Report of the Committee to Study The Future of Regional Stock Exchanges (RSEs) – Post Demutualisation

Executive Summary

Introduction

1. A stock exchange in India is recognized by the Central Government under section 4 of Securities Contracts (Regulation) Act, 1956 (SCRA) for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities, after it is satisfied that it would be in the interest of the trade and also in the public interest to grant such recognition. This power to grant recognition to a stock exchange can also be exercised by SEBI. Over a period of time, stock exchanges came to be set up almost in every State. These stock exchanges set up regionally were known as the Regional Stock Exchanges (RSEs). The objective of establishing the RSEs was to enable regional companies in the respective geographical locations to raise capital and to help spread the equity cult amongst investors across the length and breadth of the country. However, with the various changes in the capital market micro structure, the scope of operations of the RSEs became limited. The trading in these RSEs had also dwindled over the past several years. *(Para 1.1)*

Reasons for the formation of the Committee

2. The stock exchanges are now completing the process of corporatisation and demutualisation. It was found necessary to examine the role and relevance of RSEs in the changed circumstances and the productive utilization of the available infrastructure in these RSEs. In order to deliberate on these issues and make suitable recommendations in this regard, SEBI constituted a Committee under the Chairmanship of Shri G.Anantharaman, Whole Time Member, SEBI. The other members of the Committee are:

   i. Shri M.R. Mayya, Former Executive Director- Bombay Stock Exchange and Former Chairman - The Inter Connected Stock Exchange Ltd.
   ii. Shri Sandeep P. Parekh, Advocate, Supreme Court of India, and visiting faculty, Indian Institute of Management, Ahmedabad.
   iii. Shri Ramu Sharma, Director - Bangalore Stock Exchange Ltd. and Chairman, Federation of Indian Stock Exchanges (FISE)
   iv. Shri J. Jayaraman, Chartered Accountant, Ahmedabad
   v. Shri Rajnikant Patel, MD and CEO, BSE Ltd. - co-opted as a member.
   vi. Shri Manas S Ray, Executive Director, (OSD) SEBI, Mumbai - co-opted as a member.
   vii. Prof. Mousumi Ghosh, Professor, Finance & Control, IIM- Calcutta (ceased to be a member from March 14, 2006)
   viii. Shri Pratip Kar, Executive Director, SEBI, Mumbai – Member Secretary. *(Para 2.1)*

Terms of reference of the Committee

3. The terms of reference of the Committee were as under: -
   to review and examine -
   - the future role of the RSEs and their subsidiaries – post demutualisation, keeping in view the legal requirements of the SCRA;
   - the manner of dealing with the assets of the RSEs in the event of withdrawal of recognition;
   - the qualitative and quantitative restrictions to be specified, if any, for limiting the investment or voting rights of prospective investors in the process of divestment of the shareholding of the RSEs.

- The terms of reference as above would include certain related issues incidental to the course of demutualisation as well and resolution of such issues considered essential to the issues arising post-demutualisation. *(Para 3.1)*

Present status of the RSEs

4. Out of the 22 recognised stock exchanges in India (SEBI has refused renewal of recognition to Mangalore Stock Exchange), NSE and BSE account for almost 100% of the total turnover. As far as RSEs are concerned, except for the Calcutta Stock Exchange (CSE) and the Uttar Pradesh Stock Exchange (UPSE), there is no trading on any other stock exchange and even on the CSE and UPSE, the business is down to a trickle. The financial condition of the RSEs is by and large also weak. This state of affairs has been prevailing for the past several years. Three factors have been primarily responsible for this: a) the advent of automated trading and extension of nationwide reach of BSE and NSE which offered a large and liquid market to investors across the country; b) the introduction of uniform rolling settlement from June 2001 in place of account period settlement with varying settlement cycles and c) the abolition of the concept of regional listing. *(Paras 6.1 and 6.2)*

Initiatives taken for the revival of the RSEs

5. Considering that the RSEs had invested substantially in the infrastructure, which included building, hardware and software for automated trading, several initiatives were taken to revive these exchanges so that the infrastructure could be put to productive use. The first among them was the setting up of the ICSE platform to regroup the RSEs to provide a third national market. The ICSE was promoted in 1998 by 14 RSEs for providing an additional trading platform where the shares listed on any of these 14 exchanges would be traded. The ICSE was thus conceptualised as a stock exchange to provide a common trading platform to members of all participating stock exchanges, mainly with the objective of boosting trade in the securities listed on the participating stock exchanges. It was felt that such trading across different stock exchanges would generate renewed trading interest among investors by providing them an opportunity to trade in large number of shares that were listed on the participating exchanges. But this did not happen. The existing regional order books of the participating exchanges continued. This fragmented the order book and thus depleted the liquidity in the shares exclusively listed and traded on the RSEs. On account of lack of liquidity, ICSE did not succeed. *(Para 7.1)*

6. The second effort was to permit the RSEs to set up broking subsidiaries which could pool the financial resources of regional brokers and of the exchanges and obtain membership of the BSE and NSE. The regional brokers could then act as sub brokers to the subsidiaries (which had registered as brokers) and have access to the markets of BSE and NSE. Even the ICSE set up such a broking subsidiary. Though the scheme maintained the purity of the functions of the exchanges, though dysfunctional, most subsidiaries became successful brokers in the market of other exchange(s). Although the subsidiaries were basically brokers, there were several differences between them and corporate broking firms, primarily because these were subsidiaries of the stock exchanges. *(Para 7.2)*

7. SEBI took the initiative to encourage the BSE and the smaller stock exchanges to set up the BSE Indo Next trading platform as a separate trading platform under the present BOLT trading system of the BSE. It was a joint initiative of the BSE and the Federation of Indian Stock Exchanges (FISE) of which 18 RSEs are members. The BSE IndoNext market was intended to be an SME specific market. The BSE IndoNext trading platform was supposed to be implemented in phases. But it has not yet gone beyond the first phase in which the major

shares transferred are from the B1 and B2 group of the BSE and only a few shares of some of the RSEs have been transferred. *(Para 7.3)*

8. The Committee appraised itself of the present status of the RSEs in the light of the discussions with all the RSEs as well as with the BSE, NSE and OTCEI and the written submissions made by them. Analysis of the financial conditions of the RSEs and their subsidiaries, and of the listing, trading and compliance status of the companies listed in these RSEs was equally important for a complete appreciation of the present conditions of the RSEs and the choices available with the subsidiaries. *(Para13.1.1)*

9. The Committee notes that the RSEs were established with the objective of providing a regional market for raising capital by companies in the respective regions by garnering regional savings to help achieve a balanced regional development and to spread the equity cult among investors in the country. This objective has been fairly served by the RSEs for a length of time. But with the advent of modern telecommunication and information technology and the symbiotic interaction of technology and the markets, which facilitated a fundamental transformation of the market micro structure, the scope of the RSEs became limited till they virtually lost their relevance. *(Para13.1.2)*

10. The Committee recognises that even internationally, and precisely for similar reasons, the RSEs have had a chequered past and over a very short period of time became moribund before the burgeoning growth of the national stock exchanges with national and international reach. This prompted a move towards consolidation of RSEs. *(Para13.1.3)*

11. The above situation naturally raises the basic question on the *raison d'être* of the RSEs and their subsidiaries in the present market structure. When this question was posed before the RSEs, it did not evince any convincing response. They did not come with any specific viable business plan for the revival of the RSEs excepting pinning hopes on a future which might be bright. The Committee also notes that there are certain deeply embedded behavioral issues which continue to dominate the mind set of the members of the RSEs and they seem to be coming in the way of some of the RSEs accepting the reality which demands sub-ordination of their individual and independent identity before the larger interest of the very survival of the RSEs.. Indeed, it was this attitude coupled with the equally uncompromising attitude of the business partners which were responsible for the failure of the various rehabilitatory measures taken in the past for the revival of the RSEs. Equally the members of the RSEs, by virtue of their access to national trading platforms through the subsidiary route did not find any incentive to trade and promote trading in the RSEs. *(Paras13.1.4, 13.1.5)*

12. There have also been serious regulatory concerns from time to time on the functioning of some of the RSEs. These regulatory concerns had led SEBI to take recourse to the extreme measure of superseding the governing boards of some exchanges and even to withdraw the recognition in the case of one RSE. These regulatory concerns still remain in the case of some of the RSEs where the members continue to remain recalcitrant and resort to undesirable market and governance practices. *(Para13.1.6)*

13. Although the RSEs have ceased to perform the basic economic function for which they were set up, their continued existence by itself, necessitates regular on site and off site regulatory monitoring and surveillance. Regulatory resources are thus thinly spread and the attention of the regulator is diverted from more emergent issues to grappling with such routine issues which relate to dysfunctional entities. *(Para13.1.7)*

14. It was clear to the Committee that any solution to the conundrum posed by the RSEs, must encompass all the issues delineated above including the deeply embedded behavioral issues. Equally, such solutions must not only be practicable and implementable but also eschew adhocism and discretion which had informed and also thwarted some of the past initiatives for revival of the RSEs. *(Para13.1.7)*

Recommendations

15. The Committee feels that (a) such of the RSEs which do not want to continue as exchanges should be given an exit option, (b) the recognition of such of the RSEs which are notorious for their rank indiscipline besides giving rise to serious regulatory concerns should be compulsorily withdrawn and (c) a continuing option may be given to such of the RSEs which have the potential and the willingness to participate in any alternate trading platform. *(Para13.1.8)*

16. The Committee is strongly of the view that it does not serve either the interest of trade or public interest, to forcibly keep alive the recognition of an exchange which does not have any potential for survival and is keen for an exit option or is posing to be regulatory burden. The Committee therefore recommends that (a) such of the RSEs which do not want to continue as an exchange, should be given an exit option by withdrawing their recognition upon a specific request or application made by them; (b) recognition should be withdrawn compulsorily for such of the RSEs which are notorious for their rank indiscipline besides giving rise to serious regulatory concerns and (c) the recognition of those RSEs which have the potential and the willingness to participate in any alternate trading platform may be continued. The Committee is of the view that sections 4 and 5 of the SCRA sufficiently empower SEBI to withdraw recognition for both the category of exchanges whether an exchange is recognized permanently or from year to year. *(Para13.1.9)*

17. The Committee feels that the withdrawal of recognition to the above two categories of RSEs would help clean up the system, besides reducing the regulatory hazard to the investors, various regulators including tax authorities and the government. The issue of distribution of assets would become relevant in the eventuality of withdrawal of recognition for any reason. There is at present no provision for such distribution either under the SCRA or within the regulatory framework of SEBI. As distribution of assets would be an impending consequence of any withdrawal of recognition of a stock exchange, there is an urgent need to formulate a permanent and appropriate scheme. The Committee therefore recommends that suitable rules be formed under section 30 of the SCRA, for distribution of assets of any stock exchange which ceases to be a recognised stock exchange. *(Para13.1.10)*

18. The corpus of any stock exchange is made up of (1) the contribution of the members, (2) the income of the exchange, and (3) the fiscal incentives which had helped the accumulation of reserves. In addition, it may include an adventitious factor by way of appreciation in the value of the assets over a period of time. The net worth of the exchange after revaluation of the assets and liabilities based on market value could be apportioned on the basis of the three components of the corpus mentioned above. The share relating to the members' contribution should be made available to the members. The balance will be transferred to an escrow account and then to a fund earmarked for the purpose of investor protection managed by SEBI. This scheme will need a proper methodology for valuation of the assets and liabilities as well as for determining the proportion mentioned above and should be carried out by an independent entity. In this regard, the Committee recommends that a Task Force be

constituted by SEBI comprising a chartered accountant, an approved valuer and a representative of SEBI for the purpose. *(Para13.2.1)*

19. The Committee strongly feels that in the absence of such a provision, no RSE would seek a voluntary exit option and one would have to live with a situation in which RSEs would continue to exist nearly in perpetuity and continue to remain a burden on the investor and the regulatory system. *(Para13.2.2)*

20. The closure of the RSEs will have concomitant consequences on the companies which are listed exclusively on these stock exchanges and their shareholders who would be denied an opportunity to trade. These have been dealt with later in this report. *(Para13.2.3)*

21. The entity which remains after withdrawal of recognition must immediately change its name and style and cannot continue in any business as a stock exchange. In case a stock exchange whose recognition is withdrawn has a subsidiary, such an entity would also have to change its name and style to avoid any representation of any present or past affiliation with an exchange. It would be upto the subsidiary to carry on broking operations as any other broking entity registered with SEBI subject to the same rights and duties. *(Para13.3.1)*

22. The Committee felt that the impact on account of withdrawal of recognition either on request or on compulsory direction on the companies exclusively listed on the RSEs and their shareholders would also need to be suitably addressed. An analysis of the compliance status of these companies indicates that only about 500 companies are compliant with the continuous listing requirements. It is felt that such compliant companies in an exchange which will no longer remain recognized, should be allowed to migrate to any other exchange with minimum procedure and hassle to the company. SEBI can prescribe that files of such compliant companies be moved inter-exchange with minimum burden on such companies. *(Para13.4.1)*

23. The Committee also recommends that before seeking voluntary withdrawal of recognition, the RSEs would have to compulsorily delist all non-compliant companies. *(Para13.4.1)*

24. The Committee expects that the mechanism as provided for asset distribution would encourage a large number of RSEs to seek voluntary exit option. The compulsory withdrawal of recognition would also help close down a number of RSEs against which there exists serious regulatory concerns. These two processes will help clean up and streamline the system. *(Para13.4.5)*

25. In the event of some of the remaining RSEs which have already been corporatised and are unable to demutualise within the stipulated time such RSEs will also attract the consequences of withdrawal of recognition under sec. 5(2) of the SCRA and their recognition will be compulsorily withdrawn and accordingly, they would have recourse to the same mechanism of asset distribution as recommended supra.. *(Para13.4.5)*

26. While considering the various options available for the sustainable existence of the remaining stock exchanges, the Committee examined the reasons for the failure of the various regulatory initiatives that were taken from time to time for their revival. The seeds of failure of these two well-intended initiatives lay in the deep rooted behavioral issues, mind sets with the attendant resistances and conflicts. The Committee is of the view that the success of any other initiative to be taken in future would be solely dependent on the willing co-operation of the RSEs and its members and the BSE or NSE. It would not be wise to recommend a

measure for the development of a third platform at the national level building purely only on a sanguine estimate of expected success. At the same time, the Committee also recognizes that in the absence of a third platform, the SMEs in India would have virtually no avenue for raising capital from the public and this would not be in the interest of the Indian economy in the long run. *(Paras13.5.1 and 13.5.3)*

27. The Committee recommends that all the RSEs whose recognition has not been withdrawn either voluntarily or compulsorily must collectively choose (in order for it to succeed) either the BSE model or in the alternative, the ICSE model. The FISE will have to take the initiative of evolving a consensus amongst the RSEs. In order that the Public representative (PR) Directors are able to discharge their responsibilities, it is important that they are conversant with the governance of the RSEs, have a reasonable knowledge of the securities market and are aware of their own functions as PR Directors. The Committee, therefore, recommends that SEBI should work out an appropriate training programme for the PR Directors. *(Para13.9)*

28. The Committee, however, is of the view that in case both of these models fail for whatever reasons, there would be no merit in the continuation of the RSEs and the recognition of all the RSEs will, therefore, have to be compulsorily withdrawn. Once the RSEs have chosen a particular model, such of the RSEs which are unwilling to accept that model will have to face compulsory withdrawal of recognition in the future as they provide neither a trading platform nor serve any public interest. *(Para13.10)*

29. The actions consequent to withdrawal of recognition discussed in the earlier paragraphs would be applicable in these cases also. The other more serious consequence would be that SMEs would be bereft of any avenue for raising capital from the public. This would be detrimental to the economy in the long run and this will always remain a concern. *(Para13.11)*

30. The Committee is of the view that the future of the subsidiaries is inter-linked with the survival of their parent RSEs. In case a stock exchange whose recognition is withdrawn has a subsidiary, such an entity would also have to change its name and style to avoid any representation of any present or past affiliation with an exchange. It would be upto the subsidiary to carry on broking operations as any other broking entity registered with SEBI. The subsidiaries' demand of level playing field could then easily be recommended as they become brokers (or other registered financial intermediaries) simplicitor. This would necessitate the NSE to modify suitably its norms relating to dominant holdings in the case of these entities. SEBI should consider extending turnover fee continuity benefit to such entities. *(Paras14.1 and 14.2)*

31. In case of the subsidiaries of the RSEs whose recognition is not withdrawn, the RSEs should preferably cease to have any shareholding in the subsidiary within a period of three years. However, the RSEs may be allowed to retain less than 15% of the shareholding in the spun-off entity. *(Para14.3)*

32. One of the terms of reference of the Committee was to recommend modalities for increasing the public shareholding in demutualised stock exchanges in accordance with the provisions of SCRA. The Committee notes that the procedure for Corporatisation and Demutualisation of stock exchanges laid down in sec. 4B of SCRA envisages that majority of the shareholding of a demutualised stock exchange in India should be held by the public or in any manner as may be specified by SEBI regulations, within a period of one year from the date of publication be

SEBI of the order approving the scheme. Any non-compliance with the provisions of C&D scheme, including failure to increase the public shareholding within the stipulated time would result in withdrawal of recognition of a stock exchange under sec. 5(2) of the SCRA. *(Paras 15.1 and 15.2)*

33. The Committee notes that in case a stock exchange adopts the route of public issue, it would necessarily have to be in accordance with the SEBI (Disclosure & Investor Protection) Guidelines, 2000. The Committee recognizes that all stock exchanges might not necessarily adopt the IPO route for increasing the public shareholding. The Committee recognizes that it may perhaps be necessary in the interest of the development of the stock exchanges to induct some strategic partners. *(Paras 15.4 and 15.5)*

34. The Committee also recognizes that in the present Indian context, it may not be desirable to adopt fully the approaches followed internationally. At the same time, the Committee felt that excessive qualitative and quantitative restrictions would not only thwart the process of divestment but would also become difficult to monitor in the practical sense. Besides, such restrictions may dampen valuations and limit the choice of investors thereby raising the cost of capital. The Committee, therefore, recommends that any entity other than exchange, multilateral agency, insurance company, bank, depository and clearing corporation can be allowed to hold less than 15% of the share capital and voting rights of the stock exchange either singly or collectively along with persons acting in concert. However, in case a strategic partner is an exchange, multilateral agency, insurance company, bank, depository or clearing corporation, it would be allowed to hold upto a maximum of 26% of the share capital and voting rights of the stock exchange either singly or collectively along with persons acting in concert. Any strategic partner must comply with SEBI (Criteria for Fit and Proper Person) Regulations, 2004. The holding by any foreign entity including FIIs would be subject to the overall policy of the Government on FDI. These recommendations would have to be incorporated suitably in the divestment regulations to be framed and notified by SEBI. *(Para 15.10)*

35. The Committee recommends that self-listing should be permitted, either through the IPO route or by way of listing with appropriate exemptions from Rule 19(2)(b) of SCRR in case a stock exchange does not make a public offer. The regulatory conflicts which are likely to arise will have to be dealt with by suitable provisions in the listing agreement of the stock exchanges and the stock exchanges will have to fully comply with the provisions of corporate governance incorporated in clause 49 of the listing agreement. Overseas listing will also be permitted after the exchange has been listed on the domestic exchange. *(Para 15.11)*

1. Introduction

1.1 A stock exchange in India is recognized by the Central Government under section 4 of Securities Contracts (Regulation) Act, 1956 (SCRA) for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities, after it is satisfied that it would be in the interest of the trade and also in the public interest to grant such recognition. This power to grant recognition to a stock exchange can also be exercised by SEBI. This implies that no entity can act as a stock exchange in India, unless it is recognized as such under this section of the SCRA. Over a period of time, stock exchanges came to be set up almost in every State. These stock exchanges set up regionally were known as the Regional Stock Exchanges (RSEs). The objective of establishing the RSEs was to enable regional companies in the respective geographical locations to raise capital and to help spread the equity cult amongst investors across the length and breadth of the country. However, with the various changes in the capital market micro structure, the scope of operations of the RSEs became limited. The trading in these RSEs had also dwindled over the past several years.

2. Reasons for the formation of the Committee

2.1 The stock exchanges are now completing the process of corporatisation and demutualisation. It was found necessary to examine the role and relevance of RSEs in the changed circumstances and the productive utilization of the available infrastructure in these RSEs. In order to deliberate on these issues and make suitable recommendations in this regard, SEBI constituted a Committee under the Chairmanship of Shri G.Anantharaman, Whole Time Member, SEBI. The other members of the Committee are:

i. Shri M.R. Mayya, Former Executive Director- Bombay Stock Exchange and Former Chairman - The Inter Connected Stock Exchange Ltd.
ii. Shri Sandeep P. Parekh, Advocate, Supreme Court of India, and visiting faculty, Indian Institute of Management, Ahmedabad.
iii. Shri Ramu Sharma, Director - Bangalore Stock Exchange Ltd. and Chairman, Federation of Indian Stock Exchanges (FISE)
iv. Shri J. Jayaraman, Chartered Accountant, Ahmedabad
v. Shri Rajnikant Patel, MD and CEO, BSE Ltd. - co-opted as a member.
vi. Shri Manas S Ray, Executive Director, (OSD) SEBI, Mumbai - co-opted as a member.
vii. Prof. Mousumi Ghosh, Professor, Finance & Control, IIM- Calcutta (ceased to be a member from March 14, 2006)
viii. Shri Pratip Kar, Executive Director, SEBI, Mumbai – Member Secretary.

3. **Terms of reference of the Committee**

3.1 The terms of reference of the Committee were as under: -

To review and examine -

- the future role of the RSEs and their subsidiaries – post demutualisation, keeping in view the legal requirements of the SCRA;
- the manner of dealing with the assets of the RSEs in the event of withdrawal of recognition;
- the qualitative and quantitative restrictions to be specified, if any, for limiting the investment or voting rights of prospective investors in the process of divestment of the shareholding of the RSEs.
- The terms of reference as above would include certain related issues incidental to the course of demutualisation as well and resolution of such issues considered essential to the issues arising post-demutualisation.

4. **Methodology and the structure of the report**

4.1 Section 5 of the report traces the historical background of the RSEs. Section 6 discusses the present status of the RSEs and the evolution of the Indian securities market. Section 7 delineates the various regulatory initiatives taken from time to time for the revival of the RSEs along with the causes for their failure. Section 8 details the meetings held with the representatives of the RSEs, BSE and NSE. Sections 9, 10, 11 and 12 outline the various suggestions made by the representatives of the RSEs for their and their subsidiaries as well as the specific proposals submitted by BSE, NSE and ICSE to the Committee. A summary of the deliberations of the Committee in the light of the above suggestions and the recommendations of the Committee are given in sections 13 and 14. The issues involved in the divestment of shareholding of the stock exchanges and the recommendations of the Committee in this regard are discussed in section 15 of the report.

5. **Historical Background of RSEs**

5.1 The Bombay Stock Exchange (BSE), the Calcutta Stock Exchange (CSE) and the Ahmedabad Stock Exchange (ASE) were set up before independence and recognised in 1956 under the SCRA. Thereafter, 20 other stock exchanges were set up under the SCRA in various States including the Over the Counter Exchange of India (OTCEI) in 1990 and the National Stock Exchange (NSE) in 1994.

5.2 The concept of RSEs has its genesis in a circular issued by Ministry of Finance, Government of India vide F. No. 14 (2)/SE/85 dated September 23, 1985 which stipulated that all then existing listed companies were required to be listed on the stock exchange located in an area where the registered office or the main works / fixed assets of the company were situated. When there was little automation and the modern advanced telecommunication systems were not available, these stock exchanges catered to the needs of the industry for mobilization and regional allocation of capital and resources and also met the needs of regional investors in the remotest parts of the country.

6. **Present status of the RSEs**

6.1 Out of the 22 recognised stock exchanges in India (SEBI has refused renewal of recognition to Mangalore Stock Exchange), NSE and BSE account for almost 100% of the total turnover. As far as RSEs are concerned, except for the Calcutta Stock Exchange (CSE) and the Uttar Pradesh Stock Exchange (UPSE), there is no trading on any other stock exchange and even on the CSE and UPSE, the business is down to a trickle as may be seen from the following table:-

Table 1: Turnover of the RSEs (Rs. Crores)

SEs\Year	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06
Bhubaneshwar	0.02	0	0	0	0	0
Calcutta	355035	27074	6539	1927	2714	2800
Coimbatore	0	0	0	0	0	0
Cochin	26	1	0	0	0	0
Pune	6171	1150	2	0	0.37	0
Vadodara	0.85	10	260	0	0	0
Ahmedabad	54035	14644	15482	5044	8	0
Uttar Pradesh	24741	13337	14763	13130	5343	1487
Jaipur	0	0	0	0	0	0
OTCEI	126	4	0.54	16	0.01	0.01
Ludhiana	9154	857	0	0	0	0
Madras	109	24	38	99	27	5
Hyderabad	978	41	5	3	14	97
Magadh	1	0.0041	1	0.09	0	91
Saurashtra Kutch	0	0	0	0	0	0
Bangalore	10187	934	0.11	0.1	0	0
Delhi	82996	5526	11	3	0	0
Gauhati	0	0	0	0	0	0
Madhya Pradesh	4	10	0	0	0	0
Inter-connected	237	69	24	0.034	0	0

6.2 The financial condition of the RSEs is weak. This state of affairs has been prevailing for the past several years. Three factors have been primarily responsible for this –

a) the advent of automated trading and extension of nationwide reach of BSE and NSE which offered a large and liquid market to investors across the country;
b) the introduction of uniform rolling settlement from June 2001 in place of account period settlement with varying settlement cycles and
c) the abolition of the concept of regional listing.

Advent of automated trading system

6.3 The NSE was established in 1994 with nation-wide electronic trading terminals. Subsequently, in 1995, the Stock Exchange, Mumbai (BSE) also converted its manual trading system into a nation wide electronic trading system. Between 1995 and 1998, all the remaining stock exchanges also converted themselves into electronic exchanges. They however did not expand their reach.

6.4 This advent of automated trading and advancements in technology facilitated the BSE and NSE to expand their reach across the country. At present, both NSE and BSE have their terminals in more than 400 cities. This had an impact on the trading of securities in RSEs. In the absence of modern telecommunication and automation, listing of securities of companies was always permitted in more than one exchange. To encourage regional industrial development, the regional companies were compulsorily required to list on the RSE which was closest to the registered office of the company, in addition to any other stock exchange. In addition, shares listed in exchanges were also allowed to be traded on

other exchanges as a class of "permitted" securities. It was, therefore, common for one company to be listed on BSE (and later on the NSE) as well as on one or more RSEs and also trade on multiple stock exchanges. But the expansion of the terminals of NSE and BSE across the country provided access to all investors to two large, liquid and deep national markets in all these securities. Other stock exchanges, thus, found little incentive to simultaneously expand their terminals.

6.5 A decline in liquidity and dwindling of business in the RSEs was inevitable. As the RSEs ceased to provide a liquid market in active stocks which were also listed on BSE/ NSE, the liquidity in the securities of companies which were exclusively listed on the RSEs also declined. The cost of membership in BSE and NSE was comparatively higher than in the RSEs and all large brokers in the RSEs obtained membership of BSE or NSE. They had little commercial interest to continue trading on the RSEs or promoting them. The smaller brokers were not able to garner sufficient resources to obtain membership of the two national exchanges. This, in turn, also led to increase in the number of inactive members in the RSEs. The business done on the RSEs was adversely affected as a result of the cumulative impact of these factors. Whatever business was left, was mainly on account of varied account period settlement cycles across the RSEs which allowed for a product differentiation of sorts among the RSEs.

Introduction of rolling settlement

6.6 All stock exchanges in India settled traded on weekly basis till June 2001. The settlement cycles varied from exchange to exchange. Additionally carry forward transactions or deferral products were permitted on the major stock exchanges viz. BSE, NSE, CSE, ASE, DSE and UPSE. Varying account period settlement cycles across exchanges and deferral products gave sufficient incentives to brokers to move positions from one exchange to another offering arbitrage opportunity. This contributed to the turnover of the exchanges. With the introduction of rolling settlement since June 2001 and abolition of deferral products followed by the introduction of derivatives trading on the NSE and BSE, the incentive of the brokers to shift positions from one exchange to another was lost. The result was a sudden decline in the business in CSE, ASE, DSE and UPSE. The business in other RSEs which only had a cash market had already declined by then; little that remained also withered away.

Abolition of the concept of regional listing

6.7 With the availability of nation wide access to a liquid market, the need for compulsory listing on the RSEs lost its relevance. Regional listing proved to be an unnecessary burden in terms of cost to companies which were listed on NSE and BSE. SEBI therefore issued the SEBI (Delisting of Securities) Guidelines, 2003 vide circular SMD/Policy/Cir-7/2003 dated February 17, 2003 which, inter-alia, did away with the requirement for existing companies to remain listed on any stock exchange merely because they were incorporated or did business from a region, provided such companies were also listed on either of the two national exchanges. Freedom was given to companies to list on a stock exchange of their choice. Companies, therefore, chose to remain listed on BSE and NSE and opted for delisting from the RSEs. This resulted in further loss of revenue by way of listing fees for the RSEs.

6.8 Consequent to issuance of the SEBI's circular referred to in the foregoing paragraph, the Government of India vide circular No.F.No.1/9/SE/2003 dated April 23, 2003 inter-alia,

withdrew the requirement relating to compulsory listing by companies on RSE. The concept of RSEs was, thus, finally abolished.

7. Initiatives taken for the RSEs revival

Setting up of the Inter-Connected Stock Exchange of India Limited (ICSE)

7.1 Considering that the RSEs had invested substantially in the infrastructure, which included building, hardware and software for automated trading, several initiatives were taken to revive these exchanges so that the infrastructure could be put to productive use. The first among them was the setting up of the ICSE platform to regroup the RSEs to provide a third national market. The ICSE was promoted in 1998 by 14 RSEs for providing an additional trading platform where the shares listed on any of these 14 exchanges would be traded.

7.2 The ICSE was conceptualised as a stock exchange to provide a common trading platform to members of all participating stock exchanges, mainly with the objective of boosting trade in the securities listed on the participating stock exchanges. The inter-connectivity of stock exchanges was meant to facilitate the member of one stock exchange to deal with the member of another stock exchange through an electronically inter-connected market system, which was provided by ICSE. This system is referred to as a Central Limit Order Book (CLOB) in exchange parlance.

7.3 It was felt that such trading across different stock exchanges would generate renewed trading interest among investors by providing them an opportunity to trade in large number of shares that were listed on the participating exchanges. A CLOB should ideally have eliminated fragmentation of the market and consequently, created liquidity. But this did not happen. The existing regional order books of the participating exchanges continued alongside CLOB. This fragmented the order book and thus depleted the liquidity in the shares exclusively listed and traded on the RSEs. On account of lack of liquidity, ICSE did not succeed.

Permitting RSEs to set up broking subsidiaries

7.4 The second effort was to permit the RSEs to set up broking subsidiaries which could pool the financial resources of regional brokers and of the exchanges and obtain membership of the BSE and NSE. The regional brokers could then act as sub brokers to the subsidiaries (which had registered as brokers) and have access to the markets of BSE and NSE. Even the ICSE set up such a broking subsidiary. The setting up of the subsidiaries followed from the recommendation of an Expert Committee on revival of smaller stock exchanges constituted by SEBI. Based on the recommendations of the Committee, SEBI had vide Circular dated November 26, 1999, permitted the RSEs to form wholly owned subsidiaries which could then obtain membership of larger stock exchanges (primarily NSE & BSE). This route was envisaged as a temporary lifeline to the members of RSE and it was not contemplated that the arrangement would continue permanently. Though the scheme maintained the purity of the functions of the exchanges, though dysfunctional, most subsidiaries became successful brokers in the market of other exchange(s). Although the subsidiaries were basically brokers, there were several differences between them and corporate broking firms, primarily because these were subsidiaries of the stock exchanges. Hence, different norms and criteria were applied to the subsidiaries as well as to the sub brokers of the subsidiaries who were actually also brokers of the parent exchanges. Some of the areas of difference are as follows:

a) The parent stock exchange and its members were together required to hold 100% in nominal value of the equity share capital of the subsidiary / company with parent

exchange holding not less than 51% in nominal value of the equity share capital of the subsidiary.

b) The subsidiary was not allowed to undertake any dealing in securities on its own account, unlike any other registered broker.
c) The subsidiary could trade only on behalf of the members of the parent stock exchange, and for no other client or sub-broker unlike any other registered broker.
d) The board of the subsidiary was approved by SEBI unlike other registered brokers.

Setting up of the BSE's Indo Next Trading Platform

7.5 The Hon'ble Finance Minister had, in his Budget Speech delivered on July 8, 2004, announced the intention of the Government to set up a trading platform which would enable the Small and Medium Enterprises (SMEs) to raise capital – both debt and equity, as well as provide liquidity to such securities.

7.6 To operationalise the announcement, SEBI took the initiative to encourage the BSE and the smaller stock exchanges to set up this trading platform. Accordingly, the BSE IndoNext was set up as a separate trading platform under the present BOLT trading system of the BSE. (see Box 1) It was a joint initiative of the BSE and the Federation of Indian Stock Exchanges (FISE) of which 18 RSEs are members. The BSE IndoNext market was intended to be an SME specific market. The Government also amended Section 13 of the SCRA to facilitate trading by the trading members of RSEs on this market. To begin with, the securities listed in the B1 and B2 group of the BSE and some of the securities of mid cap and small cap companies which were exclusively listed on the RSEs and which had no trading were transferred to this segment of the BSE. The risk management and monitoring responsibility was that of BSE. Brokers of the participating RSEs could trade in any security that is permitted to be traded on this platform. As a single national order book was expected for any security traded on BSE IndoNext, unlike in the case of ICSE, it was hoped that some of the securities listed in the RSEs will have greater liquidity. It was envisaged that over a period of time, the participating RSEs would enter into agreements with BSE to delineate the responsibilities of risk management and monitoring of listing agreement of the companies listed on the RSEs which would be traded on the BSE IndoNext. The BSE's responsibility would then only be to provide a trading platform. It was also envisaged that once trading of the existing mid cap and small cap companies picked up on the BSE IndoNext, new SME companies which may not qualify for listing on the BSE and NSE on account of the minimum capital requirement prescribed by these exchanges may be encouraged to raise capital on this platform. This would enable capital formation by SME companies from the capital market and help develop the entrepreneurial back bone of the country.

Box 1: BSE Indo*Next*

The BSE Indo*Next* has been set up as a separate trading platform under the present Bombay On Line Trading System (BOLT) of the BSE. It is a joint initiative of the BSE and the Federation of Indian Stock Exchanges (FISE) of which 18 Regional Stock Exchanges (RSEs) are members. The members of the RSEs have been allowed to trade in this market. The BSE Indo*Next* trading platform has introduced the concept of single order book for a security as against multiple listings permitted in other securities. Once a security is eligible for trading in the BSE Indo*Next* market, it will not be available for trading on any other exchange and orders from brokers of all exchanges in that security will flow only to this market. The objectives of the BSE Indo*Next* trading platform are: a) to provide a nation-wide trading platform for the SMEs already listed with the participating RSEs and BSE; b) to create liquidity in eligible securities listed on the participating RSEs; c) to create an avenue for the existing and new SME companies from various regions of the country to raise fresh capital, both equity and debt, which would help achieve balanced regional growth; and d) to use the available infrastructure of the participating RSEs for productive purposes. The BSE Indo*Next* trading platform was to be implemented in phases. Honourable Finance Minister had inaugurated the BSE Indo*Next* trading platform on January 7, 2005 and operationalised the first phase of the BSE Indo*Next* platform. The BSE would transfer eligible securities within the range of paid-up capital between Rs.3 crore and Rs.20 crore, currently traded in the B1 and B2 groups in BSE against which there is no regulatory action. Similarly, the participating RSEs will also transfer eligible securities to BSE Indo*Next* to be traded as permitted securities. At this stage, the entire responsibility for monitoring and surveillance is vested with BSE as the brokers who would be trading on the BSE Indo*Next* will be members of BSE. For this purpose, SEBI has already granted necessary approvals. The second phase when implemented will allow participation of all brokers of RSEs in the BSE Indo*Next* taking benefit of the recent amendment to the SC(R)A. For this, the BSE and the RSEs will have to amend the respective Bye-laws as well as enter into MoUs. These legal requirements are in progress. Once the Bye-laws are approved by SEBI, the second phase will be implemented and the responsibility for surveillance, monitoring and compliance will be jointly shared between BSE and RSEs. In the third phase, the BSE as well as the RSEs will have to work out an effective marketing and business development strategy.

7.7 The BSE IndoNext trading platform was thus supposed to be implemented in phases. But it has not yet gone beyond the first phase in which the major shares transferred are from the B1 and B2 group of the BSE and only a few shares of some of the RSEs have been transferred. Members of RSEs do not have trading access to the limited platform of securities on IndoNext as envisaged. Currently, shares of 520 companies are eligible to trade in the BSE IndoNext segment and its average daily trading turnover is over Rs.100 crores.

8. **Meetings held with RSEs**

8.1 The Committee held seven meetings in all. The Committee had also invited the representatives of the stock exchanges in order to ascertain their views on the subject. The dates of the meetings and the representatives of the various RSEs who met the Committee are as under:-

S.No.	Date of the meeting	Stock Exchanges which met the Committee
1.	February 13, 2006	Introductory meeting of the Committee
2.	March 01, 2006	Representatives of Bangalore SE, Coimbatore SE, Hyderabad SE, Madras SE and Cochin SE
3.	March 13, 2006	Representatives of Inter-connected SE, Pune SE, Vadodara SE, Saurashtra Kutch SE and Ahmedabad SE
4.	March 21, 2006	Representatives of BSE and NSE
5.	April 10, 2006	Representatives of Delhi SE, Jaipur SE, Ludhiana SE and UPSE
6.	April 19, 2006	Representatives of Calcutta SE, Bhubaneshwar SE and Magadh SE
7.	April 29, 2006	OTCEI
8.	April 29 – May 01, 2006	Concluding meeting

9. **Summary of submissions made by RSEs**

9.1 The representatives of the RSEs made various suggestions on the subject which have been summarized under the following categories:-

- For the revival of the RSEs
- For the restructuring of the subsidiaries of RSEs
- For the BSE Indo*Next* segment
- For the divestment of the stake of the demutualised / corporatised RSEs
- Exit route for the RSEs which desire withdrawal of recognition

9.2 **Suggestions for the revival of the RSEs**

a) All the RSEs may be given a regulatory mandate to consolidate and form a third stock exchange, in addition to BSE and NSE.

b) The un-utilized funds lying with the RSEs may all be pooled in and transferred to a common "stock exchange fund" that could be used for funding securities market transactions.

c) As some of the RSEs may not be viable and/or interested in their revival, region-wise consolidation of RSEs should be facilitated. An active market for trading in commodities could be developed by the stock exchanges in the southern region. Similarly, stock exchanges in the northern, eastern and western regions could be consolidated.

d) The Indo*Next*, which is presently under the aegis of BSE, may be shifted and given to the "consolidated RSEs" under a unified trading platform and clearing corporation.

e) RSEs may be encouraged to consider any revival initiatives including corporate restructuring by merger with any of the premier stock exchanges subject to mutual agreement.

f) There is a felt need expressed for an active and liquid market for SMEs. The RSEs may not be able to survive independently in view of the changed circumstances in the Indian securities market. Therefore, some of the RSEs which are interested, financially sound and compliant with the regulatory requirements may come together and set up a

common trading platform for such SMEs which have sound financials and viable business strategies.

g) In addition to providing specific trading platform for SMEs, the RSEs may be permitted to evolve an active market for structured products, securitized instruments and derivative products.

h) That RSEs be permitted to diversify into other areas like conducting training programs for participants in capital market, providing services to investors like MAPIN registration, redressing investor complaints by acting as local forums of arbitration, distributing mutual fund products, acting as Registrar and Transfer Agents, providing securities lending & borrowing scheme and playing an advisory role to the SMEs in their need for capital creation. RSEs should be allowed to diversify into other areas of business like commodity exchange or other such suitable business through creation of a special purpose vehicle.

i) RSEs may be permitted to establish a platform for book building, both for initial public offerings (IPOs) and follow-on public offerings (FPOs) and also for delisting of companies.

j) Those RSEs that are willing to exit the business of functioning as a stock exchange should be permitted to reverse merge with their subsidiaries.

k) The present corpus of IPF and ISF should be retained with the RSEs so as to facilitate them in taking more initiatives for protecting the interests of the investors in the securities market.

l) The disclosure norms for the companies that are presently listed at the RSEs may be diluted to incentivise the companies to remain listed in the RSEs.

m) The members of the RSEs who were also members of the national level stock exchanges, viz., BSE/NSE should not be allowed to be on the Board of the respective RSEs, as it results in a conflict of interest due to dual membership and hamper any developmental initiatives for the RSEs.

n) The issues on taxation regarding the investment of RSEs in their subsidiaries and the taxability of the accumulated reserves of the RSEs upon conversion into "for-profit" corporate entities needs to be sorted out, as it would otherwise be a drain on the already weak financials of the RSEs.

o) BSE/NSE may be advised to share a part of their revenues with the RSEs based on the volume of transactions generated by the members of the RSEs.

p) RSEs may be permitted to explore alternatives like liasioning with the other national level exchanges in their respective geographical locations, playing the role as local /nodal centres for the national level exchanges and acting as an extended arm of such national level exchanges for functions like handling investor grievances/complaints, conducting training programmes in securities market, etc.

q) OTCEI may be recognised as a national level stock exchange. It may be provided exclusivity for trading in securities of companies with a paid up capital below Rs. 20 crores, mutual fund units, privately placed corporate bonds etc. Post-demutualisation, the securities of the BSE Ltd. should be listed in OTCEI.

r) A National Market Dealer System may be provided for trading in securities of companies which are neither in their infancy nor at a stage from which they can access the national markets. A study may be conducted to assess the number of such companies so as to determine the viability of the proposal.

9.3 Suggestions for the restructuring of the subsidiaries of RSEs

a) Subsidiaries should be considered to be on par with any other stock broker, thereby ensuring a level-playing field for all broking entities in all aspects like freedom of appointing franchisees, flexibility in appointment of directors on the board, enrollment

of direct clients, executing proprietary trades. For this purpose, most of the exchanges were willing to fully or partly spin-off the broking subsidiary from the RSE parent as described below.

b) The RSEs may be mandated to disassociate totally from the subsidiaries and the umbilical cord between the stock exchanges and their subsidiaries may be snapped. The subsidiaries shall be mandated to function as independent broking entities. Alternatively, RSEs may be allowed to dilute a part of their stake, say, to hold less than 26% in the subsidiaries, in which case, the RSEs will cease to be holding companies of their subsidiaries. It was pointed out that this would require amendment to the regulations of NSE regarding "dominant promoter group" and provisions relating to payment of fees to SEBI, i.e., turnover fee continuity benefit to be extended by SEBI.

c) The subsidiaries should be permitted to operate in all areas of business like institutional business, margin trading, F&O segment, taking membership of commodities exchanges etc.

9.4 **Suggestions for the BSE Indo Next segment**

a) Eligibility criteria for securities admitted into this segment need to be reviewed, so that many of the securities listed in the RSEs are able to get entry into the BSE Indo*Next* segment.

b) The second and third phases of the segment should be operationalised without any further loss of time.

c) The Indo*Next*, which is presently under the aegis of BSE, may be shifted and given to the "consolidated RSEs" under a unified trading platform and clearing corporation.

9.5 **Suggestions for the divestment of the stake of the demutualised and corporatised RSEs**

a) The scheme of Corporatisation and Demutualisation mandates a divestment of atleast 51% shareholding from trading members to the public or to the strategic investors. Presently, some of the RSEs are granted recognition on an annual basis. Such periodic recognition would create uncertainty in the minds of any prospective investor who is willing to take a stake in the RSE. Therefore, the RSEs should be granted permanent recognition so as to enable them to attract strategic investors during the process of divestment.

b) The Regulations to be notified by SEBI on divestment should provide for Foreign Direct Investment (FDI) in RSEs, issuance of shares carrying differential voting rights, limited exercise of voting rights irrespective of the shareholding by an investor etc.

9.6 **Suggestions for providing exit route for RSEs which desire withdrawal of recognition**

a) SEBI should come out with clear guidelines providing permission to such RSEs which desire to exit the business of functioning as a stock exchange on a voluntary basis, spelling out the modalities for distribution of both financial and physical assets.

b) Post withdrawal of recognition, the surviving entity which becomes a regular company should be allowed to utilize the infrastructure for any other business purposes as deemed fit by that entity.

c) There could be companies which are exclusively listed only on a particular RSE which seeks voluntary withdrawal of recognition. Such companies should be allowed to get listing in the to be formed "consolidated RSE".

10. Proposal of BSE

10.1 The salient features of the proposal of BSE are as under:-

a) BSE shall offer the arrangement set out below to such of the RSEs which do not opt either for voluntary withdrawal of recognition or in respect of whom SEBI does not withdraw recognition in terms of the provisions of the SCRA.

b) In terms of the arrangement, all eligible trading members of the RSEs who accept the arrangement and who enter into the necessary agreements with BSE shall be allowed access to trade on the national trading platform of BSE both in the cash and F&O segments.

c) Such access shall be with respect to the entire universe of securities listed on the segments.

d) Settlement obligations arising out of trades executed by the trading members of the RSEs shall be settled by the respective RSE.

e) In respect of trades so executed, the trading members of RSEs shall be required and entitled to issue contract notes in their names as members of the respective RSE.

f) For the purpose of clearing of obligations, each of the participating RSE shall be allotted a Clearing ID by BSE.

g) For discharging its settlement obligations, the RSEs shall have recourse to their trade guarantee fund. This is as a first line of defence and in all cases the settlement guarantee fund of BSE shall operate.

h) In terms of the arrangement, BSE shall be entitled to place restrictions on the RSEs with respect to:
   - Admission of new trading members
   - The territories from which the trading members of the RSE may access the trading platforms of BSE

i) In terms of the arrangement, on access being provided, trading members of RSEs shall execute both proprietary and client orders in the cash segment only on the BSE trading platform and activities of the subsidiaries in the cash segment shall cease.

j) In terms of the arrangement, on access being provided, members of RSEs shall endeavour to build-up activity (both on proprietary and client account) in the F&O segment of BSE. Once BSE F&O segment gains viability and size, trading members of RSEs shall execute both proprietary and client orders in the F&O segment only on the BSE trading platform and activities of the subsidiaries in the F&O segment shall cease.

k) The terms and conditions of the arrangement (both commercial and otherwise) shall be such as are to be agreed to between BSE and RSEs.

l) BSE shall permit securities of companies which have been compliant with the listing requirements of RSEs which participate in this arrangement with BSE to be traded under a separate segment on its trading network on an national order book platform. Members of BSE shall also be permitted to trade on this segment.

11. Proposal of NSE

11.1 The salient features of the proposal of NSE are as under:-

a) A third national level exchange could be successfully created by the merger of all the RSEs into a single unified entity. This should be very much possible although the perceived regional differences and political compulsions that exist amongst the RSEs at present will need to be overcome. The RSEs, in such a scenario, would need to come

together to create a unified, strong, single entity which could cater effectively to the capital creation needs of the SMEs sector.

b) If some of the RSEs were to show interest in coming together to create a national level stock exchange, NSE would also consider participating in the equity of such an exchange and help play a developmental role in making such an exchange a success. All the trading, clearing and settlement functions of such a national level exchange could be handled by the RSEs (through a single platform) and activities such as listing compliances, member compliances and investor grievances, etc could be contracted out at the local level. This exchange would need to innovate to meet the needs of the SME sector, for example, by exploring the introduction of a call auction market.

c) Typically, liquidity in an exchange for a given security is a function of the number of analysts who track a security in the market. Therefore, it is necessary that analysts' interest be generated, at least initially, in tracking these securities till sufficient liquidity is generated. To this end, analysts may need to be incentivised for tracking the listed SMEs.

d) It is vital that the national level platform so created be restricted only to those SMEs with sound fundamentals and viable business strategies. Once the market takes off, a more inclusive view can be taken.

e) Subsidiaries of RSEs need to be spun off their parent exchanges and should be provided a level playing field similar to other broking entities in all aspects including the participation of subsidiaries in the derivatives segment.

12. Proposal of ICSE

12.1 The salient features of ICSE are as under:-

a) ICSE would create a common trading platform in association with some of the promoting stock exchanges which are interested in the initiative. The recently amended sec 13 of SCRA enables trading members belonging to a set of stock exchanges to trade on the proposed common trading platform without having to go through a separate process of registration with SEBI.

b) Either the ICSE or the proposed common trading platform may be granted recognition as a national platform so that the said platform can be used for book building, both for initial public offerings (IPOs) and follow-on public offerings (FPOs) and also for delisting of companies.

c) The Exchange would also like to promote a common clearing corporation for providing cost-effective clearing services to the trading members of the participating stock exchanges.

13. Discussions and Recommendations for RSEs

13.1 Preliminary Discussions

13.1.1 The Committee appraised itself of the present status of the RSEs in the light of the discussions with all the RSEs as well as with the BSE, NSE and OTCEI and the written submissions made by them which have been summarized in the early part of this report. Analysis of the financial conditions of the RSEs and their subsidiaries, and of the listing, trading and compliance status of the companies listed in these RSEs was equally important for a complete appreciation of the present conditions of the RSEs and the choices available with the subsidiaries.

13.1.2 The Committee notes that the RSEs were established with the objective of providing a regional market for raising capital by companies in the respective regions by garnering regional savings to help achieve a balanced regional development and to spread the equity

cult among investors in the country. This objective has been fairly served by the RSEs for a length of time. But with the advent of modern telecommunication and information technology and the symbiotic interaction of technology and the markets, which facilitated a fundamental transformation of the market micro structure, the scope of the RSEs became limited till they virtually lost their relevance. Although there are over 4000 companies exclusively listed on these RSEs, there has been no *de facto* trading in the listed securities of these companies. The sizeable capital investment made by the RSEs towards fixed assets and technology has thus become redundant. The large assets of the RSEs, especially the land and buildings have good realisable value, but have been of little economic utility for the RSEs, listed companies or investors. Under these unenviable conditions, the RSEs were forced to take up ancillary activities such as training, investor education and depository services. The income generated from listing fees and the ancillary activities, return on the investments made by the RSEs and surplus generated by the subsidiaries became the main sources of revenue for the RSEs. In sum, most of the RSEs ceased to be markets where securities of companies listed on them are bought and sold.

13.1.3 The Committee recognises that even internationally, and precisely for similar reasons, the RSEs have had a chequered past and over a very short period of time became moribund before the burgeoning growth of the national stock exchanges with national and international reach. This prompted a move towards consolidation of RSEs.

13.1.4 The above situation naturally raises the basic question on the *raison d'être* of the RSEs and their subsidiaries in the present market structure. When this question was posed before the RSEs, it did not evince any convincing response. They did not come with any specific viable business plan for the revival of the RSEs excepting pinning hopes on a future which might be bright. Most seemed keen to be part of a solution if an appropriate nucleus of leadership could be found. Moreover, all of them were looking to SEBI to assist in creating a viable business model for the future. There were some who were willing to participate in a common trading platform and also engage themselves in various capital market related activities. Some of them even suggested that such a trading platform could be set up on a regional basis in each of the four regions. A few of the RSEs were confident of being able to survive as independent exchanges, again with some support from SEBI. There were others who were not confident of the success of any of these models in the light of their past experiences and were willing to accept a financially attractive exit option.

13.1.5 The Committee notes that there are certain deeply embedded behavioral issues which continue to dominate the mind set of the members of the RSEs and they seem to be coming in the way of some of the RSEs accepting the reality which demands sub-ordination of their individual and independent identity before the larger interest of the very survival of the RSEs.. Indeed, it was this attitude coupled with the equally uncompromising attitude of the business partners which were responsible for the failure of the various rehabilitatory measures taken in the past for the revival of the RSEs. Equally the members of the RSEs, by virtue of their access to national trading platforms through the subsidiary route did not find any incentive to trade and promote trading in the RSEs.

13.1.6 There have also been serious regulatory concerns from time to time on the functioning of some of the RSEs. These regulatory concerns had led SEBI to take recourse to the extreme measure of superseding the governing boards of some exchanges and even to withdraw the recognition in the case of one RSE. These regulatory concerns still remain in the case of some of the RSEs where the members continue to remain recalcitrant and resort to undesirable market and governance practices.

13.1.7 Although the RSEs have ceased to perform the basic economic function for which they were set up, their continued existence by itself, necessitates regular on site and off site

regulatory monitoring and surveillance. Regulatory resources are thus thinly spread and the attention of the regulator is diverted from more emergent issues to grappling with such routine issues which relate to dysfunctional entities. Deployment of regulatory resources for monitoring such a large number of exchanges thus entails an avoidable and huge regulatory cost and imposes both a risk and a burden on the regulatory system.

13.1.8 It was clear to the Committee that any solution to the conundrum posed by the RSEs, must encompass all the issues delineated above including the deeply embedded behavioral issues. Equally, such solutions must not only be practicable and implementable but also eschew adhocism and discretion which had informed and also thwarted some of the past initiatives for revival of the RSEs. Keeping that in view, *the Committee feels that (a) such of the RSEs which do not want to continue as exchanges should be given an exit option, (b) the recognition of such of the RSEs which are notorious for their rank indiscipline besides giving rise to serious regulatory concerns should be compulsorily withdrawn and (c) a continuing option may be given to such of the RSEs which have the potential and the willingness to participate in any alternate trading platform.*

13.1.9 The Committee is strongly of the view that it does not serve either the interest of trade or public interest, to forcibly keep alive the recognition of an exchange which does not have any potential for survival and is keen for an exit option or is posing to be regulatory burden. *The Committee therefore recommends that (a) such of the RSEs which do not want to continue as an exchange, should be given an exit option by withdrawing their recognition upon a specific request or application made by them; (b) recognition should be withdrawn compulsorily for such of the RSEs which are notorious for their rank indiscipline besides giving rise to serious regulatory concerns and (c) the recognition of those RSEs which have the potential and the willingness to participate in any alternate trading platform may be continued*. The Committee is of the view that sections 4 and 5 of the SCRA sufficiently empower SEBI to withdraw recognition for both the category of exchanges whether an exchange is recognized permanently or from year to year.

13.1.10 *The Committee feels that the withdrawal of recognition to the above two categories of RSEs would help clean up the system, besides reducing the regulatory hazard to the investors, various regulators including tax authorities and the government. The issue of distribution of assets would become relevant in the eventuality of withdrawal of recognition for any reason. There is at present no provision for such distribution either under the SCRA or within the regulatory framework of SEBI. As distribution of assets would be an impending consequence of any withdrawal of recognition of a stock exchange, there is an urgent need to formulate a permanent and appropriate scheme. The Committee therefore recommends that suitable rules be formed under section 30 of the SCRA, for distribution of assets of any stock exchange which ceases to be a recognised stock exchange*.

13.2 Distribution of assets

13.2.1 *The corpus of any stock exchange is made up of (1) the contribution of the members, (2) the income of the exchange, and (3) the fiscal incentives which had helped the accumulation of reserves. In addition, it may include an adventitious factor by way of appreciation in the value of the assets over a period of time. The net worth of the exchange after revaluation of the assets and liabilities based on market value, could be apportioned on the basis of the three components of the corpus mentioned above. The share relating to the members' contribution should be made available to the members. The balance will be transferred to an escrow account and then to a fund earmarked for the purpose of investor protection managed by SEBI. This scheme will need a proper methodology for valuation of the assets and liabilities as well as for determining the proportion mentioned above and*

should be carried out by an independent entity. In this regard, the Committee recommends that a Task Force be constituted by SEBI comprising a chartered accountant, an approved valuer and a representative of SEBI for the purpose.

13.2.2 *The Committee strongly feels that in the absence of such a provision, no RSE would seek a voluntary exit option and one would have to live with a situation in which RSEs would continue to exist nearly in perpetuity and continue to remain a burden on the investor and the regulatory system.*

13.2.3 *The closure of the RSEs will have concomitant consequences on the companies which are listed exclusively on these stock exchanges and their shareholders who would be denied an opportunity to trade. These have been dealt with later in this report.*

13.3 **Terms of withdrawal of recognition**

13.3.1 *The entity which remains after withdrawal of recognition must immediately change its name and style and cannot continue in any business as a stock exchange. In case a stock exchange whose recognition is withdrawn has a subsidiary, such an entity would also have to change its name and style to avoid any representation of any present or past affiliation with an exchange. It would be upto the subsidiary to carry on broking operations as any other broking entity registered with SEBI subject to the same rights and duties.*

13.4 **Effect on listed companies on withdrawal of recognition**

13.4.1 *The Committee felt that the impact on account of withdrawal of recognition either on request or on compulsory direction on the companies exclusively listed on the RSEs and their shareholders would also need to be suitably addressed. The Committee noted that there are about 4000 companies which are exclusively listed on the RSEs, a majority of which are listed in DSE and CSE. It is important to note that save a handful of these companies, there is no trading in any of the companies on the RSEs for the past several years. An analysis of the compliance status of these companies indicates that only about 500 companies are compliant with the continuous listing requirements. It is felt that such compliant companies in an exchange which will no longer remain recognized, should be allowed to migrate to any other exchange with minimum procedure and hassle to the company. SEBI can prescribe that files of such compliant companies be moved inter-exchange with minimum burden on such companies. The Committee also recommends that before seeking voluntary withdrawal of recognition, the RSEs would have to compulsorily delist all non-compliant companies.*

13.4.2 It can be argued against the proposal that delisting shares of non-compliant companies would hurt the shareholders of the company as they will be left with no exit option. But this exit option is in reality a theoretical one, because the shares of these companies have not been trading on the RSEs for several years and in any case the investors were not able to deal in those shares. This theoretical exit option has a huge cost to the system.

13.4.3 It might be argued that the above process of withdrawal of recognition could result in a particular State not having any stock exchange. This should not be cause of concern as in any case the RSEs whose recognition may be withdrawn were virtually defunct for several years and did not serve any economic purpose as none of the companies of the region that were exclusively listed on the RSEs were being traded in those RSEs. Further, the two national level stock exchanges in any case provide access to investors across the length and breadth of the country.

13.4.4 The aforesaid recommendation if implemented will have several advantages. First, the regulatory hazard described above and cost of supervision would significantly reduce. Secondly, it would facilitate the gainful use of the assets of such RSEs that have hitherto

remained idle. An incidental consequence would be that the subsidiaries which were hitherto functioning as a broker under certain restrictive conditions could function as any other registered corporate broker.

13.4.5 *The Committee expects that the mechanism as provided for asset distribution would encourage a large number of RSEs to seek voluntary exit option. The compulsory withdrawal of recognition would also help close down a number of RSEs against which there exists serious regulatory concerns. These two processes will help clean up and streamline the system.* In this context, the Committee examined the possible prospect of some of the remaining RSEs which have already been corporatised and are unable to demutualise within the stipulated time. *In the event of non-compliance by such RSEs with the scheme of Corporatisation and Demutualisation within the stipulated time, they will attract the consequences of withdrawal of recognition under sec. 5(2) of the SCRA. Such RSEs would fall in the same category of RSEs whose recognition has been voluntarily or compulsorily withdrawn and accordingly, they would have recourse to the same mechanism of asset distribution as recommended supra.*

13.5 Review of existing ICSE and BSE IndoNext

13.5.1 *While considering the various options available for the sustainable existence of the remaining stock exchanges, the Committee examined the reasons for the failure of the various regulatory initiatives that were taken from time to time for their revival.* The ICSE was set up with the hope that it would become a viable third national platform with the participation of the RSEs to provide for a market in the securities listed exclusively in the participating RSEs. The success of the ICSE hinged on the willingness and co-operation of the participating RSEs and their members to actively support trading of the exclusively listed securities on the participating RSEs. This initiative, however, failed at the nascent stage itself because the RSEs were not willing to provide the extent of support and co-operation that was necessary and required for the success of this venture. But more importantly, there was no common order book and the order book was fragmented between the ICSE and the participating RSEs. Besides, it was not contemplated in the scheme of the ICSE to permit members of BSE and NSE to trade on ICSE. This subtracted a large body of well capitalized brokers from this market.

13.5.2 In view of the failure of the ICSE to grow into a viable third trading platform and considering the need to provide an avenue to the SMEs to raise capital, BSE IndoNext was set up. As already discussed earlier in the report, BSE IndoNext was to be implemented in three phases. In the first phase, the BSE would move the eligible securities in its B1 and B2 groups to be traded on this platform which would essentially be a separate screen of BSE's BOLT system. Some of the exclusively listed securities of the RSEs would be permitted to trade on this platform. While the members of the BSE would be free to trade on this platform, the members of the RSEs would trade on this platform through their subsidiaries in the first phase. The risk management and the responsibility for regulatory compliance would remain with the BSE in this phase. The second phase envisaged all the eligible securities which are exclusively listed on the RSEs to be traded in this segment and the responsibility for risk management, compliance and clearing & settlement would vest with the RSEs through an MoU to be entered between the RSEs and the BSE. In order to facilitate this process of trading of exclusively listed securities at a national level and to enable all members of RSEs to trade on the BSE in this segment and issue contract notes, sec. 13 of the SCRA was amended. Since the eligible securities that were exclusively listed on the RSEs fall in the SME category, it was hoped that BSE IndoNext would provide a viable market for the securities of SMEs besides addressing the issue of RSEs at the same

time. Thereafter, in the third phase, SMEs could raise capital and list on this platform with appropriate listing requirements and corporate governance procedures which the SMEs could easily comply with. However, this experiment too did not meet with any measure of success and the BSE IndoNext did not take off beyond the first phase. The failure in this case could be attributed to the reluctance on the part of BSE to dilute its entry norms and the eligibility criteria of securities for trading on this platform.

13.5.3 *The seeds of failure of these two well-intended initiatives lay in the deep rooted behavioral issues, mind sets with the attendant resistances and conflicts. The Committee is of the view that the success of any other initiative to be taken in future would be solely dependent on the willing co-operation of the RSEs and its members and the BSE or NSE. It would not be wise to recommend a measure for the development of a third platform at the national level building purely only on a sanguine estimate of expected success. At the same time, the Committee also recognizes that in the absence of a third platform, the SMEs in India would have virtually no avenue for raising capital from the public and this would not be in the interest of the Indian economy in the long run.* Internationally, markets have developed and successfully grown such exclusive platforms for the SMEs. These platforms have acted as nurseries for nurturing the growth of SMEs into larger enterprises and their ascendancy to the big boards.

13.5.4 The Committee assessed the various suggestions received for establishment of an alternate platform at the national level for trading in the securities that are exclusively listed on the RSEs. The proposal of RSEs providing four platforms at regional levels was clearly unviable because the number of RSEs left in each region after withdrawal of recognition as described above would be very few which would not be able to provide a market with depth and liquidity. In any case, a merger of RSEs without any viable business plan can possibly serve no purpose as the cause of failure is not the lack of size or even of money. The alternative prospect of some of the RSEs setting up a separate third platform is fraught with the same kind of risks which plagued the earlier initiatives. The success of this measure would be a function of the leadership which could be provided by one or more of the participating RSEs. Given the insularity of some of the RSEs, it is unlikely that any RSE would be able to provide the desired leadership. The Committee, therefore, does not consider it practicable to recommend the setting up of a third platform by means of participating RSEs.

13.5.5 The NSE in its presentation to the Committee had expressed its willingness to provide technological support and equity participation in case some of the RSEs were willing to set up a third platform. However, the initiative for this purpose would have to come first from the RSEs which is unlikely as discussed at length in the previous paragraphs. Therefore, the Committee is of the view that this proposal may not succeed.

13.5.6 The Committee was, therefore, left only with two choices. One, the proposal given by the BSE and the other, by the ICSE.

BSE's proposal – benefits

13.6.1 The Committee discussed the features of the BSE's proposal (see Box 2) and analysed the possible implications.

Box 2: BSE proposal – salient features

- The offer of BSE would be to those RSEs which do not opt either for voluntary withdrawal of recognition or in respect of whom SEBI does not withdraw recognition in terms of the provisions of the SCRA subject to certain conditions.
- All eligible trading members of the RSEs who accept the arrangement and who enter into the necessary agreements with BSE shall be allowed access to trade on the entire universe of securities listed on the all India trading platforms of BSE both in the cash and F&O segments.
- the trading members of RSEs shall be required and entitled to issue contract notes in their names as members of the respective RSE.
- Settlement obligations arising out of trades executed by the trading members of the RSEs shall be settled by the respective RSE.
- For the purpose of clearing of obligations, each of the participating RSE shall be allotted a Clearing ID by BSE.
- For discharging its settlement obligations, the RSEs shall have recourse to their trade guarantee fund. This is as a first line of defence and in all cases the settlement guarantee fund of BSE shall operate.
- BSE shall be entitled to place restrictions on the RSEs with regard to admission of trading members in RSEs and the territories from which the trading members of RSEs may access the trading platforms of BSE.
- Trading members of RSEs shall execute both proprietary and client orders in the cash segment only on the BSE trading platform and activities of the subsidiaries in the cash segment shall cease.
- Trading members of RSEs shall endeavor to build-up activity (both on proprietary and client account) in the F&O segment of BSE. Once BSE F&O segment gains viability and size, trading members of RSEs shall execute both proprietary and client orders in the F&O segment only on the BSE trading platform and activities of the subsidiaries in the F&O segment shall cease.
- BSE shall permit securities of companies, which have been compliant with the listing requirements of RSEs, which participate in this arrangement with BSE, to be traded under a separate segment on its trading network on an all-India order book platform. Members of BSE shall also be permitted to trade on this segment.
- RSEs would have to compulsorily delist all non-compliant companies before getting into any arrangement with BSE.

13.6.2 The BSE's proposal envisages that the members of all the RSEs whose recognition has not been withdrawn would be allowed to trade on both the cash and F & O segments of BSE, subject to the fulfillment of the prescribed requirements for trading members. In terms of the BSE's proposal, the RSE members shall issue contract notes in their own names as a member of the respective RSEs for the trades executed on these segments. BSE shall permit securities of companies which have been compliant with the listing requirements of participating RSEs to be traded under a separate segment on its BOLT network. The members of BSE shall also be permitted to trade on this segment. One of the conditions of this proposal is that the participating RSEs must first compulsorily delist all the non-compliant companies listed in that RSE. In the interregnum before this initiative takes off fully, such of the subsidiaries of the RSEs which are members of the NSE in the

cash and derivatives segment would be allowed to continue to trade only in the derivatives segment of NSE.

13.6.3 The above proposal of BSE offers several benefits. One, it would enable compliant companies listed on the RSEs to have national reach. The investors in such companies will get the benefit of enhanced liquidity as a result of these securities being traded on national platform. Besides, the RSE members would be able to conduct business in their own names and issue their own contract notes (a topic of immense importance to RSE members, as was learnt during the meetings with RSEs, as the members of RSEs felt humiliated being reduced to sub-brokers and not being able to issue their own contract notes). The redressal of investor grievances in respect of trades of the members of the RSEs would be handled at the regional level in the respective RSEs and thus would be beneficial to the investors in the region. The RSE members would also gain access to the F & O segment of the BSE. It is likely that the enhanced participation of large number of brokers across the country would provide the much needed impetus and help kick start the F & O segment of the BSE. This, in turn, would fulfill the long standing demand of the members of the RSEs to participate in the F & O segment. The activation of the F & O segment on the BSE would also provide desirable competition in the derivatives market. This initiative of the BSE will also obviate the need for the continuation of the subsidiaries in the long run. With the success of this initiative, it is possible that the SMEs will have a liquid market where they would be able to raise capital in the future. A pertinent question in this context is the future of the IndoNext. The Committee weighed the proposal of BSE in the context of the operation of BSE Indonext which has not taken off in the real sense and the Committee feels that the present proposal of BSE goes beyond the scope of Indonext by providing access to the entire universe of securities listed on BSE including F & O to the members of RSE.

13.7 ICSE's proposal

13.7.1 The proposal of ICSE (see Box 3) was also discussed by the Committee and a compared with the BSE's proposal.

Box 3: ICSE proposal – salient features

- ICSE would create a common trading platform in association with some of the promoting stock exchanges which are interested in the initiative. The recently amended sec 13 of SCRA enables trading members belonging to a set of stock exchanges to trade on the proposed common trading platform without having to go through a separate process of registration with SEBI.
- Either the ICSE or the proposed common trading platform must be granted recognition as a national platform so that the said platform can be used for book building, both for initial public offerings (IPOs) and follow-on public offerings (FPOs) and also for delisting of companies.
- ICSE would also promote a common clearing corporation for providing cost-effective clearing services to the trading members of the participating stock exchanges.
- ICSE will allow the listing and trading of all the securities exclusively listed on the RSEs.
- ICSE will allow the members of BSE and NSE to trade in these securities even though they are not participating exchanges in the ICSE.
- ICSE would have to be granted exclusive trading rights for a period of atleast five years in these securities i.e. these will not be allowed to be traded as permitted securities in other exchanges.

13.7.2 The Committee also took note of the proposal of ICSE. The ICSE had suffered from several deficiencies which have been discussed earlier. In order to remove these deficiencies, ICSE is willing to allow the listing and trading of all the securities exclusively listed on the RSEs. The ICSE is also agreeable to allow the members of BSE and NSE to trade in these securities even though they are not participating exchanges in the ICSE. With the participation of a large number of brokers across the country, there could be a fair possibility of the exclusively listed securities gaining liquidity which would in turn deepen the market in these securities. However, both as an incentive and as a promotional measure, ICSE would have to be granted exclusive trading rights for a period of atleast five years in these securities, i.e., these will not be allowed to be traded as permitted securities in other exchanges. If the trading volumes of some of these companies listed and traded increases significantly even during this five year period and in case these companies decide to raise capital and become eligible to trade either in BSE or NSE, ICSE would not hinder such a migration. It is also important that ICSE be given recognition as a national level platform so that it has the same benefits as that of the other exchanges.

ADB's proposal

13.8 The Committee noted that the ADB had sometime back prepared a report on the survival of the RSEs and had suggested certain measures. The acceptance by the RSEs of either of the aforesaid two models would obviate the need to adopt the course of action and the suggestions recommended in the ADB report.

13.9 In the light of the aforesaid deliberations, *the Committee recommends that all the RSEs whose recognition has not been withdrawn either voluntarily or compulsorily must collectively choose (in order for it to succeed) either the BSE model or in the alternative, the ICSE model. The FISE will have to take the initiative of evolving a consensus amongst the RSEs.* The Committee notes that governance would play an important role in the efficient and effective functioning of the RSEs in the emergent scenario. The Public Representative (PR) Directors would have a key role to play in the efficient and effective functioning of the Boards of the remaining RSEs. *In order that the PR Directors are able to discharge their responsibilities, it is important that they are conversant with the governance of the RSEs, have a reasonable knowledge of the securities market and are aware of their own functions as PR Directors. The Committee, therefore, recommends that SEBI should work out an appropriate training programme for the PR Directors.*

13.10 *The Committee, however, is of the view that in case both of these models fail for whatever reasons, there would be no merit in the continuation of the RSEs and the recognition of all the RSEs will, therefore, have to be compulsorily withdrawn. Once the RSEs have chosen a particular model, such of the RSEs which are unwilling to accept that model will have to face compulsory withdrawal of recognition in the future as they provide neither a trading platform nor serve any public interest.*

13.11 *The actions consequent to withdrawal of recognition discussed in the earlier paragraphs would be applicable in these cases also. The other more serious consequence would be that SMEs would be bereft of any avenue for raising capital from the public. This would be detrimental to the economy in the long run and this will always remain a concern.*

14. Regulatory framework for the Subsidiaries of RSEs

14.1 The subsidiaries of the RSEs have opened up an avenue to the members of the RSEs to gain access to trading on the BSE and NSE. The success of these subsidiaries as brokers can be estimated by the fact that over 10% of trades on NSE and BSE are carried out by these subsidiaries. Though the subsidiaries trade on the NSE and BSE as brokers, there are

certain restrictions imposed on these subsidiaries to address certain regulatory concerns. On account of these restrictions, there is a lack of level playing field between any member of the BSE and NSE and the subsidiaries. Barring three subsidiaries, others have not been given access to the derivatives market by SEBI on account of various regulatory concerns. As already mentioned in the foregoing paragraphs, many of the subsidiaries have been demanding such access and several of them have also paid deposits with the NSE. *The Committee is of the view that the future of the subsidiaries is inter-linked with the survival of their parent RSEs.*

14.2 *In case a stock exchange whose recognition is withdrawn has a subsidiary, such an entity would also have to change its name and style to avoid any representation of any present or past affiliation with an exchange. It would be upto the subsidiary to carry on broking operations as any other broking entity registered with SEBI. The subsidiaries' demand of level playing field could then easily be recommended as they become brokers (or other registered financial intermediaries) simplicitor. This would necessitate the NSE to modify suitably its norms relating to dominant holdings in the case of these entities. SEBI should consider extending turnover fee continuity benefit to such entities.*

14.3 The Committee is of the view that *in case of the subsidiaries of the RSEs whose recognition is not withdrawn, the RSEs should preferably cease to have any shareholding in the subsidiary within a period of three years. However, the RSEs may be allowed to retain less than 15% of the shareholding in the spun-off entity.*

15. Divestment of shareholding of the stock exchanges

15.1 *One of the terms of reference of the Committee was to recommend modalities for increasing the public shareholding in demutualised stock exchanges in accordance with the provisions of SCRA.*

15.2 *The Committee notes that the procedure for Corporatisation and Demutualisation of stock exchanges laid down in sec. 4B of SCRA envisages that majority of the shareholding of a demutualised stock exchange in India should be held by the public.* The specific provision for dispersal of shareholding to the public in sub clause (8) of sec. 4B of the SCRA is as follows:

> "*Every recognised stock exchange, in respect of which the scheme for corporatisation or demutualisation has been approved under sub-section (2), shall, either by fresh issue of equity shares to the public or in any other manner as may be specified by the regulations made by the Securities and Exchange Board of India, ensure that at least fifty-one per cent. of its equity share capital is held, within twelve months from the date of publication of the order under sub-section (7), by the public other than shareholders having trading rights:*
>
> *Provided that the Securities and Exchange Board of India may, on sufficient cause being shown to it and in the public interest, extend the said period by another twelve months*."

15.3 *Any non-compliance with the provisions of Corporatisation and Demutualisation scheme, including failure to increase the public shareholding within the stipulated time would result in withdrawal of recognition of a stock exchange under sec. 5(2) of the SCRA.*

15.4 The SCRA provides that SEBI will have the power to prescribe regulations to provide for means other than an IPO for divestment. *The Committee notes that in case a stock exchange adopts the route of public issue, it would necessarily have to be in accordance*

with the SEBI (Disclosure & Investor Protection) Guidelines, 2000. However, the route of IPO is likely to be adopted by the stock exchanges only if there is a requirement of infusion of funds. *The Committee, therefore, recognizes that all stock exchanges might not necessarily adopt the IPO route for increasing the public shareholding.* Besides, there may not be any guarantee that the IPO of all stock exchanges would meet with the same degree of success, especially in the absence of a viable business model for most of the stock exchanges. This implies that the stock exchanges would have to necessarily opt for either an offer for sale to the public or offer for sale to strategic investors or a mix of the two. The stock exchanges may also follow the route of preferential allotment to strategic investors.

15.5 *The Committee recognizes that it may perhaps be necessary in the interest of the development of the stock exchanges to induct some strategic partners.* In that case, the question arises whether there should be any qualitative/quantitative restrictions on the strategic investors or other investors.

15.6 There could be several possibilities in the choice of a strategic partner. The strategic partners could be one or more of individuals, corporate entities, exchanges, multilateral agencies, insurance companies, banks, financial intermediaries, financial institutions and depositories. These entities could either be domestic or foreign. Each of these entities becoming strategic partners could give rise to different levels of conflict of interest and regulatory concerns. In case the strategic partners are foreign entities, the FDI policy of the Government will become relevant.

15.7 The Committee in this context examined the various approaches taken by the stock exchanges in other countries that have been demutualised. The Committee also studied the reports of IOSCO and the World Bank on demutualisation of stock exchanges.

15.8 The Committee notes that countries such as Australia, Singapore, Hong Kong and Malaysia which have successfully demutualised their stock exchanges have by and large proceeded on the following lines :-

a) No particular entity was prohibited from acquiring shares of exchange in case of Australian Stock Exchange (ASX) and Hong Kong Exchange (HKEx).
b) While ASX and HKEx had no requirement of reduction in shareholding of trading members/brokers, Singapore Stock Exchange (SGX) reduced member shareholding by listing of shares through a public offer and a private placement route. Bursa Malaysia also reduced the same through IPO route.
c) A cap or a limit was placed on the shareholding of any one shareholder including persons acting in concert to avoid an "unacceptable control situation" in exchanges.
d) While ASX initially restricted ownership limit to 5% of voting rights and shareholding limitation was subsequently changed to 15% for any one shareholder. HKEx does not allow any investor to hold more than 5% of shares. In Bursa Malaysia, shareholding is subject to restriction of less than 5% and Singapore allows 12% control or 20% control of exchange only after approval of Monetary Authority of Singapore.

15.9 It is clear from the international experience that regulators and stock exchanges have not prohibited any class of investors from acquiring any shares of the exchange but have placed ceiling on the shareholding of an investor along with persons acting in concert. This is almost similar to the case of restrictions on holding shares in Indian banks imposed by the Reserve Bank of India. In the case of Indian banks also, there is no restriction or prohibition of any class of investors to acquire shares in a commercial bank in India, but there is a ceiling on shareholding of any investor along with person acting in concert. It was

also noticed that internationally there is no restriction on ownership of stock exchanges or trading systems which carry out trade and order matching on screens. It is, therefore, possible internationally for individuals, corporates and exchanges to takeover other stock exchanges.

15.10 *The Committee also recognizes that in the present Indian context, it may not be desirable to adopt such an approach. At the same time, the Committee felt that excessive qualitative and quantitative restrictions would not only thwart the process of divestment but would also become difficult to monitor in the practical sense. Besides, such restrictions may dampen valuations and limit the choice of investors thereby raising the cost of capital. The Committee, therefore, feels that any restriction in regard to the nature of the strategic partners and the percentage of shareholding should be reasonable and pragmatic. The Committee, therefore, recommends that any entity other than exchange, multilateral agency, insurance company, bank, depository and clearing corporation can be allowed to hold less than 15% of the share capital and voting rights of the stock exchange either singly or collectively along with persons acting in concert. However, in case a strategic partner is an exchange, multilateral agency, insurance company, bank, depository or clearing corporation, it would be allowed to hold upto a maximum of 26% of the share capital and voting rights of the stock exchange either singly or collectively along with persons acting in concert. Any strategic partner must comply with SEBI (Criteria for Fit and Proper Person) Regulations, 2004. The holding by any foreign entity including FIIs would be subject to the overall policy of the Government on FDI. These recommendations would have to be incorporated suitably in the divestment regulations to be framed and notified by SEBI.*

15.11 The other relevant question in this context is of listing of a demutualised stock exchange. Internationally, demutualised stock exchanges have usually listed on the stock exchange itself and regulatory conflicts have been addressed through specific provisions in the Listing Agreement. *The Committee recommends that self-listing should be permitted, either through the IPO route or by way of listing with appropriate exemptions from Rule 19(2)(b) of SCRR in case a stock exchange does not make a public offer. The regulatory conflicts which are likely to arise will have to be dealt with by suitable provisions in the listing agreement of the stock exchanges and the stock exchanges will have to fully comply with the provisions of corporate governance incorporated in clause 49 of the listing agreement. Overseas listing will also be permitted after the exchange has been listed on the domestic exchange.*

16. **Acknowledgements**

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