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Moving Ahead with Exchange Reforms

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Abstract

The paper discusses three critical issues pertaining to stock exchange reforms viz. a) conflict of interest between the exchange's regulatory role and commercial role b) desirability of listing of exchanges and c) appropriateness of a special ownership regime for exchanges. The paper advocates that there is a need to address the issue of conflict of interest between the regulatory and commercial roles of the exchanges on a priority basis. In this connection, a road map needs to be drawn and acted upon, regardless of what decision the policy makers take on the issue of listing of exchanges. The paper is in favor of dispersed onwership structure for exchanges and the presence of Anchor Institutional Investors (AIIs), while emphasizing the need for ensuring that the presence of AIIs does not dilute the dispersed ownership structure.

[1] Chairman, National Stock Exchange of India Ltd. This paper is based on Shri R. Venkataraman Endowment Lecture 2011 ('On Economics of Stock Exchange') delivered by the author on March 29, 2011 at Madras School of Economics, Chennai. This paper has been published earlier in Prime Directory 2011. The views expressed in the paper are those of the author and not necessarily of the National Stock Exchange of India Ltd.

Moving Ahead with Exchange Reforms

I. Introduction

A stock exchange is a critical institution of the capital market in any modern economy and India is no exception. In India, capital markets are increasingly playing an important role, determining the pace and pattern of economic growth, with the stock exchanges acting as their lynchpin. The institution of stock exchanges has a long history in India; the oldest stock exchange in India being more than 100 years old. The major reforms in the structure and governance of the exchanges in their long history, however, came only in the early 1990s. Modernization of stock exchanges and other trading related institutions during this period coincided with the establishment of India's capital market regulator, the SEBI. In the past two decades, the Indian capital markets have grown tremendously with exchanges and SEBI playing a central role. Over the years, the price discovery has become more efficient resulting in better resource allocation; transactions have become faster, safer and cheaper; number of investors has risen and markets have become globalized. Overall, the Indian markets have become larger, deeper, diversified and more modernized.

In the recent period, some reform measures in the form and structure of stock exchanges are being discussed. The pressures to change are emerging in the context of the exchanges' role as a firm and not in the context of the exchanges' macroeconomic role. The achievements of Indian exchanges in their macroeconomic roles (such as improving allocative efficiency, reducing cost of capital, fostering democratic capitalism, enhancing financial stability, acting as an instrument for global integration and so on) have been widely acknowledged. What has now come under focus is the exchange's role as a firm.[2] The current motivations for changes in the organizational form of exchanges are largely the imperatives of the decision in the past to demutualize exchanges, and derive partly from the trends seen in some other parts of the world.

[2] Like other firms, an exchange has a set of customers, multiple stakeholders and a board of directors to guide its management; it incurs costs, earns revenue, optimizes profits, competes with its peers and is also a closely regulated entity.

Historically, exchanges in India, as elsewhere in the world, were not-for-profit organizations and were in the nature of “clubs”. The club had a membership of brokers, who operated the exchange for mutual benefit. In fact, the exchanges were run primarily for the benefit of the brokers. This, unsurprisingly, gave rise to a number of governance problems, which are quite well known and need not be discussed here. 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. The idea behind demutualization was that the for-profit exchanges would be disciplined by profit-seeking investors and this would mean better financing for exchanges, higher accountability to the shareholders and more nimble decision making.

While demutualization addressed some of the existing governance issues, it gave rise to three important issues. First, with exchanges becoming for-profit entities, there arose a conflict of interest where exchanges also performed the regulatory functions. Second, as a natural next step to demutulaization, should an exchange list itself and under what conditions? Third, to protect the public interest, is there a need to impose a special regime on exchanges such as rules regarding share ownership? The road ahead for exchanges would be largely determined by how these issues are addressed.

II. Resolving the conflict between commercial and regulatory roles

Of the three issues mentioned above, the conflict between commercial and regulatory roles of the exchange is the most critical. It is the drive for profit that determines the scope and intensity of this conflict. For example, a for-profit regulatory organization may be unwilling to commit adequate resources to enforce regulation vigorously. Similarly, under pressure to generate high returns on investment, an exchange may be less willing to take action against customers or users who are a large, and direct source of income for the exchange. The real problem is that while both the costs and benefits of the commercial function are clear, only the cash outlays of the regulatory function is clear. The benefits of regulation are more difficult to quantify and hence,

may not be given adequate importance. The “spill over benefits” from better regulation can not be fully captured by the “Firm”, i.e., the exchange. Hence, it is more than likely that there will be under investment in improving regulation.

There is therefore a need to address this issue on a priority basis, and a road map needs to be drawn, regardless of what decision the policy makers take on the issue of listing of exchanges. Of course, if the decision is in favor of listing, the resolution of the conflict becomes even more critical, for reasons that will be described later.

The autonomy of the regulatory departments by the creation of a ‘Chinese wall’ is only one of the available options. There are other ways to insulate the regulatory functions from commercial pressures. For example, all exchanges could be divested of their regulatory roles and these roles could be entrusted to a newly created industry-wide SRO. Yet another alternative is that the government regulator assumes all the regulatory functions and there is no front-line regulator.

The effectiveness of ‘Chinese walls’ to persistently preserve autonomy under pressures to raise returns is yet to be proven in the context of India, or any other part of the world.. In fact, the exchanges worldover that have relinquished regulatory functions have followed either of the other two alternatives or some sort of a combination,

As regards the alternative of the industry-wide SRO, there is a need to address issues relating to funding; but that may not be a very difficult task. What may prove to be a bit challenging is to find institutional mechanisms to keep the ‘industry lobbying’ functions of the SRO distinct and separate from its ‘regulatory’ tasks, as has been borne out by the Indian experience.

Finally, while examining the option of entrusting SEBI with all the regulatory responsibilities that the exchanges are currently holding, we have to ensure that SEBI, the state regulator, has adequate capacity in terms of skilled human resources to take on such responsibilities. Some believe that advanced technologies that are now available would help the state regulators to have electronic trails and using them, they can catch any instance of market abuse. The fact however

is that technology is not just the preserve of regulators; deviant market players can and do use technology to stay ahead of the regulators. So, there is no substitute for high quality and well paid staff in adequate number at SEBI who are capable of efficiently exercising the regulatory responsibilities that the exchanges are currently holding.

Each of these options discussed above may have some advantages but the reason why we discussed only the difficulties is that each of the options, to be carried out successfully, would require one or more issues to be addressed. The upshot is that the ensuing policy debate would have to closely examine all the tradeoffs and identify the option best suited for Indian conditions.

III. Should exchanges be listed?

The question as to whether exchanges should be listed has been widely debated. Those in favour of listing hold that like in some of the OECD countries, listing is a natural event to follow demutualization and hence, disallowing listing could defeat the purpose of demutualization. They emphasize the advantages of listing, such as increasing the scope of raising capital at a lower cost, providing exit route to shareholders and promoting transparency and better governance of exchanges. But, there are downside risks too.

The problem is that the conflict between the commercial and regulatory roles of the exchange, if unresolved, will get exacerbated if an exchange gets listed, because listing would create incentives for the management to get more closely aligned with their share price performance, which would effectively be the barometer of the management efficiency. Listing would also induce a more short term orientation for the management. Falling share prices (of an exchange), for example, which may be due to reasons outside the control of the exchange may induce the exchange management to be lax on its regulatory role at a time when enforcement of regulation may actually need strengthening. Further, when an exchange lists on itself, it would be required to regulate itself, which is a clear case of conflict of interest. Besides, the main benefit of exchange listing from the economy's viewpoint—namely improved governance of exchanges—can be attained by exchanges acting as if they were listed—that is complying with the provisions

of ‘Clause 49’, even though they are not listed. This can be done either voluntarily by the exchanges or through a regulatory requirement.

An important point to note is that while several exchanges around the world have already listed themselves, most of them are in mature markets where the regulatory roles of exchanges have been hived off.

In any event, if we opt for listing, its adverse consequences can be reduced only if listing is preceded by the resolution of the conflict between the regulatory obligation and commercial operations of the exchange, because as stated earlier, listing aggravates the conflict. There are some who argue that listing will not complicate matters even if the exchanges continue to have their regulatory functions. This argument is based on the premise that exchanges are too concerned about their ‘reputational capital’ to neglect their regulatory obligations and if they do, they would collapse the next day! In real life, this rarely happens. It may take considerable amount of time before these exchanges are exposed and it may take much longer, possibly years, for their reputational capital to erode to a point that they actually collapse. Meanwhile, the damage to the economy would have been enormous.

IV. Reforms in the ownership structure

The final issue relates to the ownership structure of exchanges, which also has a bearing on exchange governance. Given that the exchange is entrusted with vital economic functions, dispersed ownership structures have been adopted by stock exchanges the world over, so that there is no undue influence of any single individual on decision making. In line with this thinking, most regulatory regimes in the world have imposed ceilings on individual shareholding in the range of 5-15 percent of the total; only in exceptional cases, and after seeking specific approval from the concerned regulator or government, individual shareholding has been allowed to exceed 15 percent. There is, however, a contrary view that limiting the maximum permissible holding to a very small percentage of the exchange’s share capital would reduce the incentives for the shareholders to take adequate interest in the progress of the stock exchanges. There is

little doubt that on balance the large benefits obtained from limiting individual ownership would far outweigh the possible costs.

The regulatory framework in India too requires dispersed ownership with a ceiling of 15 percent of total shareholding by any single entity. It also calls for the application of 'fit and proper' criteria for entities holding more than 5 percent. Given the vital nature of the exchange's functions, it is prudent to apply more stringent eligibility criteria to relatively larger shareholders of exchanges. Accordingly if 'Anchor Institutional Investors' (AIIs), are to take the lead role of setting up stock exchanges and hence be permitted to hold a higher percentage of shareholding (that is, more than 15 percent), they should not only be found 'fit and proper' by a financial regulator such as RBI, SEBI, IRDA etc, but also be required to fulfill more stringent eligibility criteria than other shareholders. Further, care should be taken to ensure that the implementation of the AII proposal does not dilute the dispersed ownership norms.

V. Concluding remarks

Timing and sequencing are important factors that determine the success of any institutional reform program. This is especially so in the case of financial markets. The world has yet to emerge completely from the financial crisis. Any error in judgment in introducing exchange reforms in a country such as India can wipe off decades of progress in a very short time. So, we have to pay adequate attention to timing and sequencing of exchange reforms that are currently being discussed.

While designing exchange reforms, policy makers need to ensure that no incentives are created at the micro level that are not aligned with the macroeconomic role that exchanges are expected to play. After all, exchanges serve the capital market which is a very delicate market having economy-wide implications. Hence, the precautionary principle typically applicable in the case of environmental policies is perhaps also applicable here. This principle states that if an action or policy has a suspected risk of causing harm to the public or to the environment, in the absence of sufficient knowledge about the matter, the burden of proof that it is *not* harmful falls on those taking the action or policy. We have very limited knowledge of what can go wrong in the

exchange industry with policy changes; but we do know that wrong incentives for exchanges can lead to a breakdown of trust and subsequently to the failure of exchanges, no matter how big they are and have disastrous effects, much worse than bank failures. The responsibility to protect the public from exposure to harm, in this case, means taking the proposed policy actions only after sound evidence emerges that no harm will result. Hence, at this stage of our growth phase, we need to eschew "policy adventurism" such as a premature adoption of practices followed by authorities in mature capital markets as a paradigm for managing our own stock exchanges. So let us make policy changes only after in-depth analysis, greater deliberations and with proper care.