# Redefining the Role of Stock Exchanges

**Chitra Ramkrishna**
*Managing Director & CEO*
*National Stock Exchange of India Ltd.*

The institution of stock exchanges is a critical institution of the capital market and indeed a significant component of the entire financial system of any modern economy. The aim of this article is to describe how the role of this institution is undergoing a change from its traditional role over the years. The discussion will be split into three areas:

– traditional role of exchanges
– factors affecting the roles of exchange
– New roles of exchanges

**Core functions of exchange**

Traditionally, the stock exchange is seen as an organized marketplace for transparent price discovery, where trading members (or brokers) use a trading platform, which could be a trading pit or an electronic one, to trade in securities such as equities or bonds either on behalf of their clients or on their own account. It is the responsibility of the stock exchange to ensure that these trades are safe, fair and efficient. The core activities of an exchange thus include:

- Maintaining an orderly trading platform
- Permitting securities that can be traded on that platform
- Admitting brokers who can trade on that platform
- Clearing and settling trades executed on the platform in a safe and secure way
- Maintain discipline in the market by regulating and supervising the behavior of the issuers of securities and the members.

One may wonder why an organization that engages in activities such as these should be termed as an important fulcrum of all modern economies. In this context, it may be worth quoting Mr. W.C. Antwerp, one of the Governors of NYSE, who wrote in 1913, 'Singing the praises of Stock Exchanges is a thankless task, and one that falls upon deaf ears. The very nature of its functions makes dull reading. It cannot hope to enlist the lively enthusiasm of the casual observer, nor has it [the] picturesqueness to brighten the pages of history. The layman visits the great exchanges as a matter of course … but too often he misses the great silent forces at work. The eye has a fine time of it, but the intellect comes away empty.' The 'great silent forces at work' that Antwerp wrote about a hundred years ago hold true even now. The seemingly mundane core functions of the exchange stated above give rise to 'great silent forces' that have far reaching impact on the macro-economy.

It may be useful to give a few examples to examine the nature of this impact. First, by providing clear price signals about the prospects of companies, sectors, commodities, crops etc., exchanges contribute to better allocation of resources. Second, efficient stock markets reduce the cost of both risk capital and debt capital and thereby, boost the competitiveness of the entire economy. This happens through two routes: (a) the easy, quick and cheap exit option that the secondary market provides reduces the liquidity risk; and (b) exchanges make it easy for investors to build a diversified portfolio, which reduce their investment risk. Third, exchanges contribute to the promotion of corporate governance in their listed companies through monitoring compliance with listing and disclosure standards. After all, an orderly and transparent business environment, that the exchanges strive to create, inspires confidence on the part of domestic and international investors.

Exchanges produce this wide-ranging impact through four of its core products/services, which are interrelated. They are: Access to capital, liquidity, information about firms' prospects and security prices.

The important point to note is that the functions and the products stated above are absolutely fundamental to any exchange and such functions and products cannot be taken away from the realm of the exchange. Any attempt to the contrary or even attempt to create conditions that reduces the ability or incentive of the exchange to carry out these functions or produce these products will defeat the very purpose of the exchange and undoubtedly affect its impact on the economy. So, while redefining the role of the exchange, this part of the exchange's functions must be left intact.

**Factors affecting the role of exchange**

In the past two decades or so, there have been some major developments which have had significant impact on exchange functioning. These factors are discussed below.

*Demutualization and listing*

Historically, exchanges were not-for-profit organizations and were organized like 'clubs'. Brokers were members of this 'club' and they operated the exchange for mutual benefit. This gave rise to a number of governance problems, which are well known. Over the past two decades, securities exchanges all over the world have been demutualizing and converting from non-profit mutual organizations to for-profit, shareholder owned enterprises. These enterprises are organized as corporations, where the owners, decision-makers and users of trading services may well be three separate groups. As a result of this move, exchanges have been functioning in a far more regulated framework.

But this conversion also had an unintended consequence. With exchanges becoming for-profit entities, there arose a conflict of interest where exchanges carried out both commercial and regulatory functions. Initially, this 'conflict of interest' was not a matter of major concern, as the exchanges in their own long-term self-interest generally refused to compromise their regulatory roles to advance their commercial objectives. In the light of the recent financial crisis, the matter got greater regulatory attention. The case for greater regulatory oversight became stronger when listing of exchanges was contemplated. Several exchanges have since been listed globally; in India, exchanges have been permitted to list themselves, although none has done so far. In this context, it is expected that the SEBI's recently notified new regulations known as the Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations 2012 would effectively address the issue.

*Shift of trades from OTC to the exchanges*

The global financial crisis of 2008 revealed the problems related to the structured products. Prior to the crisis, all these products were traded on OTC markets which were liquid and functioned pretty well; but they failed to demonstrate resilience to market disturbances and became illiquid and dysfunctional at critical times. This illiquidity in OTC markets contributed substantially to the financial crisis. In contrast, all exchanges functioned smoothly during the crisis, without even a single hitch!

Since then there has been a marked shift in preference among policy makers from OTC to the exchange platform. The IMF has observed, "The major regulatory reform initiatives under way in the United States, European Union, and other developed financial markets are directly addressing these issues. In some cases the trading is being shifted from OTC markets to exchange markets. In others, the post-trade clearing process of OTC trades is being moved increasingly into clearinghouses (also known as central clearing counterparties). Trade reporting for OTC transactions is also a part of reform efforts."[1] This policy shift would entail an expanded role for the exchanges in the years to come.

*Advances in technology*

The exchange business has over the years become a technology intensive business. Technology began to play a key role in exchange business about two decades ago. The introduction of the screen-based trading system (SBTS) technology transformed the way exchanges did business and was responsible in a significant way for the transformation of the securities market. It replaced the open cry system which was time-consuming and inefficient, and also brought in transparency. Subsequent introduction of NOW (Neat-On-Web) facilitated the investors to execute trades from their homes through internet. More recently, the emergence of algorithmic trading and co-location had a tremendous impact on the speed of trade execution. The use of advanced technology has not been confined to trading alone; it has been used in other activities such as clearing, settlement, risk management services, surveillance and listing activities. The upshot is that the constant updation and modernization of technology has helped exchanges to discharge all their traditional roles more efficiently.

**New frontiers of exchanges**

While the factors stated above had bearing on the traditional roles of the exchange either in terms of expanding the scope of the traditional role or facilitating the exchanges to discharge their roles more efficiently or creating a conflict between its roles, exchanges have been proactive in exploring new frontiers, which are discussed below.

*Governance*

Many academic studies all over the world have shown that the good corporate governance adds value to the company. The problem is that many companies do not recognize these benefits. This is partly because the benefits generally tend to accrue in the long-term and the management is often swayed by short term benefits that may come by violation of accepted norms.

As stated earlier, it is part of the traditional mandate of the exchanges to contribute to the promotion of corporate governance in their listed companies through (a) monitoring compliance with listing and disclosure standards, and (b) raising transparency standards. Of late, however, exchanges have begun to go beyond the traditional mandate. For example, the Brazilian exchange has created a separate platform where companies voluntarily commit themselves to higher standards of governance than permitted by law. It is called *Nuvo Mercado* (or New Market). In return for adopting higher governance standards, companies that opt for such listing get an improved image and greater liquidity to their securities. The initiative has been significantly successful.

At NSE, there has been a recognition that the CG standards must be persistently improved, keeping in view the challenges facing Indian companies and the new developments. In view of the same, NSE organizes seminars and roundtables from time to time to facilitate a wider debate to influence the evolution of CG standards and also encourages research in the area. More recently, NSE has set up a NSE Centre for Excellence in Corporate Governance, an independent expert advisory body to facilitate research on international best practices in CG.

*Financial inclusion*

Discussion on financial inclusion has been traditionally dominated by the banking sector; for example, the percentage of poor households having credit accounts or savings accounts, number of bank branches per thousand population etc has been typically shown as measures of financial inclusion. The role of securities market in financial inclusion debate is of relatively recent origin.

It is often not recognized that the exchange business is inherently inclusive, as they provide equal access to people regardless of their social and economic background. Two persons investing in the same security on an exchange for the same period of time get exactly equal returns, no matter what the difference in their economic status is. This is not necessarily true in other areas of finance, where cost of borrowing could depend on 'relationship' with customer or return on savings could depend on savings size.

As in the case of governance, exchanges have gone beyond their mandate in this area too. Financial inclusion in the context of exchanges has taken two main forms: promoting financial literacy and creation of dedicated platforms for SMEs.

Financial inclusion and financial literacy are two sides of the same coin. While financial inclusion provides access, financial literacy provides awareness. Disadvantaged people need both – access to and awareness of financial services. To enhance capabilities of people to exploit the available opportunities, financial education is critical. Financial literacy is not just about markets and investing, but also savings, budgeting, financial planning, and about being 'Financially Smart'. In India, exchanges have taken initiatives through collaborations with schools and colleges to impart educational programs, short-duration training programs, on-line certification and so on. Similar initiatives have been taken by exchanges in other parts of the world.

Further, it is widely recognized that any assistance to the small and medium enterprises (SMEs) to overcome their constraints is an effort toward inclusion, because SMEs play a key role in job creation and wealth distribution. SMEs in India, as elsewhere in the world, face significant challenges in raising non-debt capital, which many times results in their overleveraging. This increases the vulnerability of both the SME and the debt provider, especially in case of adverse economic cycles. In view of these challenges, SEBI announced a landmark regulation in April 2010 that has the potential to revolutionise the way small and growing companies obtain access to capital. As a result, NSE's EMERGE was launched in March 2012, and similarly, BSE has launched its own platform. In this new SME landscape, there is a growing expectation that a large number of SMEs are able to raise and service capital in a cost-effective, orderly, and well-supervised manner.

Similar attempts have been made in some other countries as well. Successful examples include the Canadian market (the Toronto Stock Exchange), the Korean market (KOSDAQ), and the junior market of the London Stock Exchange (Alternative Investment Market) (LSE (AIM)). These markets have a significant number of listings. Some other markets such as the Growth Enterprise Market (Hong Kong), AltX (South Africa), Mothers (Tokyo), have remained relatively low volume markets with very modest listings.

Since there is no clear evidence of what incentives, policies and regulations improve the chances of making such a platform work, policy makers will need to resort to significant experimentation and innovation in this area and encourage the market participants to do the same.

*Exchanges as social agents*

Social responsibility is a mission from which businesses, governments, civil society organizations, and populations cannot escape. Exchanges are no exception to this. There is awareness and consensus among exchanges regarding the importance of their role in conducting socially and environmentally responsible policies. (WFE, 2010) Shenzhen and Shanghai stock exchanges, for instance, encourage the publication of standardized annual social responsibility and sustainability reports by listed companies. Besides, they are also engaged in an initiative supported by the Chinese government to accept only IPOs of companies that have passed a sustainability test. Such examples depict the increasing role that exchanges are playing to encourage or guide the largest companies in every country to socially responsible practices. In the process, exchanges are effectively contributing as agents of vital importance to improving their communities.

**Summary and Conclusion**

Securities exchanges have been operating for a few centuries; yet their core functions have remained broadly unaltered. It is argued that for an exchange to serve its greater macroeconomic role, its core functions should not be taken away from its realms; nor should any step be taken to reduce its ability or incentive to carry out these functions. Some of the developments in the past two decades have had far reaching impact on the exchange functioning. While advances in technology have allowed exchanges to carry out their traditional roles more efficiently and more safely, even when their task rises manifold, the global financial crisis has highlighted the exchange's capacity to 'stabilize' the financial system. In contrast, demutualization and listing of exchanges have tended to exacerbate the conflict between the exchange's role as regulator and its commercial role; of course, new regulations have emerged to address this conflict. Interestingly, the new frontiers that the exchanges have been exploring are because of their own volition and not due to any regulatory mandate. It needs however be noted that the new regulations as well as some major developments in the past two decades have facilitated the exchanges to take on these new roles.

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[1] http://www.imf.org/external/pubs/ft/fandd/basics/markets.htm