

Increasing Regulatory Role of Stock Exchanges – Challenges and Opportunities



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Regulatory framework in India's securities markets have assigned a significant supervisory, market surveillance, enforcement and corporate governance responsibility to the stock exchanges. Exchanges act as the first line of defence, primarily for market integrity, investor protection and implementation of the robust risk management rules that have been prescribed

by the regulator.

OBJECTIVES

Regulatory role of Exchanges broadly consist of supervision of members, market surveillance and listing regulation compliance.

I. Supervision of Members

An effective market supervision system must have a mechanism for monitoring compliance with securities laws, regulations and Exchange rules, operational competence requirements and broker's code of ethics. The objective of supervision in securities market includes:

- Ensuring fair, efficient and transparent organized securities markets.
- Monitoring compliance by market intermediaries.
- Ensuring integrity of securities market by improving customer protection.
- Ensuring identification and monitoring of default risk and potential market disruption.

II. Market Surveillance

The role of Surveillance function in exchanges is to ensure that markets are fair and that trading platform is not used for unfair trade practices or manipulative trades. We do this by monitoring trading behaviour and patterns of suspicious transactions and responding with surveillance and investigative actions.

III. Corporate Governance – Listing Regulation

Listing regulations that came into force in 2015 include the scope and responsibility of the board, audit committee, nomination and remuneration committee, disclosures to be made to the shareholders and to the market, items of information to be placed before the board and audit

committees. The objective of corporate governance and listing compliance function of exchanges are:

- Ensuring disclosure requirements of corporates prescribed in listing regulation are met.
- Monitoring compliance/non-compliance of the listed companies.
- Helping build compliance capacity among the staff working in listed companies and their secretarial auditors with advice and training.

MECHANISM AND ROLE OF REGULATORY FUNCTIONS

I. Supervision of Members and Enforcement

- **Selection of Members:** Every stock broker is inspected at least once in three years. Stock brokers who meet any one or more of the risk criteria defined by SEBI are inspected every year. Inspection covers a whole range of broking activities from process of on-boarding of clients, financial dealings with the investors, receipt and delivery of securities from and to the investor, process and internal controls on receipt of orders, execution of trades, settlement of trades, collateral management, etc.
- **Enforcement:** Enforcement function is segregated from inspection function. Enforcement officers evaluate inspection reports, establish non-compliances, if any and recommend action.

Exchanges have also initiated certain proactive supervision measures including Data Structuring and Validations. Exchanges use various analytical tools to transform large complex data which contains scattered information, into meaningful and actionable information and reports. For instance, tools have capability of structuring depository statements and as a result provides information on transactions that are frequent as well as high value in nature. Exchanges are also examining cash generation and utilization pattern of stock brokers to determine whether client funds are used for the client's transactions. Such an exercise is aimed at giving an early warning signal on any possible misuse of client funds and securities.

II. Market Surveillance and Investigation

While there is a view that over-regulation may hinder free discovery of price, impact the order flow and liquidity, bid ask spreads, impact cost, it is our belief that investors desert the market because of lack of faith in market integrity and that prevention checks bring in orderliness and contribute to market integrity. In market

surveillance, the role of exchanges and the mechanisms and measures used have been evolving and increasing substantially over time.

Some of the various preventive surveillance measures taken are-

A. Pre-Trade controls –

1. Index circuit filters - This brings coordinated trading halt in all equity and equity derivative markets at 3 stages of the index movement, either way viz., at 10%, 15% and 20% based on previous day closing index value.
2. Trade Execution Range – Orders shall be matched and trades shall take place only if the trade price is within the reference price and execution range. Adoption of this range helps in rejecting orders with limit prices placed outside the acceptable execution range.
3. Cancel on logout - All outstanding orders are cancelled if the enabled user logs out. This is a service provided to reduce risk emanating out of loss of connectivity between participant and the Exchange's platform.
4. Kill switch - All outstanding orders of that trading member shall be cancelled if trading member executes a kill switch. This helps a member for effective reduction of loss in case of malfunctioning in software at member end.

B. Surveillance Actions –

1. Fixed Price Band / Dynamic Price band - Limits applied within which securities shall move, lowering volatility. For non-derivative securities price band is 5%, 10% & 20%. For Derivative products an operating range of 10% is set and subsequently flexed based on market conditions.

Rationale - Errors may be prevented by rejecting orders with limit prices placed outside the acceptable range.

2. Trade for Trade Settlement - The settlement of scrip's available in this segment is done on a trade for trade basis and no netting off is allowed.
3. Periodic call auction – Shifting the security from continuous to call auction method.
4. Rumour Verification – Any unannounced news about listed companies is tracked on online basis and letter seeking clarification is sent to the companies and the reply received is disseminated. This helps investors to take informed decisions.

C. Alert Generation and analysis - This is a key component of the surveillance process. Real time alerts and end of day alerts are generated and analysed for

aberrations and abnormalities in orders and trades including algorithmic trades.

A comprehensive and robust surveillance process results in-

- Reduction in unfair practices without impacting liquidity and spreads.
- Helping members in effective compliance at low cost, as small and medium sized members rely extensively upon transaction alerts/ exchange communication to monitor trading activity of their clients.
- Preventing flash crashes.
- No trade annulment / trade cancellation bringing certainty to trades.
- Reduction in volatility.

III. Corporate Governance - Listing Regulation

Listing Regulations, with the recent changes and SEBI's acceptance of key recommendations of the Kotak Committee report provide a comprehensive framework for corporate governance practices in listed entities. SEBI has also introduced penalty provisions for non-compliance with listing regulations like submission of results, corporate governance, annual report, shareholding pattern, in the form of fines, which are monitored and administered by exchanges. Exchanges also seek and disseminate announcements and clarifications received from companies to the market, monitor compliances and in certain circumstances, suspend and/ or delist companies.

CONCLUSION

India boasts of a robust capital market with well defined rules. Exchanges play an important partnership role in making markets safer for all participants through effective surveillance, robust supervision and close monitoring of listing requirements. This role is critical to reassuring regulators and investors about the safety and depth of markets. However the number of transactions, various stakeholders and the general level of awareness poses a significant challenge. NSE has attempted to tackle this with a two pronged approach. One, with significant investments in technology to enable use of -

- large data powering surveillance technology
- complex event processing
- business rule-based text mining
- predictive analytics

Two, increasing awareness and capacity building through seminar/workshops for listed companies and for investors on regulatory changes, commissioning reports on corporate governance, advance alerts for compliance and early alerts to investors through depositories.