Increasing Regulatory Role of Stock Exchanges - Challenges and Opportunities

V.Balasubramaniam
Managing Director & CEO
India International Exchange (IFSC) Ltd.

Post pandemic (Covid19) outbreak was one of the most turbulent years in recent history, which has disrupted the entire global economy and testing resilience of the financial market's infrastructure. However, the resilience shown by the financial markets in the country despite lockdowns and work-from-home model was the sheer outcome of emphasis put forth by the market regulators on operational resilience and regulatory structure over the years.

Role of Regulation in Market Development

Regulations provide the appropriate framework within which the markets can thrive by way of innovation, fairness, efficiency, competition and trust. Efficiently structured securities markets enable economic growth and development of a nation by facilitating mobilization of financial resources and bring together those who need capital and those who have resources to invest. This is where stock exchanges are uniquely positioned as the fulcrum between various stakeholders such as investors, companies, and regulators and play a vital role in promoting responsible investment and sustainable development.

Stock Exchanges as a Frontline Regulator

A core function of exchanges, as market operators, is the creation and enforcement of the rules regulating the markets they operate, which often play an important part of their branding exercise. Exchanges have traditionally performed key roles as regulators, making and enforcing rules for a range of market activities. Some of these core areas of regulation of exchanges include rulemaking regarding members/participants, products considered for trading and the trading itself. While some exchanges also have regulatory or quasi-regulatory functions regarding number of other market services, including clearing and settlement.

To ensure market participants get a safe and fair deal in the market, membership of stock exchanges is well regulated. The exchanges set certain binding rules (bylaws) within the existing legal framework for their members and ensures members adherence to such rules. Thus, by fulfilling the regulatory role, exchanges become the frontline regulators in the financial market.

Exchange Business – A Balancing Act

The Exchange as a frontline regulator must ensure balance among the competing concerns such as investor protection, participants confidence in the market, market development and business interests. With stock exchanges increasingly becoming publicly listed and traded, both regulatory functions and commercial interests have gained prominence.

A stock exchange which is a kind of self-regulatory organisation must balance between various interest groups and varied functions. The stock exchange should not only operate the trading platform, regulate the listed companies, provide the IT infrastructure, etc. but, apart from these, it must regulate and monitor the members and other intermediaries and most importantly take care of investors' interest. Hence, stock exchanges are delicately placed with the mantle of balancing both regulatory responsibilities and business operations.

The market dynamics together with a higher level of scrutiny and expectations regarding exchanges' regulatory and governance functions, brings in new set of challenges and opportunities for the exchanges.

Contemporary Challenges

Advent of fintech and other regulatory reforms carried out by the market regulator brought greater regulatory responsibility on the stock exchanges, thus, brings with it a new set of challenges.

Today, any regulations, which are ineffective or unworkable will place Indian financial markets at a disadvantage in the global competition for capital. While India's deepening economic linkages and interdependencies with the rest of the world, merits promoting a robust International Financial Services Centre (IFSC). Thus, arrival of India's 1st IFSC at GIFT City has necessitated need for a sound regulatory system. Any regulatory inadequacies or inefficiencies will discourage companies from coming here to list in our marketplace. Regulation which are sound and sensible will help Indian financial markets to remain competitive thereby provide the optimal environment for economic growth. Thus, International Financial Services Centre Authority (IFSCA), the unified regulator at GIFT IFSC has been at the forefront spearheading the transformation by either bringing-in new rules and regulations or amendments to the existing ones.

IFSCA is working towards making GIFT IFSC an investment destination by providing an efficient financial platform for various financial products and services. As a part of that recently, IFSCA notified IFSCA (Market

Infrastructure Institutions) Regulations, 2021. Some of the other measures include promotion of GIFT IFSC as a hub for Alternative Investment Funds (AIFs), promoting a Fin-tech hub, product diversification on the Exchanges by including REITS, INVITS, etc. All these proactive measures by the regulator have put greater onus on stock exchanges to design a robust regulatory framework.

Interaction between finance and technology is not novel but it witnessed a paradigm shift in the last one decade. With FinTech entered a phase of rapid development, the new era put forth fresh challenges for regulators including stock exchanges. The evolution of FinTech demands a parallel development of RegTech. This compelled the stock exchanges (as frontline regulators) to develop a robust framework, which promotes innovation and market confidence, assisted by using regulatory “sandboxes”. IFSCA, with an objective to develop a world class FinTech hub at the IFSC, endeavors to encourage the promotion of ‘FinTech’ initiatives in financial products and financial services. The regulator has already approved the regulatory sandbox framework for the stock market ecosystem in 2020.

Listing standards are a regulatory responsibility and processes must be in place to ensure the practicing standards remain up to date. However, excessive compliances standards might upset listed companies and driving such businesses to competing exchanges while easing those standards will be at the cost of investors. In digital India, FinTech firms play a crucial role and are drivers of economic development. But one of the major issues hampering them is access to capital. Considering the stringent regulatory criteria, most of them fail to meet the eligibility criteria for listing in the domestic market. Hence, there is a need for the regulator and stock exchanges to create an ecosystem to support FinTech firms by fostering innovative listing practices at IFSC, but balancing issues related to customer protection.

Operational resilience is another key aspect that an exchange must keep in mind. Exchanges are particularly wary about market and infrastructure disruptions, and cyber-attacks, which can be detrimental to the interests of investors. Both in the global and domestic markets, there are various such instances, prompting exchanges to prepare for such types of risks in their operational resilience models.

In the present competitive exchange space, offering multiple products has become more of a necessity. For exchanges to remain competitive they must widen the product base but dealing in varied products might compel exchanges to revisit existing risk, compliance and other internal control frameworks. Stock Exchanges need to be conscious of not providing any opportunity for regulatory arbitrage either between categories of entities or jurisdictions, etc.

Exchanges’ preparedness towards these new challenges requires continuous investments in modern technology apart from investment in other resources.

Converting Challenges into Opportunities

Though in a competitive financial market, Exchange’s endurance is tested to the brink, but inherent in nearly all the challenges are opportunities for renewal and transformation. Exchanges by investing in FinTech innovation and integrating it into their services, can access a far wider investor base and at the same time address the challenges of ever-increasing compliances burden. Though advanced technology comes at a cost, it has come to the rescue of trading platforms during the pandemic (Covid-19) period, with hassle free trading amidst the pandemic related restrictions..

RegTech can be used by stock exchanges to address increasingly cumbersome compliance processes. Further, efficient discharge of regulatory obligations instil confidence among new investors to participate in the market while also creating new market entrants. Increase in retail participation acts as a testimony and how exchanges could meet the compliance challenges such as KYC norms, surveillance, etc.

Exchanges that provide a well-regulated and transparent markets open new opportunities. The phenomenal growth of the global green bond market, even though from a small base, is one such example. Success of green bond market depends on investors’ confidence and utmost faith in regulatory system of an exchange.

In 2019, India International Exchange (IFSC) Limited (India INX), a subsidiary of BSE Ltd., which is India’s first International Exchange set up at GIFT City India INX, had launched its green listing and trading platform ‘GSM Green’ that serves as a plank for fundraising and trading in green, social and sustainable bonds exclusively. The Exchange, which commenced its trading activities on January 16, 2017, is committed to facilitate fund raising for green financial projects and promotes ESG (environment, social and governance) standards through GSM Green Platform. As a part of its role in facilitating green finance, on November 19, 2020, India INX signed a MoU with Luxembourg Stock Exchange (LuxSE). The pact with LuxSE will provide opportunities for dual listing, enhancing visibility and increase secondary market trading in green.

Success of green bond market at GIFT IFSC reflects of one such well-regulated and transparent market. Hence, exchanges by providing such well-regulated markets can facilitate a robust green bond market development.

Conclusion

Considering the current dynamic business environment, Exchanges need to ensure an independent, robust and efficient regulations, which can continuously engage in forming partnerships with market participants to protect their interests. At the same time, exchanges need to maintain conducive environment to ensure the markets remains vibrant and continues to attract existing and new market participants. This is a transformative time for Indian financial markets and an opportunity for exchanges to put in place not only the best market structure, but also the best regulatory structures for sustainable growth and development of the markets.