

REVIEW OF OWNERSHIP AND GOVERNANCE OF MARKET INFRASTRUCTURE INSTITUTIONS (MIIs)

Dr. Bimal Jalan Committee

Stock exchanges in India have a long history of more than 175 years. These institutions have witnessed drastic change in their ownership and governance structure over time, from a purely closed club of trading members to full demutualization, and from an organization resembling more a self regulatory organization to a SEBI regulated entity. Changes have been made from time to time in the management and functioning of the stock exchanges to serve the overarching objective of market development, financial inclusion, transparency, developing and operating efficient and risk free trading system. Along with stock exchanges other institutions (depositories and clearing corporations) which are as much a vital part of the market infrastructure, for achieving the above objectives also developed. These institutions (i.e., stock exchanges, depositories and clearing corporations) are systemically important for the country's financial development and serve as the infrastructure necessary for the securities market. These institutions are collectively referred to as Market Infrastructure Institutions (MIIs).

Government has issued various Acts and SEBI has prescribed various Regulations from time to time for the smooth functioning of these MIIs. These Acts and Regulations have been modified from time to time as to respond to the needs of the market and in keeping with financial and technological advancement world over. Development is a continuous process and each change brings a new challenge. The case of MII's has been no different.

Corporatisation has brought to the fore a new conflict between the 'profit maximization goal' of an Exchange vis-à-vis its 'regulatory role'. Exchanges have traditionally been the first line of regulators in the securities market. With growing commercialisation of the exchanges and the resultant competition between exchanges, it would be necessary for the market regulator to recognize the possibility that exchanges may compromise on its regulatory role in its urge to canvass larger volumes of business from intermediaries and investors.

In many jurisdictions across the world, exchanges as part of the trading infrastructure are viewed as public utilities. As a public utility, an Exchange becomes the organization that maintains the infrastructure, (the trading avenues and platforms and offers services incidental to this) for a public service (running a market for securities trading). Internationally, the practice prevalent among regulators has been to allow Exchanges to pursue their commercial operations, while exercising regulatory oversight. It has also been argued that any micromanagement of the commercial operation of exchanges by a regulator might stifle their initiative in contributing to a buoyant securities market in India.

*The SEBI Board, in its meeting held on December 22, 2009, (the detailed agenda note is available at <http://www.sebi.gov.in/boardmeetings/129/corpgovern.html>) decided to set up a Committee to look into the above issues and give suitable recommendations. Accordingly, a Committee under the Chairmanship of Dr. Bimal Jalan has been constituted. The Committee has decided to adopt a consultative process. Accordingly, a questionnaire has been devised to seek the views of market infrastructure institutions, market participants, users and public on the concerns related to Ownership and Governance of Market Infrastructure Institutions, as elaborated above. You are requested to forward your responses for the questionnaire to any of the following email ids latest by **May 10, 2010**:*

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Part –A

(Applicable to all three categories of MIIs)

Functions

1. Do you view MIIs largely as commercial, public utility or regulatory institutions? What kind of ownership and governance norms would enable MIIs in discharging the functions for which they were created?
2. What should be the regulatory function of MIIs in terms of regulating its members/ market/ participants/users, etc?
3. Which are the functional areas that could be solely demarcated as falling under regulator's supervision vis-à-vis those that falling under the MIIs' purview?
4. Do MIIs typically perform the functions of a SRO as recognized internationally? Do you see any potential conflict of interest between the regulatory function and the commercial interest of MIIs? Can the conflict of interest be eliminated through specific stipulations on structure and governance of MIIs? (For e.g. erection of Chinese wall between the two functions or hiving it off to a subsidiary or transferring to a regulatory body)?
5. What other businesses should a MII be allowed to do? Can they set up another MII with 100% shareholding? What kind of non-MII businesses can they perform? Can they set up related businesses such as independent software vendors?

Ownership and governance

6. How do you place MIIs in India vis-à-vis their international counterparts? What are the major differences in ownership/governance between Indian MIIs and their international counterparts? What is your recommendation?
7. Does the present ownership restrictions on MIIs need review?
8. Which is a better model for ownership? – (a) Diversified ownership (as in the case of stock exchanges) or (b) anchor/strategic investor approach (as in the case of depositories).
 - a. In case (b) is suitable for MIIs, what classes of entities can be permitted to be anchor investors?
 - b. Should there be lock-in restrictions for anchor investor?
 - c. What are conflicts arising out of private entities becoming anchor investors? Please recommend measures to address them.
9. Should the shares of MIIs be with differential voting rights so that the control is separated from economic interest?
10. In the light of the recent global financial crisis, and the debate on management compensation, is there a case for enunciating principles for management compensation of MIIs? Should the fixation of management compensation be entrusted to an independent Appointments Committee which reports to the Board of the MII and/or to the Regulator? What should the management be accountable for – profitability, regulatory efficiency, etc? Please specify.

11. What should be process of appointment of Senior Management in MIIs? Should the regulator be involved in it? Can this task be entrusted to an independent Selection Committee which reports to the Board of the MII and/or to the Regulator? What other safeguards are to be put in the management framework? Can there be an independent risk management Committee (please identify other such sensitive areas) reporting directly to the Board of the MII and/or to the Regulator?

Market structure for MIIs

12. Do you perceive an optimal number of MIIs (Number of stock exchanges; number of depositories; number of clearing corporations), for the Indian Securities Market, taking into account the present status as well as growth possibilities in the future?
13. What should be entry and exit norms applicable to MIIs?
14. Are there any regulatory issues arising out of competition such as discrimination by a MII against a competing MII or any intermediary or technology provider, that needs to be regulated? What should be the norms to regulate relationship of MII with technology providers and intermediaries?
15. To what extent should commercial functions of a MII be regulated? Specifically, should charges and fees levied by MIIs be regulated in a competitive environment?
16. Is there a case for capping the charges on a 'cost plus' basis and/or for capping distribution of profits?
17. There are twin dangers for all MIIs – 'regulatory race to the bottom in the face of competition' or 'becoming too big to fail'. What safeguards can be built to prevent the same. In the case of clearing corporations, are rigorous 'stress tests' adequate to address the same?

Listing

18. What is the primary objective of listing a MII? What are the alternatives to achieve these objectives (transparency being one of the objectives)?

Part - B (Only for Stock Exchanges)

1. Should separate requirements be put in place for QIBs participating in the primary issue of stock exchanges and should they be granted positions on the Boards of Exchanges?
2. Should foreign stock exchanges be permitted to hold upto 15% or more of the equity shares in the Indian stock exchanges?
3. Whether the current limit for FII in stock exchanges need a review? What should be the manner of participation of FIIs in the equity of stock exchange?
4. Should FIIs also be permitted to participate in IPO or FPO of stock exchanges?

5. What are the issues arising out of the listing of shares of a stock exchange on itself?
6. What are the issues arising out of an MII which has a substantial stake in a stock exchange listing on the same stock exchange?
7. Should dual listing (including listing of shares of the stock exchange on itself) of shares may be considered?
8. Whether cross listing is desirable?

In respect of the above queries on listing, suggestions/comments may be provided after considering the various models viz: committee model, company model¹ etc used internationally to address the issue of 'conflict of interest'.

9. SEBI broadly prescribes the Board composition in the case of stock exchanges. Currently there is a restriction on the extent of representation by trading members on the Board (maximum 25%). The PIDs (minimum 25%) are empanelled by SEBI. The balance are shareholder directors.
 - a. Does the present Board composition (including manner of appointment of the Board) prescribed by SEBI for stock exchanges need a review? If yes, how should separation of members, owners and management of MIIs be ensured to avoid conflicts of interest and also ensure independence of Board?
 - b. Further, should the same be extended to other MIIs?
10. Trading Members on the Board of the Exchange can potentially have access to confidential information in respect of trading information pertaining to other members as well as sensitive information. In light of the above,
 - a. Please elucidate your view on the role of trading members on the Board of the Exchange.
 - b. Should there be any trading member representation on the Board of the Exchange or alternatively, can they be put on a separate Advisory Board to the main Board?
 - c. Should safeguards similar to Insider trading rules be prescribed for trading members on the Board of the Exchange?
 - d. What should be the extent of participation of trading members on the various committees of the Exchanges?

Part – C
(Only for Clearing Corporations)

1. Should clearing corporations be subsidiaries of exchanges or a completely separate entity? What should be the ownership restrictions for clearing corporations? Which model is preferred and why?
2. Is there a case for stipulating the same networth requirement for clearing corporation and exchanges and depositories (i.e., Rs. 100 crores) or is there a case for it to be higher? Alternatively, a minimum amount of Rs. 100 crores may be prescribed plus an additional multiplier based on the number of exchanges or volumes or products that are cleared and

¹ For details regarding various models, please refer to Annexure V of the agenda note available at <http://www.sebi.gov.in/boardmeetings/129/corpgovern.html>

settled through the clearing corporation. If the second alternative is preferred, kindly suggest a suitable formula for determining the same.

Part – D
(Only for Depositories)

1. Is it desirable to allow Exchanges, (who are in a related business) to own more than 50% of the ownership of Depositories, by virtue of being a sponsor of the depository in effect leading to the depository becoming a subsidiary/ group company of the Exchange?