibility of improving the investor protection system through monetary penalties and regulatory force.

The Broader purpose of both these acts was to make the market meet the needs of various users transparently by keeping the integrity of the market intact. In case this is done then investor protection is achieved by and large automatically. The Investor Protection desired by an investor may broadly include the following, efficient access into the market for dealing in securities, having intermediaries who are transparent and well regulated to protect the interest of clients, availability of facility for cross verification of the credentials of intermediaries and services available to the investors from them, recourse for quick redressal of grievances, timely support, scheduled performance of the post trade commitments, availability of information on companies in a timely manner, announcements from Exchanges on any possible price manipulation or circular trading during unexplained volatility, validation of volatility in stock prices from the companies, enquiry of the intermediary and the

company in case of any suspicion on price manipulation. Today, even the regulator is expressing a need for greater power to regulate the companies and intermediaries. If this is the need of the regulator and if we expect that the Exchanges should be the extended arms of the regulator then there is a greater need to harmonise the relationship and power of Exchanges and the regulator.

Taking into account specifically the present state of the capital market, the problems of the investors in such a market include, lack of liquidity in large number of companies, unchecked and blatant use of system by the intermediaries, no recourse to an investor for any credit risk, no centralised place to easily know the rights of an investor and the remedies available to him under the current framework, Exchanges do not identify non-compliance by a broker during routine operations, high pricing of IPO's with no protection in the secondary market, price manipulation by companies and intermediaries creating a false market to attract investors and creation of a false market by making announcements in media on the improved functioning of the company which are un-substantiated. With the level of information available to us today on the trading pattern during the last one year, we are sure that an early enquiry of Brokers with concentration of business could have reduced the damage to the market.

This could be the proactive role played by an Exchange in maintaining the sanctity of the market. Normally the Exchanges do not check the books of the brokers and inspect their clients until SEBI directs it to do so. The routine inspection of ten per cent of the active members looks at statutory compliance and not at price manipulation, etc.,. The Exchanges consider completion of settlement safely as a sufficient condition and the tool available to secure the completion of settlement is adequate collection of margin and proper surveillance. We have seen that some Exchanges even failed to collect adequate margins despite such strict regulations and thereby put the entire market to risk. However, I think that the Exchanges have the expertise to monitor the market and all they would require would be a directive of standing instruction to investigate every major price volatility for members with concentration of volume and this investigation should be done at client and company level. We have to understand that along with completing the settlement schedules in time, we have to also maintain the confidence of the investor so that he perceives that the market is fair and true representation of the fundamental state of the economy and also as collective sentiment of all the investors devoid of any manipulation. If the investors doubt the integrity of the market then they will take time to react to the improved market movements quickly. We therefore saw that between December 1994 to December 1998, the SENSEX moved between the range of 3300 and 3800 with occasional peaks of 4000 and bottoms of 2800.

During the last five years, the Exchanges have managed to create a system for handling situations of default through good margining systems and creation of large Settlement Guarantee Funds. This fund and margining system has managed the worst crisis of default in most Exchanges during the recent meltdown in the market. Today this problem may not arise in a rolling settlement as the risk is frozen each day and theoretically the worst case would mean failure on any day would mean couple of days of additional risk. Besides, SEBI has insisted that margin money should be collected through direct debit into the Brokers account in a Bank instead of a Cheque. The Clearing and the settlement system in the market has improved significantly since demat trading has been introduced and we expects that the Exchanges would not face any problem on this front. With the introduction of the system of direct credit of deliveries into the clients account on a pay out, we have further safeguarded the investors.

The Settlement Guarantee Funds steps in when there is a default of a Broker so that the counter party of the brokers is not made to suffer as they are insulated from the risk of completion of settlement. However, there is a risk carried by the investors of a broker who defaults. In this case though the settlement goes through but the investors of the defaulting Brokers are not secured and they have to take recourse under the Investor Protection Fund. The maximum coverage under this funds varies from Exchange to Exchange with BSE having a coverage of Rs. 10 Lakhs, NSE having a coverage of Rs. 5 lakhs and other Exchanges having a coverage ranging between Rs. 50,000/= to Rs. 2.5 lakhs. Now with most Exchange Brokers trading on NSE or BSE directly or indirectly, the coverage of their client goes further down as the trades would not be covered directly by NSE or BSE until their intermediary is not declared defaulter which would be the subsidiary of a Exchange. The Investor Protection Fund of the local Exchange would not be available technically for meeting any default by the client of the broker of any regional Exchange trading indirectly on NSE or BSE. Besides, the remedy under this scheme comes with a considerable lag as it is difficult to identify the authenticity of the claim and due to sheer inertia of Exchanges in releasing funds for such claims. The claim would still get handled on National Level Exchanges due to greater standards of corporate governance adopted by large and National Level Exchanges but it may not be the case in smaller regional Exchanges.

In the USA, besides the existence of Clearing Corporation which secures the settlement, all clients also have recourse to an additional protection under the Securities Investor Protection Corporation (SIPC)

wherein all client are protected to the extent of US $ 500,000 in securities including US$ 100,000 for cash dealings, if any broker were to default. This agency has a blanket line of credit to the extent of US$ 1 billion from the US Government for any contingency. Despite such safety cover, the total money used from this agency during a 30 year period, i.e., 1970 to 2000, was US$ 3.8 billion in cash and securities of which US$ 3.5 billion came from debtors estates and only US$ 257 million came from SIPC own Funds. During these 30 years a total of 440,000 claims were satisfied and only 291 claims were more than the entitlement amount. This speaks volumes about the commitment of the Government in USA to protect the investors in the worst case of defaults. In India while DIGC protects depositors to the extent of Rs. 100,000 in the banking system but nothing like this exists today in the capital market. The Department of Company Affairs, Government of India, is trying to create a similar Fund in India out of the unclaimed dividend proceeds lying with the Government but it has to still be formulated and established. The Indian Government always kept a hands off approach from the capital market until it was forced to use the market for itself during the disinvestment and only then it realised the need for a vibrant market. Still this realisation is far too less than the requirement of the day and it is time that the Government stops distancing itself from the market and does not consider such hands off approach as a virtue.

Investor Services and Investor Education is another area where our Country has not been able to achieve much. While SEBI and the Ministry of Finance circular provides that the Exchanges should set aside 20 per cent of their listing income towards investor services which may be in the nature of investors education or investor information, few Exchanges are spending money of this nature and in the specified quantum. There seems to be no desire on the part of most Exchanges to build their image, educate investors and carry out these obligations. These may now happen with competition but the financial condition of Exchanges may not permit them. In the US, the SEC has established a very good system of corporate database apart from the Exchange database and a similar beginning is now being made in India by SEBI. These services will enhance equity culture in our Country. The investing population in developed countries is roughly 50 per cent of the total population whereas in India it is merely 10 per cent.

Information dissemination is the prime responsibility of the Exchanges and the company are bound by virtue of the listing agreement to provide information to the Exchanges. However, we see that once the Companies are listed on the Exchanges, they enjoyed all perks of listing irrespective of their performance. Since listing of securities bestows so much of rights on a company to borrow capital, the Exchanges could be more serious of continued compliance to see that there is a disinsentive for the company to under perform and still enjoy the benefit of a listed company. The companies went unnoticed for long and large number of companies have just disappeared now after the public issue and no regulator could do anything for such companies. Such a dormant regulatory environment does not discourage the under performers. Exchanges should have greater focus on the history of the promoters and should insist on highlighting all the risk factors when the offer document is approved by them. apart from the disclosures already made by the merchant bankers. If required, a public advertisements could be issued seeking complaints against the promoters before the issue is approved to protect the investors proactively. Since most of risk of the company impacts the Exchanges in the secondary market, they should be most watchful of the correctness of an issue.

Investor grievances which are a barometer of the safety and protection available to the market has never been taken seriously by the Exchanges or by the Regulator. The person who is the cause of action understands that the system is not geared to or committed to pursue the matter to its logical end. Thus we see that the culture of letters and reminders in Exchanges without any consequent actions. If consequent action in the nature of suspension or monetary fine followed by suspension was initiated then the company and the members would be serious about settling any dispute. The new arbitration system has now improved as against the earlier system of unending and prolonged dispute redressal system. The statutory committees also have become more decisive with the dominance of the Public Representatives on these committees which has been a good change.

There have been instances recently wherein the clients have been subjected to a credit risk of a broker wherein the brokers have failed to return the badla finance money given by a client as it has been used for some other purpose. Such defaults in paying up such money is not covered under the normal protection as there is a likelihood of the client not having a contract to support these transactions of badla finance. However, it is a clear case of financial weakness of a member. In the securities industry any complaint of this nature should be taken seriously as this could be the first sign of the financial weakness of a Broker and also of the system in general, if the complaints are large. It is time that the Indian Capital market starts looking at the causes and effect as early as possible to protect the sanctity of the market. We cannot have a market shock every two years due to some scam or misuse of the system. Market sanctity is not established easily and therefore anyone responsible for distorting the market or playing with the sanctity of the market should be

given exemplary punishment to discourage others.

We are now gradually heading towards a system of single digit Exchanges from the existing system of multiple Exchanges. It may be interesting to note the impact of competition on issues like investor protection. The debate about investor protection would get further heated amidst the debate of demutualisation of Exchanges wherein it is being proposed that the members and others could be shareholders in an Exchange and the Exchanges would 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 may 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. Generally, most Exchanges have been treating all expenses on investor services as a non-productive cost as regulatory protection never forced Exchange to win the investors goodwill. It may therefore have to be seen how Exchanges would keep up these noble objectives as drivers for growth in a more competitive era when they did not do justice towards investor protection during a protected environment when there was no constraint of profit maximisation.

A good thing that has been happening in the market now is that with the increase in competition, the credit risk associated with a firms is being considered seriously by the investors. The industry is perceiving that brand building and credibility of the firm will decide the future business flow. In this scenario we see a greater move towards consolidation through franchisee arrangement and also through branch office expansion. We also feel that focus of the industry will now shift from mere plain vanilla order execution facility to more value added investment advisory services. This will create a more formal bonding between the clients and the brokers and therefore induce greater long term relationship based on trust and professional service levels. This bonding would rest on the financial and professional risk-return equation of such relationship.

We expect that industry practice in such a scenario would elevate towards a service level which considers, best price and best market execution, sound investment advise, disclosure of risk involved with signing of risk awareness agreement with the client, indemnity from consequential liability for a trader and investor service level agreement with adequate disclosures. In such a scenario there would be a lot at stake for the Exchanges and also for its intermediaries and therefore, it is expected that the Brokers would be the first level of remedy for redressing the grievances of the investors and then the Exchanges will ensure that no grievance ever reaches beyond a tolerance level. It is possible that the Exchanges may begin risk categorisation of Brokers based on their performance and complaints which may prove to be a disincentive for the Brokers to do any non-compliance. Despite, all the problems highlighted above, it is expected that the outcome of the current scenario would strengthen the securities industry structurally and Stock Exchange would emerge as more powerful players in regulating the market and in protecting the interest of the investors.

(The views expressed here are personal)