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REFORMING SECURITIES LAWS FOR SUSTAINABLE DEVELOPMENT OF CAPITAL MARKET

M S Sahoo*, FCS

Economic Adviser
National Stock Exchange of India Limited

This paper confines discussion to reforming legislative framework for sustainable development of securities market, not reforming securities laws (which includes rules and regulations) for sustainable development of capital (which includes non-securities) market. Development of securities market does not mean only growth in terms of quantity (amount of capital raised, turnover on stock exchanges, market capitalisation, index value, number of participants, etc.), but also improvement in quality of such growth (on-line IPOs, market determined allocation of resources, dematerialisation of securities, screen based trading, trading of derivatives, settlement guarantee, etc.). The sustainable development, therefore, means continued growth with improved quality so that investors and issuers are able to undertake more and more transactions in securities with higher levels of confidence, efficiency and safety. An appropriate legislative framework is essential (not sufficient) condition to either initiate development or support development initiatives of market participants. This paper briefly explains legislative reforms undertaken in the last decade to promote orderly development of securities market. These reforms have changed market design drastically, as may be seen from Table 1, and have contributed to both quality and quantity dimensions of development. The paper also explores further reforms required for sustenance of such development.

Table 1

Market Design in Indian Securities Market

Element	*1992*	*2002*
Regulator	No specific regulator, but central government oversight	A special regulator for securities market (SEBI) vested with powers to protect investors' interest and to develop and regulate securities market. SROs strenghtened

* The views expressed and the approach suggested in this paper are of the author and not necessarily of his employer.

Element	*1992*	*2002*
Intermediaries	Some of the intermediaries (stock brokers, authorised clerks, and remisiers) regulate d by SROs	A variety of specialised intermediaries emerged. They are registered and regulated by SEBI (also by SROs). They as well as their employees are required to follow a code of conduct and are subject to a number of compliances
Access to market	Granted by government	Eligible issuers access the market after complying with the issue requirements. SEBI can, however, prohibit a company from accessing the market in the interest of investors
Pricing of securities	Determined by government	Determined by market, either by issuer through fixed price or by investors through book building
Access to international market	No access	Corporates allowed to issue ADRs/GDRs and raise ECBs. ADRs/GDRs have two way fungibility. FIIs allowed trade in Indian market. MFs allowed to invest overseas
Trading mechanism	Open outcry, Available at trading rings of exchanges, Opaque, Auction / negotiated deals	Screen based trading system, Orders are matched on price time priority, transparent, trading system accessible from all over the country
Aggregation of order flow	Fragmented market through geographical distance. Order flow unobserved	Order flow observed. The exchanges have open electronic consolidated limit order book
Anonymity in trading	Absent	Complete
Settlement system	Bilateral	Clearing house of the exchange or the clearing corporation is the central counter-party
Settlement cycle	14 day account period settlement, but not adhered to always	Rolling settlement on T+3 basis
Counter-party risk	Present	Absent
Form of settlement	Physical	Mostly electronic
Basis of settlement	Bilateral netting	Multilateral netting
Transfer of securities	Cumbersome. Transfer by endorsement on security and registration by issuer	Securities are freely transferable. Transfers are recorded electronically in book entry form by depositories
Risk management	No focus on risk management	Comprehensive risk management system encompassing capital adequacy, limits on exposure and turnover, VAR based margining, client level gross margining, on-line position monitoring, etc.
Derivatives Trading	Absent	Exchange traded futures and options available on two indices and select securities

Recent Legislative Reforms

The last decade witnessed eight legislative interventions, including two new enactments (Securities and Exchange Board of India (SEBI) Act, 1992 and the Depositories Act, 1996) to accommodate developments in the securities market. The SEBI Act and the Securities Contracts (Regulation) Act (SCRA), 1956 were amended five and six times respectively in the last decade. The need for legislative reforms was so urgent at times that the last decade witnessed four ordinances to amend securities laws. In the interest of securities market, a number of other legislations (the Income Tax Act, the Companies Act, the Indian Stamps Act, the Bankers' Book Evidence Act, the Benami Transactions (Prohibition) Act etc.) were also amended. These indicate importance of reforms in securities laws for development of the market.

As a part of the liberalisation process, the Capital Issues (Control) Act, 1947 was repealed in 1992 paving way for market determined allocation of resources. The Act earlier required a firm wishing to issue securities to obtain prior approval from the government, which also determined the amount, type and price of the issue. The SEBI Act, 1992 established SEBI with statutory responsibility for (i) protecting the interests of investors in securities, (ii) promoting the development of the securities market, and (iii) regulating the securities market. It amended the SCRA to enable the government to delegate powers under the Act to SEBI. It brought the government securities and any other instruments as may be declared by the government within the ambit of securities under the SCRA. It exempted SEBI from any tax in respect of its wealth, income, profits or gains. The subsequent amendments in securities laws and also other laws strengthened SEBI and supported development initiatives. Since the enactment of the SEBI Act, 1992 the market witnessed following five legislations:

The Securities Laws (Amendment) Act, 1995 amended the SEBI Act, 1992 to extend SEBI's regulatory jurisdiction over corporates in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. It empowered SEBI to (i) register and regulate all market intermediaries and also certain persons associated with the securities market, (ii) appoint adjudicating officers to adjudicate a wide range of violations and impose monetary penalties on any intermediary or other participant, (iii) issue directions to all intermediaries and other associated persons in the interest of investors, and (iv) to notify regulations without prior approval of government. It vested SEBI with powers of a civil court to carry out investigations, conduct inquiries and inspections in respect of intermediaries and SROs. It established Securities Appellate Tribunal (SAT) to hear appeals from the orders of adjudicating officer. Thus, it granted SEBI full autonomy and authority to regulate and develop an orderly securities market. It also amended SCRA to grant statutory sanctity to listing agreement and remove prohibitions on options in securities. It allowed the stock exchanges to establish additional trading floors outside their area of operation.

The Depositories Act, 1996 provides for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security by (a) making securities of public limited companies freely transferable subject to certain exceptions; (b) dematerialising the securities in the depository mode; and (c) providing for maintenance of ownership records in a book entry form. In order to streamline the settlement process, the Act envisages transfer of ownership of securities electronically by book entry without making the securities move from person to person. The Act made the securities of all public limited companies freely transferable, restricting the company's right to use discretion in effecting the transfer of securities, and dispensed with the transfer deed and other procedural requirements under the Companies Act, 1956. It segregated economic rights and political rights associated with securities and provided that economic rights can not be suspended under any circumstance. It also exempted stamp duty in respect transactions in demat securities. It provided that the ownership records of securities maintained by depositories would be accepted as prima facie evidence in legal proceedings. It empowered SEBI to regulate depositories.

The Securities Laws (Amendment) Act, 1999 amended SCRA to provide a legal framework for trading of derivatives of securities and units of collective investment schemes (CIS) by including them within the ambit of securities. It defined CIS in the SEBI Act and derivatives in the SCRA. It made clear that derivatives shall be legal and valid only if such contracts are traded on a stock exchange, thus precluding OTC derivatives. It empowered government to delegate powers under the SCRA to

Reserve Bank of India (RBI) also along with SEBI.

The Securities Laws (Second Amendment) Act, 1999 amended securities laws to empower SAT to deal with appeals against orders of SEBI under the Depositories Act and the SEBI Act, against orders of adjudicating officers under the SEBI Act and against refusal of stock exchanges to list securities under the SCRA. Earlier, the appeal against orders of SEBI under the Depositories Act and the SEBI Act could be preferred before the government.

The Securities laws (Amendment) Ordinance, 2002 promulgated on 29th October, 2002 amended the SEBI Act, 1992 to strengthen SAT and SEBI in terms of personnel and powers. It empowered government to grant immunity on the recommendation of SEBI from any action under the Act to persons making a full and true disclosure about alleged violation. It converted SAT to a three-member body and provided that any person aggrieved by an order of SAT may prefer an appeal before Supreme Court on a question of law. It empowered SAT or court to compound certain offences either before or after institution of any prosecution. It increased the number of members on SEBI Board to nine, which would include at least three full time members, excluding Chairman.

The Ordinance enhanced powers of SEBI substantially in respect of inspection, investigation and enforcement. SEBI can now (i) call for information and record from any authority, including statutory authorities, in respect of transactions in securities under investigation, (ii) conduct inspection of any listed company, (iii) suspend the trading of a security in a recognised stock exchange, (iv) restrain persons from accessing the securities market and prohibit any person associated with securities market to buy, sell or deal in securities, (v) impound or retain the proceeds or securities in respect of any transaction under investigation, (vi) attach for a period not exceeding one month, one or more bank account(s) relating to proceeds involved in violation, (vii) direct any person not to dispose off assets forming part of transaction under investigation, (viii) prohibit issue of any offer document, (ix) specify the requirements of listing and transfer of securities, (x) issue a cease and desist order to any person. The investigating authority appointed by SEBI can enter a place, search the place and seize documents and records considered necessary for investigation. The exercise of some of the above powers requires prior approval of a Magistrate. SEBI can exercise some the powers in respect of a listed public company, which is not an intermediary, if it has reasons to believe that such company has been indulging in insider trading or fraudulent and unfair trade practices relating to securities market.

The Ordinance listed a few more offences alongwith associated penalties. It enhanced penalties for the offences committed under the Act from a maximum of Rs. 5 lakh to a maximum of Rs. 25 crore or three times the amount of profit made out of violation, whichever is higher. It, however, provided that all sums realised by way of penalties would go to government. Thus, it equipped SEBI with wherewithal to bring all types of culprits to book to ensure orderly development of market.

Besides the above special securities laws, many other laws having bearing on securities market have been amended in the recent past to complement amendments in securities laws. For example, in order to boost the process of corporatisation of membership of exchanges, the Income Tax Act was amended to exempt capital gains tax on conversion of proprietary/partnership membership to corporate membership. In order to promote demutualisation of stock exchanges, transfer of capital assets from the erstwhile mutual exchange to the emerging demutual exchange has been exempted from capital gains tax. The Companies Act, 1956 was amended in 1999 to establish 'Investor Education and Protection Fund' for promotion of investor awareness and protection of their interest and to allow the companies to buy back their own shares. The Act was amended again in 2000 to empower SEBI to administer provisions relating to issue and transfer of securities and non-payment of dividend in case of listed public companies and public companies intending to get their securities listed on a stock exchange. It mandated a listed public company, making IPO of any security for Rs. 10 crore or more, to issue the same in demat form. The Securities and Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance, 2002 amended SCRA to include 'security receipts' within the ambit of 'securities'.

Further Reforms

The legislative reforms have, by and large, kept pace with the developments of the securities market.

This paper explores scope of further legislative reforms to aid sustainable development of the market.

I. Regulatory Jurisdiction

There are several statutes regulating different aspects of the securities market. The four main legislations governing the securities market are: (a) the SEBI Act, 1992 which establishes SEBI to protect investors and develop and regulate securities market; (b) the Companies Act, 1956, which sets out the code of conduct for the corporate sector in relation to issue, allotment and transfer of securities, and disclosures to be made in public issues; (c) the SCRA, 1956 which provides for regulation of transactions in securities through control over stock exchanges; and (d) the Depositories Act, 1996 which provides for electronic maintenance and transfer of ownership of demat securities. The larger the number of laws, higher is the scope for inconsistency among them and the possibility of regulatory overlaps and gaps.

There are also as many regulators as the number of laws. The responsibility for supervision and development of the securities market is shared by Department of Economic Affairs (DEA), Department of Company Affairs (DCA), RBI and SEBI. For example, many a powers under the SCRA are exercised concurrently by SEBI, RBI and DEA, as may be seen from Table-2.

Table 2

Supervisory Responsibility under the SCRA

Sections	*Responsibility*	*Administered by*
6, 9, 10, 13A, 17	Call for periodical returns or direct inquiries to be made, Approval of Bye-Laws of recognised stock exchanges, Make or amend bye-laws of recognised stock exchanges, Approval for additional trading floor, Licensing of dealers in securities	SEBI
3, 4, 5, 7, 7A, 8, 11, 12, 13, 14, 18, 28	Application for recognition of stock exchanges, Grant of recognition to stock exchanges, Withdrawal of recognition, Submission of Annual Report, Rules restricting voting rights, Direct rules to be made or to make rules, Supersede governing body of a stock exchanges, Suspend business of stock exchanges, Contracts in notified areas illegal in certain circumstances, Contracts in notified areas void in certain circumstances, Exclusion of spot delivery contracts, Inapplicability of the Act in certain cases	DEA and SEBI
16	Prohibit contracts in certain cases	DEA, RBI and SEBI
22A	Appeal against refusal by stock exchanges to list securities of public companies	SAT
All other powers under the Act		DEA
Securities Contracts (Regulation) Rules, 1992		SEBI
Rules, Regulations and Bye-Laws		Stock Exchanges

In view of involvement of so many regulators, there is scope for confusion among the regulators and the regulated, regulatory gaps and overlaps, and duplicate and inconsistent regulations. For example, no regulator regulated CIS till it assumed scandalous dimension when it was explicitly assigned to SEBI. Similarly, there is hesitation among regulators to regulate private placement of securities. The delay in initiating action against companies found guilty of market manipulation is generally attributed to the turf war between SEBI and DCA.

The protection of the interests of investors requires consolidation of all laws relating to securities market into a single piece of legislation, preferably called the Securities Act and assigning its administration to one agency with clearly defined regulatory jurisdiction and accountability. And this piece of legislation should prevail over general laws like the Companies Act, the UTI Act, the Consumer Protection Act, the Contracts Act, etc and the agency works in close coordination with regulators, domestic and foreign, for other areas of financial market.

II. Penal Provisions

The securities market is an integral part of the economy. It has the potential to destabilise other sectors. It is therefore necessary that the penalty for offences in the securities market is deterrent. The first step in this regard is to make all the offences in the securities market cognisable, as a few offences under the SCRA are. The penalty amounts for the offences under the SEBI Act, 1992 have been increased substantially by the recent Ordinance. However, the penalty prescribed under the SCRA is ridiculously low. Many of the offences under the SCRA attract a penalty of Rs. 1000, on conviction. For example, non-compliance of listing agreement, which can put investors to untold miseries and throw corporate governance norms in air, can be punished upto Rs. 1000. Listing agreement can be effectively used to discipline a listed company, if its non-compliance invites a deterrent penalty.

The penal provisions in the SEBI Act, 1992 need a little more fine-tuning. The Act provides for two alternative types of punishment for violations of the provisions of the Act, in addition to prosecution and directions. They are: (a) suspension or cancellation of certificates of registration to be imposed by SEBI only as per Regulations framed by it, or (b) monetary penalty to be imposed by an adjudicating officer, appointed by SEBI, as per Rules framed by government. These two types of punishments are mutually exclusive, not and/or punishments. If a violation is assigned to an adjudicating officer for adjudication or monetary penalty is imposed, penalty of suspension or cancellation of certificate of registration can not be imposed and vice-versa. As per the scheme of the Act, SEBI shall appoint an officer to adjudge if somebody has contravened any of the provisions of sections 15A to 15HB of the Act. Once such an adjudicating officer is appointed, SEBI loses control over the case and the adjudicating officer decides the case on merit. The adjudicating officer can at best impose monetary penalty even if he finds that the violation really warrants suspension or cancellation of registration. Similarly, if SEBI initially considers a case for suspension or cancellation, it can not impose monetary penalty even if it concludes that the violation warrants monetary penalty. This happens because SEBI does not have power to impose monetary penalty and the adjudicating officer does not have power to suspend or cancel a certificate of registration. A corollary of this is that mind is made up about the type of punishment to be imposed on the erring party when the alleged violation is referred to an adjudicating officer for adjudication or taken up by SEBI for imposition of suspension or cancellation of registration, that is, at a stage when the nature and gravity of the violation has not been fully ascertained. What would, therefore, be desirable is to authorise the adjudicating officers to try all offences under the SEBI Act and award suspension/cancellation of registration and/or monetary penalties so that SEBI can concentrate on developmental and regulatory work.

III. Investor Protection

Investors are the backbone of the securities market. Protection of their interest is essential for sustenance of their interest in securities and hence development of market.

The consumer fora provide an expeditious remedy to a consumer who has suffered loss on account of deficiency in goods/services purchased by him. A similar arrangement is called for redressal of investor grievances, given the rate of disposal of our judicial system. The investor forum as well as other authorities should have power to dispose off the cases summarily and to award compensation to the investor. It is not enough if the culprit is punished. The culprit needs to be punished in an exemplary manner, while investor should have means to recover his loss caused by the culprit. The SEBI Act should empower SEBI not only to levy penalties, but also award compensation to investor.

The depositors are protected up to Rs. 1 lakh in the event of liquidation/bankruptcy of a bank. This protects innocent depositors and thereby contributes to the stability of the financial system. A similar mechanism may be developed to compensate an investor up to Rs. 5 lakh if he suffers a loss on account of the failure of the system or mischief by any market participant. An organisation called Securities Investor Protection Corporation operates in the USA to provide similar protection to investors.

The confidence of the investors can be maintained and enhanced by making provision for professional intermediation services. Industry/SROs/Regulators have made a modest beginning, but not adequate given the dimensions of the market. NCFM or any other suitable testing system should offer a certification for each type of intermediation service. The industry body should determine the syllabus and standards for such certification. The certified people should be required to update their skills and expertise by seeking certification at intervals of five years. The personnel having supervisory responsibilities with intermediaries and issuers, and also officers working with SROs and regulators need much broader exposure (equivalent to Principal of NASDR). There are institutes like the ICSI for grooming professionals for secretarial work or the ICAI for accounting work. A similar institute, say National Institute of Securities Market (NISM), may be statutorily set up with the responsibility to develop a distinct group of professionals for a career in the securities market. The personnel with supervisory responsibilities must at least be associates of the NISM. SEBI regulations, which lay down various requirements for registration as an intermediary, should specify certification as a mandatory requirement for operational level employees and associate membership of NISM for supervisory level employees. While this requirement should apply at the entry point for all new employees joining the intermediaries, regulation may allow a period of five years for the existing employees to qualify the certification/associate examination. In addition, there should be an arrangement for grandfathering for a period of 3 years. During this period, persons at operational level with a certain minimum years experience and qualification may be exempted from the certification subject to completion of prescribed training and persons at supervisory level with specified qualification and experience may be allowed to become associates of NISM subject to passing a limited examination. NISM may maintain a database of its associates as well as certified professionals and enforce a code of conduct for them so as to enable prospective employers access the database to meet their personnel requirements. The certification may be developed and administered by industry associations under the regulatory oversight of SEBI, while NISM may be a statutory body modeled like ICSI.

An investor normally deals in securities through an intermediary, whose acts of omission and commission can cause loss to him. In order for the investor to choose the right intermediary through whom he may transact business, it may be useful to help him in taking informed decision by making details of intermediaries available to him. The details may include the form of organization, management, capital adequacy, liabilities, defaults and penal actions taken by the regulator and self-regulatory organizations against the intermediary in the past and other relevant information. If possible, the intermediaries may be rated and their ratings are disseminated.

IV. Units vs. Securities

Units of mutual funds (MFs) resemble securities. They represent the interest of the unit holder in the specific scheme just as securities represent the interest of the holder in the issuer. The unit holder has similar rights as a security holder has on the future performance of any underlying asset or group of assets. Special kinds of units (units of assured return schemes), which represent the rights of investors on a fixed income flow over the future years or a fixed maturity value at the end of a specified period, are similar to debentures issued by companies. The units are issued, dematerialised, listed, traded on exchanges in a manner similar to any other security. These are transferred from one holder to another or sold back to the issuer, at pre-specified or market determined values, just like shares, debentures and other securities are. The holders of units and securities have the same need for safety, liquidity and return. Despite such close similarities between units and securities, they are not treated legally at par.

In terms of the definition in the SCRA, an instrument can be treated as *'securities'*, if

(a) it is enumerated in the definition, or

(b) it is

  (i) marketable,

  (ii) of like nature, and

  (iii) of or in any incorporated company or body corporate, or

(c) it is declared to be "securities" by the government.

The units of MFs are not explicitly listed in the definition. These have not been declared to be securities by the government. The only other way these can considered to be securities is that these satisfy all the ingredients as at (b) above. These are clearly marketable as these are listed and traded on recognised stock exchanges. These are also of 'like nature' as these represent an undivided share in the assets of scheme of a MF. However, a MF (except UTI) being a fund established in the form of a trust to raise monies through sale of units to public is not a body corporate and hence the units issued by it do not satisfy all the three ingredients and may not be covered within the ambit of 'securities'. However the units issued by UTI are securities, as UTI is a corporation under the UTI Act, 1963, although it is managed by a board of trustees. Thus, the units of non-UTI MFs are not considered securities explicitly under law, although investors in units of MFs need similar level of protection as applicable to securities.

In case of securities, the whole process of issue, allotment and transfer of securities and various aspects relating to company management etc. are provided in the Companies Act, 1956. In addition, SEBI's jurisdiction extends over corporates in the issuance of capital and transfer of securities. All these matters relating to units of MFs are provided in the SEBI regulations. Further, the trading of securities issued by corporates are governed by SCRA and regulatory framework developed thereunder, while trading of units are not subject to similar regulatory framework. In fact, trading of units is not subject to any regulatory framework. This presents a case of regulatory gap and this is one of the reasons why the secondary market for units has not developed appreciably. It is no argument that SEBI's jurisdiction over regulation of MFs under the SEBI Act, 1992 also extends over the trading of their units. If that were so, DCA would be having regulatory jurisdiction over trading of securities as well as the powers to regulate companies. The governance of the company and trading of securities issued by them are provided explicitly in two different statutes and administered by two separate regulators. Similarly the powers of SEBI under the SEBI Act, 1992 to regulate CIS is not enough to regulate trading of units of CIS. The regulatory framework for trading of units of CIS follows from the SCRA, which includes these units under the ambit of securities. It is also no argument that since MFs is a type of CIS (SEBI Act, 1992 empowers SEBI to regulate CIS, including MFs), the regulatory framework applicable to trading of units of CIS can govern the trading of units of MFs. This could have been presumed, if the SEBI Act, 1992 had not explicitly excluded the MFs from the definition of CIS. Thus, the governance of entity issuing units/securities and trading of such units/securities need to be provided explicitly in the statutes. The statute must provide the remedy if a stock exchange refuses listing of any MF. The statute must also prescribe the requirements of listing as these have been done for units of CIS or other securities. The statute must specify who can prevent undesirable transactions in units of MFs and how. Unless these happen, the investors can not be rescued if something untoward happens in the trading of units of MFs, as no regulator has supervisory jurisdiction over trading of units.

The easiest way to develop the market for units of MFs and protect the investors investing in them is to consider the units to be securities so that the regulatory framework applicable to trading of securities would also apply to trading of units and SEBI which has the responsibility to protect the interests of investors in securities, can protect the interest of holders of units of MFs also. Since the jurisdiction of SEBI is limited to securities market and the units of MFs (except for units of UTI) are not explicitly recognised as securities in law, the actions of SEBI in protecting the interests of investors in units of MFs and developing a market for them is being challenged before the courts of law. In an appeal before SAT, an appellant contended that he was not covered by the Rules as he was not dealing in securities, but in units of MFs which are not securities and hence the SEBI had no powers, authority or jurisdiction to conduct any enquiry or impose any penalty on him. While disagreeing with this, the SAT considered the units of MFs to be securities in view of the object and purpose underlying the SEBI Act. This judicial pronouncement needs to be codified in law.

Since the units of MFs conform to the description "such other" instruments under the SCRA and can be declared as "securities" under the delegated powers, the government should declare units of MFs as 'securities' under the SCRA. Such declaration would help (i) the market regulator and stock exchanges to regulate trading of units more effectively with a view to protecting interest of investors therein, (ii) market for units to deepen, (iii) provide a level playing field to other MFs with UTI and (iv) remove confusion about the status of units of MFs. More importantly, this would remove the regulatory gap.

V. Demutualisation of Stock Exchanges

Historically the exchanges were formed as 'mutual' organisations. They are generally "not-for-profit" and tax exempted entities. The trading members who provide broking services, also own, control and manage such exchanges for their common benefit, but do not distribute the profits among themselves. In contrast, in a "demutual" exchange, three separate sets of people own the exchange, manage it and use its services. The exchanges frame and enforce rules, which may not always, further the public interest (interest of investors and society) and the private interest (interests of trading members) simultaneously. Theoretically public interest gets precedence in a demutualised exchange while private interest gets precedence in a mutual exchange in formulation and implementation of the rules. On realising the limitations of mutual structure and discovering the advantages of demutual structure, the stock exchanges are increasingly organising themselves as commercial entities and undergoing a process of "demutualisation".

It is felt in some quarters that demutualisation would require substantive changes in law. The SCRA needs to be amended to provide that a stock exchange should be a company incorporated under the Companies Act and to accommodate two types of members (trading and shareholding). The Income Tax Act needs to be amended to provide that the accumulated reserves of the stock exchange as on the day of corporatisation are not taxed. The issue of ownership rights (shares) and trading rights in lieu of the membership card should not be regarded as transfer and not attract capital gains tax. The Indian Stamp Act and the Sales Tax laws may be amended to exempt from stamp duty and sales tax, the transfer of the assets from the mutual stock exchange and the issuance of shares by the new demutualised for-profit company.

The SCRA permits different structures for stock exchanges. That is why some exchanges are association of persons, some are company limited by shares, and some others are company limited by guarantee. Since the law permits any form for a stock exchange, it may not be possible to mandate a particular form for all exchanges. However, it may be noted that the SCRA is a skeleton legislation under which regulators and SROs have substantial delegated powers of legislation. Under the delegated powers of legislation, the regulators can specify and enforce a particular structure. As a condition of recognition/renewal of recognition, a stock exchange is required to comply with such conditions as are or may be prescribed or imposed under the provisions of the SCRA from time to time. Besides, the authorities have powers to direct stock exchanges to make rules or to amend rules. In the extreme case of non-compliance by any stock exchange, the authorities can withdraw recognition. Further, demutualisation would result in two classes of members namely, trading members and shareholding members. Since "member" under the SCRA means a member of the recognised stock exchange, it is apprehended in some circles that the SCRA may not accommodate different classes of members. It has been affirmed recently by the Supreme Court that there can be more than one class of members and they will fall within the definition of "members" under the SCRA. In view of these, no amendment in the SCRA is required.

Demutualisation involves transfer of assets and liabilities from the erstwhile mutual (non-corporate) exchange to the emerging demutual (corporate) exchange. Since this transfer is a notional transfer on conversion of the exchange from mutual to demutual form, and it is in public interest, the transfer of capital assets has been exempted from capital gains tax. The demutual exchanges would also inherit the accumulated reserves and surplus which has grown because of so many concessions and tax benefits. Since this remains with the organization even after conversion and is not taken away by anybody, this would not be taxed. It would, however, require a restriction on distribution of this accumulated reserve and surplus inherited by the demutual exchange, as these belonged to erstwhile not-for-profit exchange. This reserve and surplus should be deployed by the exchange separately for common benefit of investors / exchange/market. All future profits of the organization should be subject to normal taxation. In lieu of membership card, the existing brokers should be granted non-transferable trading rights against deposits and transferable ownership rights (equity shares). However, when they transfer ownership rights, they would be subject to capital gains tax and the cost of these rights shall be the cost of acquisition of the original membership. Thus, all the genuine tax exemptions required for demutualisation have already been provided in the Income Tax Act.

Only change required in law is exempting all transactions associated with demutualisation from stamp duty as this is being done in public interest.

VI. Central Listing Authority (CLA)

Under the current dispensation, while it is mandatory to list a security on a regional exchange, it can be listed on any number of exchanges. The issuer has option to list its securities on any one or more of the exchanges. The issue fails if the regional exchange refuses listing. The issue also fails if any of the exchanges, to which application for listing has been made, refuses to list the security. This arrangement generates unhealthy competition. There is a competition among the issuers to list securities on as many exchanges as possible to attract investors from all over the country and waste resources to comply with the listing requirements of a number of exchanges simultaneously. Similarly there is a competition among the exchanges to attract as many issuers as possible at times leading to dilution of listing standards particularly when listing constitutes a major source of income for many of them.

A corollary to the above is that there is a lot of avoidable waste. For all practical purposes, listing agreement is a one sided agreement, rather an undertaking, requiring the issuer to agree to all the conditions prescribed at the time of signing the agreement or to be prescribed subsequently. The agreement is also amended unilaterally. The issuer has absolutely no choice in the matter, as none of the terms is negotiable. The issuer is deemed to have agreed to comply with anything that may be prescribed at any time in future. Even the stock exchange does not have any freedom to vary any of the terms of the agreement. Why should there be separate agreements for each security if it is the same agreement and why should an issuer sign the same agreement with a number of exchanges? Why should a company comply with listing agreement with different exchanges or why should a number of exchanges monitor compliance by a company? There are about 10,000 companies listed on Indian exchanges. Assuming that each company is listed on average on four exchanges there are 40,000 listing agreements, 40,000 sets of compliances by companies and the exchanges monitor 40,000 companies. It is just a waste of resources, as the terms are uniform across securities and across exchanges.

Every exchange exercises powers of listing/denial of listing, suspending/ delisting of securities independently. As a result, a security not found suitable for listing on an exchange gets listed on a different exchange, as they follow different criteria for listing a security. A prospective issuer informally gets a feedback from an exchange if the latter would consider listing of his security favourably. If he does not get an encouraging response, he tries his luck with other lenient exchanges. This creates an anomalous situation that a security, which is not suitable for investors in one locality, is suitable for investors in another locality. A security should either be suitable for listing on all exchanges or not suitable at all for listing on any exchange, that is, it should be suitable for all investors or not for any.

Given the speed of technological advances and trend in the market, extinction of a few stock exchanges is not a remote possibility. It is a normal market phenomenon that economic units come up and disappear due to market forces. But the exchange is just not an economic unit; it is a trustee for investors by virtue of being the listing authority. If an exchange, where a security is listed, disappears, the listing authority as well as the trading platform for the security disappears. Can a regulatory entity disappear for commercial reasons? This reinforces the argument that securities should be listed, but not listed on/by a particular stock exchange, but by a third party which would not be extinct for commercial reasons.

Listing signals that the issue has been properly supervised. The unwary investors take it as some kind of qualitative rating of the company, despite disclaimers to the contrary. Listing also casts onerous responsibilities on the exchange in the sense that it acts as a trustee for investors and ensures compliance of certain standards by a listed company. Most of the exchanges, given their financial health and organizational structure, are not in a position to supervise such large number of listed companies (9,644 companies listed on exchanges as at end of March 2002). Given their dependence on listing income, they can not discharge listing function efficiently. They can not easily deny a listing request nor can they suspend/delist a security without a second thought as they would not like offend a listed company in view of their interest. This therefore suggests the need for listing and supervision of a listed company through an independent authority who would not depend on listing income for survival.

The exchanges are now having a re-look at the way they conduct business and are gearing up to demutualise themselves by converting themselves into public limited companies. They will also be accessing securities market to finance their ever expanding trading network and would be interested to list their securities. This would create an anomalous situation where a stock exchange would admit its own securities for trading. A satisfactory solution would be to vest the listing powers with a body separate from the stock exchanges.

In view of the foregoing, it is desirable that there is only one agency which considers all requests for listing and grants listing if it finds a security suitable for investors across the country. A security granted listing by the agency would be available for trading on all exchanges who will not waste resources in terms of duplication of efforts on listing and monitoring compliance. The security should also be monitored, and suspended and withdrawn from trading by the listing agency. The investors and market participants would get all the company related information, which are mandatorily required to be filed by companies, at one location preferably a web site maintained by the CLA. The exchanges should concentrate on trading only while pre-trading activity (listing and compliance of terms of listing) is managed by CLA and post trading activity (clearing and settlement of trades) is managed by clearing corporations.

VII. Public Holding for Listing

A public company seeking listing of its securities on a stock exchange is required to satisfy the exchange that at least 10% of each class or kind of securities issued by it was offered to the public for subscription. However, this requirement is subject to the conditions that (a) minimum 20 lakh securities (excluding reservations, firm allotment and promoters' contribution) was offered to the public; (b) the size of the offer to the public, i.e. the offer price multiplied by the number of securities offered to the public was minimum Rs. 100 crore; and (c) the issue was made only through book building method with allocation of 60% of the issue size to the qualified institutional buyers (QIBs) as specified by SEBI.

If, however, a company does not fulfill the above conditions, it has to satisfy the exchange that at least 25% of each class or kind of securities was offered to the public for subscription. The exchanges can, however, relax this requirement for a government company and SEBI can relax or waive the strict enforcement of any requirement of listing.

This framework suffers from following limitations: (i) The public offer is of no consequence unless the public are actually allotted shares. The law should speak in terms of allotment to public, not just public offer. (ii) The units of CIS are securities. The same requirement (10% + 20 lakh + Rs. 100 crore) as applicable to listing of securities, should also apply to listing of units of CIS. The requirements prescribed for units of CIS may be brought at par with those for securities. (iii) The units of MFs are being considered as securities and are being traded like securities on exchanges. The requirement of public holding may apply to units of MFs as well. (iv) There should not be any discrimination between a government company and a non-government company. The powers of the stock exchange to relax this requirement in respect of a government company needs to be withdrawn. The powers of SEBI to relax or waive strict enforcement of listing requirement may also be withdrawn. (v) The words 'public' or 'offer to public' have not been defined. The Rules permit 10% public offer subject to the condition that 60% of the issue is allocated to QIBs. Since QIBs are part of public, allocating 60% to QIBs would automatically constitute 60% public offer and the retail public would not get any share. Or, if 60% of public offer of 10% is allocated to QIBs, the retail public would be left with just 4%. It is, therefore, necessary to define 'public' and other terms and explicitly exclude allocation to QIBs from the public offer.

A large number of shares in the hands of a large number of shareholders is essential for sustenance of a continuous market for listed securities to provide liquidity to investors and to discover fair prices. The Act / Rules talk about offer to public, not about continuous public holding. To ensure availability of reasonable floating stock on continuous basis, the listing agreement requires a company to maintain the minimum level of non-promoter holding at the level of public shareholding at the time of listing. If the non-promoter holding of an existing listed company as on April 1, 2001 is less than that is required at the time of initial listing, the company shall within one year raise the level of non-public holding to at least 10%.

This arrangement prescribes different standards for continued listing for existing listed companies and would be listed companies. The existing listed company is required to have non-promoter holding of at least 10%, while the would be listed company would maintain non-promoter holding at the level of public holding as required at the time of listing, that is, at 10% plus 20 lakh securities plus Rs. 100 crore or 25%. Thus existing listed and would be listed companies and consequently investors in these companies are treated differently. It would be better if all the companies are required to maintain the non-promoter holding at the level of the public holding required at the time of listing. That is, the companies listed before 1993 would maintain at 60%, the companies listed between 1993 and 2001 would maintain at 25% and the companies listed after 2001 would maintain at 10% + 20 lakh + Rs. 100 crore or 25%. This is all the more desirable because the investor subscribes to the shares of the company based on the understanding that the non-promoter holding would be maintained at the level required at the time of listing. In the alternative, regulation has to be uniform in its application and all companies should be required to maintain non-promoter holding of 10% + 20 lakh + Rs. 100 crore or 25%.

Further, the listing agreement provides that the companies would maintain public holding at the specified percentage. There is no indication as to how to achieve this. Can a company compel the promoters to divest their holdings? In case an existing listed company fails to do; it would be required to buy back the public shareholding in the manner provided in the SEBI takeover code. No such requirement has been prescribed for would be listed companies. Both the existing listed and would be listed companies should be required to buy back the public holding if they fail to maintain minimum public holding. In case the company does not buy back, would it be delisted? This needs to be clarified. All these need to be provided in the SCRA or Rules, not left to listing agreement.

VIII. Delisting of Securities

The incidence of delisting has been increasing in the recent past. This has assumed importance in view of a number of MNCs acquiring the entire equity of their Indian subsidiaries through open offers and then delisting from the exchanges.

It is argued in some circles that delisting should not be permitted at all. They argue that it is the intention of legislature, as there are statutes and rules to govern listing, but no statute/rule provides for delisting. Only law that governs delisting is a circular of SEBI. It is probably considered that listing is so sacrosanct that once a security is listed, it should not be delisted. An investor subscribes to an issue on the basis of the contents in the prospectus which may state that the security would be listed on stock exchanges. Once he subscribes to the issue, he takes an irreversible decision, as the promises in the prospectus are irreversible. Hence if one considers investors interest to be the predominant and sole factor, there should not be any delisting of securities. Once listed, a security should remain listed forever as long as the issuer exists.

Another school supports delisting. It argues that listing agreement is essentially a contract between a company and an Exchange. Like any contractual relation, it must have also a way to terminate the relationship in certain circumstances. If there is a way to get in, there must be also a way to get out. Should the exchange and the company consider terminating their relationship, after taking care of interest of the affected investors, they should be permitted to do so.

In certain circumstances, delisting may serve interest of investors. If a company has been incurring losses and its net worth has become negative, there may not be any interest in the security. In this situation, if the company has to pay the listing fees, it harms the investor further, while no public interest or investor interest is served by continued listing. Or, if the security is allowed to trade, some innocent investors would be buying them and losing ultimately. It may also happen that a security is listed on many exchanges, but traded in a few. Payment of listing fees to exchanges where the security is not traded at all or traded insignificantly affects the investors ultimately. It may be desirable to allow a company to delist its securities in these cases.

In view of the above, it may not be desirable to put an absolute ban on delisting but it may be discouraged. The statute or rules must provide a framework for delisting. If it is in the interest of investors, it must be permitted. If it is not in the interest of investors, delisting may be allowed only if investors are adequately protected. When a security at the time of issue carries an assurance that it would be listed on stock exchanges, it promises liquidity to security and hence carries a liquidity premium. This means that the security is issued at a price higher than what it would have been if it does not carry an assurance of listing. Since delisting withdraws the liquidity, the investors should be allowed get out with a premium. Non-compliance of listing agreement should not be a ground for delisting. The terms and conditions of listing have to be enforced by recourse to other means rather than delisting.

IX. Clearing Corporation

The anonymous order book does not allow participants to assess the counter party risk. It is, therefore, necessary that the exchanges use a clearing corporation to provide novation and settlement guarantee. NSCCL provides such novation for all trades executed on NSE. Similar facility should be provided for trades on other exchanges. It is not necessary that each stock exchange must have its own exclusive clearing corporation. It may be better if the stock exchanges use the services of a clearing corporation or a few clearing corporations, as they share the depository services. Such an arrangement allows the clearing corporation to have an overall view of gross exposure position of traders across the stock exchanges and is much better geared to manage the risk. However, to provide for necessary competition, it is essential that there are at least two clearing corporations, just as this has been ensured in the case of depositories.

The securities laws do not explicitly recognise existence of clearing corporation. They talk only about trading and not about settlement, which is left to bye-laws of the exchanges. The bye-laws are supposed to provide for clearing house (not clearing corporation) for settlement of securities transactions. Except NSE, all exchanges have their departmental clearing houses. Risk management requires that all exchanges are required to use the services of a clearing corporation and this is mandated in law.

The clearing corporation ensures financial settlement of trades on the appointed day and time irrespective of default by members to bring in the required funds and/or securities, with the help of a 'Settlement Guarantee Fund'. The market has full confidence that the settlement shall take place in time and shall be completed irrespective of default by isolated trading members. This has revolutionised the volumes in the secondary market. It is important to keep improving the value of the Settlement Guarantee Fund by adding back all the accruals to the fund, subject to administrative expenses, to retain and build up the faith that the retail and foreign investment have reposed in the settlement mechanism. For this purpose, it is necessary to exempt the income of the Clearing Corporation from the purview of income tax.

As the clearing corporation guarantees financial settlement, it is necessary that it has first lien over the assets of insolvent clearing members.

X. Taxability of Income arising from Derivative Contracts

The Income-tax Act does not have any specific provision regarding taxability of income from derivatives. Only provisions, which have an indirect bearing on derivative transactions, are Sections 73 (1) and 43 (5). Section 73 (1) provides that any loss, computed in respect of a speculative business carried on by the assessee, shall not be set off except against profits and gains, if any, of any speculative business. Section 43(5) of the Act defines a speculative transaction as a transaction in which a contract for purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by actual delivery or transfer of the commodity or scrips. It excludes the following types of transactions from the ambit of speculative transactions: (i) a contract in respect of stocks and shares entered into by a dealer or investor therein to guard against loss in his holding of stocks and shares through price fluctuations; (ii) a contract entered into by a member of a forward market or a stock exchange in the course of any transaction in the nature of jobbing or arbitrage to guard against loss, which may arise in ordinary course of business as such member. A transaction is thus considered speculative if (i) it is in commodities, shares, stock or scrips, (ii) it is settled otherwise than by actual delivery, (iii) it is not for jobbing/ arbitrage, and (iv) the participant has no underlying position. Thus the law considers the same transaction speculative for one party who has no underlying position and non-speculative for the other party who has an underlying position or is doing arbitrage.

In the absence of a specific provision, it is apprehended that the derivative contracts, particularly the index futures/options which are essentially cash-settled, may be construed as speculative transactions. Therefore, the losses, if any, will not be eligible for set off against other incomes of the assessee and will be carried forward and set off against speculative income only up to a maximum of eight years. The fact, however, is that derivative contracts are not for purchase/sale of any commodity, stock, share or scrip. Derivatives are a special class of securities under the SCRA and do not in any way resemble any other type of securities like shares, stocks or scrips. Derivative contracts are cash-settled, as many of these (index options / futures) can not be settled otherwise.

The hedgers, speculators and arbitrageurs enter into derivative contracts. A derivative contract has any of these two parties and at least one of the parties is a hedger or an arbitrageur. Hence some, not all, of the derivative contracts have an element of speculation. Besides, hedgers and speculators are two sides of the same coin. Hedging is not possible if there are no speculators. The derivative market's capacity to absorb buying/selling by hedgers is directly dependent on availability of speculators to act as counter parties to hedgers. The derivative market can have liquidity only if it has speculative appeal. A competitive and efficient market requires that all types of participants be provided a playing field and their income from derivatives are taxed uniformly. The income from the same transaction should have similar tax treatment irrespective of the participant involved in it. This is all the more necessary as it is well neigh impossible to ascertain if a participant is trading for speculation, hedging or arbitrage. As a result, at times a hedging transaction is misconstrued as a speculative one. It is better to give benefit of doubt to exempt all speculative transactions than to misconstrue a hedging transaction as speculative. It is like acquitting hundreds of culprits rather than convicting a single innocent person. Attempts to differentiate transactions in commodities, share and stocks for speculative purposes have led in the past to a flood of litigation at the time of assessment.

A transaction is considered speculative, if a participant enters into a hedging transaction in scrips outside his holdings. It is possible that an investor does not have all the 30 or 50 stocks represented by the index. As a result an investor's losses or profits out of derivatives transactions, even though they are of hedging nature in real sense, it is apprehended, may be treated as speculative. This is contrary to capital asset pricing model, which states that portfolios in any economy move in sympathy with the index although the portfolios do not necessarily contain any security in the index. The index derivatives are, therefore, used even for hedging the portfolio risk of non-index stocks. An investor who does not have the index stocks can also use the index derivatives to hedge against the market risk as all the portfolios have a correlation with the overall movement of the market (i.e. index).

In view of (i) practical difficulties in administration of tax for different purposes of the same transaction, (ii) inherent nature of a derivative contract requiring its settlement otherwise than by actual delivery, (iii) need to provide level playing field to all the parties to derivatives contracts, and (iv) need to promote derivatives markets, the exchange-traded derivatives contracts need to be exempted from the purview of speculative transactions. Otherwise it would be a penalty on hedging which the Securities Laws (Amendment) Act, 1999 seeks to promote. These must, however, be taxed as normal business income.