

## Bimal Jalan

Former Governor, Reserve Bank of India  
Chairman, Centre for Development Studies

November 22, 2010

Sub: "Review of ownership and governance of market infrastructure institutions".

Dear Mr. Bhave,

I am pleased to submit the final report of the Committee, set-up by SEBI on January 6, 2010, to review the ownership and governance of market infrastructure institutions in India with following members:

- f. Dr. K.P. Krishnan, Secretary, Economic Advisory Council to PM (formerly Joint Secretary, Ministry of Finance)
- g. Mr. Kishore Chaukar, Managing Director, Tata Industries
- h. Mr. Uday Kotak, Managing Director, Kotak Mahindra Bank
- i. Prof. G. Sethu, National Institute of Securities Markets, and
- j. Dr. K.M. Abraham, Whole Time Member, SEBI

It was a privilege for me to chair this distinguished Committee, and I am thankful to you for giving me this opportunity. In carrying out the task assigned to it, the Committee benefited enormously from the findings of research carried out by SEBI Secretariat on global best practices as well as experience of India's stock exchanges. A Consultative Sub-Committee also extensively consulted and discussed various issues with all the major stakeholders, particularly infrastructure institutions, investors and industry associations.

The Committee would like to convey its deep appreciation for the professional and organizational help extended by officials of SEBI, SEBI's member Dr. K.M. Abraham, and Mr. J.N. Gupta, Member-Secretary of the Committee.

The Committee understands that it is proposed to put out the recommendations of the Committee in public domain before the Board of SEBI takes a final decision. Committee very much welcomes this proposal, and hopes that in the light of public discussion, final decisions taken by the SEBI board would contribute to high growth, with stability, of India's financial sector and its real economy.

The Committee suggests that the working of market infrastructure institutions may again be reviewed by a new Committee after five years. A fresh review, after five years of experience, may be desirable in the light of new technological developments, structural changes in financial markets, outlook for capital flows, and global integration.

With regards,

Yours sincerely,

  
Bimal Jalan

Shri C.B. Bhave,  
Chairman, Securities and Exchange Board of India,  
Mumbai



**Report of the Committee  
on**

***'Review of Ownership and  
Governance of Market Infrastructure Institutions'***

**November 2010**

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**A - Sample Questionnaire**

**B - Number of responses received**

**C - Shareholding restrictions in select countries**

**D - Details of shareholding in select countries**

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**Endnotes**

## **Background**

The Securities and Exchange Board of India constituted a Committee under the Chairmanship of Dr. Bimal Jalan, (Former Governor, Reserve Bank of India) to examine issues arising from the ownership and governance of Market Infrastructure Institutions (MIIs). The other members of the Committee were:

- a. Dr. K.P. Krishnan, Joint Secretary, Ministry of Finance Secretary (till June 30, 2010), Secretary, Economic Advisory Council to the Prime Minister of India (from July 1, 2010)
- b. Shri. Kishor Chaukar, Managing Director, Tata Industries
- c. Shri. Uday Kotak, Managing Director, Kotak Mahindra Bank Ltd
- d. Prof. G. Sethu, Officer on Special Duty, National Institute of Securities Markets
- e. Dr. K. M. Abraham, Whole Time Member, SEBI
- f. Shri J.N. Gupta, Executive Director, SEBI (Member Secretary).

Under the terms of reference, the Committee needed to review and make recommendations on the following issues:

- a. Ownership structure of stock exchanges and clearing corporations
- b. Board composition of stock exchanges and clearing corporations
- c. Listing and governance of stock exchanges and clearing corporations
- d. Balance between regulatory and business functions of stock exchanges and clearing corporations, with reference to their 'for profit' status
- e. Relationship between stock exchanges and clearing corporations
- f. Relationship between stock exchanges and technology providers, and
- g. Competition policy for stock exchanges and clearing corporations

Since Depositories form an important part of securities market infrastructure, subsequently, Depositories were included under the scope of the Committee.

### **Methodology**

The committee examined the overall evolution of Indian markets over the years and noted that Indian markets have progressed and responded to its specific needs and socio-economic demands; in addition, there has been a commensurate development in the regulatory framework in line with this evolution. The committee noted that each market has its unique characteristics and Indian markets are no exception and they too have undergone significant changes over the years. This process has also encompassed changes inter-alia in ownership and governance norms of the MIIs. However, the committee recognised that participation and contribution from all stakeholders has almost invariably preceded any successful change.

Therefore, the Committee decided to adopt a consultative approach to have the benefit of views of all the stakeholders, viz. market infrastructure institutions (MII), market participants, shareholders of MIIs, industry associations, investors and general public, on the relevant issues. Accordingly, a consultative sub-committee was formed which sought comments of stakeholders by sending them a questionnaire (Annexure - A to this report). This questionnaire was also placed on SEBI's website.

Subsequently, this sub-committee also held discussions with representatives of NSE, BSE, MCX-SX, NSDL, CDSL, ANMI, BSE Broker Forum, DPAI, LIC, UBS, Deloitte, Financial Technologies and others. The consolidated views of the MIIs and various stakeholders were placed for deliberation before the Committee. The responses received have been tabulated and placed at Annexure - B to this report.

In addition, the Committee also examined the global experience concerning ownership and governance norms of MIIs. Several papers published by World Bank, IOSCO and other such institutions were studied.

This report brings out the recommendations of the Committee. The committee while framing its recommendations, has taken into account the views expressed by different stakeholders, MIIs as well as the Indian experience and global experience concerning the working of the MIIs.

The committee recommends that the report may be placed on SEBI's website for public comments and take the comments received into account before implementing the recommendations.

# **Chapter I**

## **Introduction**

### **1.1. STABILITY VERSUS GROWTH - THE PERENNIAL DEBATE**

The financial crisis over the last three years impacted world economies in varying degrees and forced them to act in different ways to meet the challenges that emerged. Since then, almost all world economies in some manner, have subjected their historically settled views on financial stability to a rigorous re-examination. In the process, many of them have critically revisited the role of important financial institutions and the risks arising to the economy from the operations of such institutions. Consequently, public policy on important financial institutions has refocused around the realization that:

- a. There are financial institutions and markets, which have systemic impact across their local economies and often beyond that.
- b. If the failure or malfunction of such institutions is not contained, it can engender widespread distress, either through its direct impact or as a trigger for broader contagion.
- c. Such contagion will impact the financial system primarily, however, it can have significant impact on the real economy as well.

The Committee has taken into account these lessons learnt since the financial crisis and recognises that in the evolutionary process characterizing a growing market, changes are inevitable; however, these changes should not cause instability. Broadly, the point of view adopted by the Committee is that, any change in the financial regulatory approach to a structure or functioning of institutions such as stock exchanges, clearing corporations and depositories should be introduced in a calibrated manner. At the same time, the Committee recognises that conditions conducive to innovation in these institutions are

necessary for the growth of an economy like India. Therefore, the governance and ownership norms for such institutions need to be tailored carefully so that on the one hand, it ensures safety and reliability of markets, and on the other, MIIs retain their ability to innovate on the products, processes and the range of services they offer.

## **1.2. MARKET INFRASTRUCTURE INSTITUTIONS**

Stock exchanges, depositories and clearing corporations are collectively referred to as securities Market Infrastructure Institutions (MIIs). Literally, the term 'infrastructure' would mean the basic, underlying framework or features of a system; and the term 'market infrastructure' denotes such fundamental facilities and systems serving this market. The primary purpose of securities /capital market is to enable allocation/reallocation of capital/financial resources. This movement helps optimal use of money in the economy and fosters economic development. Well-functioning MIIs have a net positive effect on society like any other infrastructure institutions.

The committee posed a question to itself whether these institutions can be called Market Infrastructure Institutions. Broadly, there are no set parameters drawn up to define an infrastructure institution and the same holds true for infrastructure institutions in the context of the securities markets. However, the research on attributes of infrastructure institutions yields distinct considerations that set apart an infrastructure institution from others.

The key attributes of an infrastructure institution<sup>1</sup> are listed below. These attributes are not mutually exclusive. Often, there can be a significant degree of overlap between the attributes.



1. **Essential facility doctrine:** A commonly accepted attribute of infrastructure institutions is that the goods or services they produce are *essential* in some manner. A legal doctrine has been evolved under US anti-trust law called the “essential facility doctrine”. The key thrust of this doctrine is that a monopolistic operator of an essential facility may be obliged to provide access to a competitor.

Under the Indian Competition Act, 2002<sup>2</sup>, it has been recognised that any application of the essential facilities doctrine should satisfy the following:

- The facility must be controlled by a dominant firm in the relevant market
- Competing enterprises/persons should lack a realistic ability to reproduce the facility
- Access to the facility is necessary in order to compete in the relevant market; and
- It must be feasible to provide access to the facility.

2. **Networks: Externalities, Switching Costs and Standards:** An infrastructure institution is often thought to be or to provide a *network*. Four key characteristics of network industries have been identified<sup>3</sup> which distinguish them from other types of markets:

- consumption externalities
- switching costs and lock-in
- complementarity, compatibility and standards and
- significant economies of scale in production

Infrastructure institutions may enjoy market power because of different network effects. The dependence of customer demand on the choices of

other customers is known as “participation”, “consumption” or sometimes a “network” externality. A positive consumption externality is an advantage that an incumbent firm has over potential competitors for providing a network and is a benefit that accrues to the users of such a network, which is dependent on the condition that other participants are already using the same network.

As seen from the related literature<sup>4</sup>, switching costs and product standards can also affect the economies of networks. Switching costs affect price competition in two opposing ways. First, if consumers are already locked into using a specific product, firms may raise prices knowing that consumers will not switch unless the price difference exceeds the switching cost to a competing brand. Second, if consumers are not locked in, brand-producing firms will compete intensively by offering discounts and complimentary products and services in order to attract consumers who later on will be locked in the technology.

3. **Economies of Scale:** Infrastructure institutions often exhibit *economies of scale*. These occur when the average cost of producing a good or service decline with the number of units produced. A common reason for the existence of economies of scale is the presence of fixed costs of production or marketing.

In theory, the presence of high fixed costs of production may make it impossible for any new entrant to cater to a market and cover its long-run average costs while providing competition to existing players. Other effects are more common with high fixed costs of production. One is a scale monopoly, in which a single incumbent firm is able to cover its costs and is not threatened by new entry because the market is too small to

support two firms. Another is a concentrated or oligopolistic market, where the market is able to support two or three firms.

If competition is effective, however, it may drive average pricing below the long run average costs, leading to one or more firms exiting the market. The eventual outcome may thus be competitively inefficient, as the continuing exit of firms may result in a monopoly. Even though it may appear that, while industries with high fixed costs and low variable costs may be competitively efficient, even if there are only two or three competing firms, the most likely outcome would still be competitive inefficiency.

4. **Sunk Costs:** Infrastructure institutions are often characterized by the presence of *sunk costs*. Such costs are expenses, which a firm needs to incur to enter a market, but cannot recover if it leaves the market. Sunk costs are barriers to exit and prevent “hit and run” entrants who exploit any inefficiency present, and then leave the market when such inefficiency has been exploited.
  
5. **“Natural” Monopoly:** Infrastructure institutions are frequently referred to as being, or operating, *natural monopolies*. This term has historically been used to describe situations where it was believed that only one firm was able to operate in a specific market, with the implication that any such firm should be subject to special regulatory arrangements. The most common reason for the perceived existence of a natural monopoly was that it was uneconomic to replicate expensive infrastructure, given the presence of economies of scale.

The word “natural” in the phrase “natural monopoly” is misleading, as it implies that a particular structure of the relevant industry is natural and inevitable. This has frequently been shown to be not true. Economies of scale need not give rise to monopolies inevitably. A competitor may be able to enter the relevant market and force the incumbent firm to exit; the threat of potential entry too can impose a significant competitive discipline. Technological developments also have allowed competition to threaten many monopolies previously considered “natural”.

Stock exchanges and clearing corporations are subject to significant network externalities. In case of stock exchanges, ‘liquidity begets liquidity’ is a well-known fact. The probability of an order being executed is higher in a liquid stock exchange. Moreover, the bid-ask spread will be lesser which will result in a lesser impact cost for a transaction executed on a liquid stock exchange. Similarly, the benefits of netting will result in lesser margins and collateral requirements for clearing members transacting through larger clearing corporations. Other factors that increase market power for MIIs are economies of scale and law/regulation that deny access to new entities, switching costs, etc.

The observations above also seem to suggest that a single trading system, clearing corporation and depository is likely to gain and keep market power in the provision of services in any one market.

### **1.3. MIIs AS SYSTEMICALLY IMPORTANT INSTITUTIONS**

MIIs are systemically important institutions in any economy. In India, this can be observed from the phenomenal growth of these institutions in terms of market capitalization of listed companies, amount of capital raised and number of investor accounts with brokers and depositories and value of assets held in the depositories’ account. Market capitalization of listed companies in the securities

market has grown many folds as compared to growth in non-food bank credit (which is taken as an indicator of economic growth) in last decade. MIIs constitute the nucleus of capital allocation system and are indispensable for economic growth. They are therefore, 'vital economic infrastructure'. The recent financial crisis has shown the importance of financial institutions to economic stability. Unlike typical financial institutions, the number of stock exchanges / depositories / clearing corporations in an economy is limited due to the nature of its business, although catering to the entire marketplace. Any failure of such an MII could lead to even bigger cataclysmic collapses that may result in an overall economic downfall that could potentially extend beyond the boundaries of the securities market/country. Therefore, such MIIs are considered systemically important institutions.

#### **1.4. MIIs AS PRODUCERS OF PUBLIC GOOD**

The price signals produced by the MIIs partake of the character of public good as these are something that must be provided and accessible to every one and cannot be withheld from anyone who seeks it. Therefore, essentially, the three MIIs in the securities holding-trading-clearing-settlement chain are engaged in the business of producing a valuable public good for society, which are essentially the price signals produced by a transparent and efficient market mechanism. The product that flows from the coordinated functioning of the three MIIs is at the core of modern financial systems. They are the vital to the functioning of the market.

The prices discovered through the operation of these MIIs have to be fair, failing which, they will result in the expropriation of unjust profits by any one side of the transaction. Corporates and Investment Funds use these price signals to value their investments and mark them to market. The Net Asset Value of a Mutual Fund, which guides investments and redemptions by investors, directly

reads off the prices discovered. The valuation of securities collaterals pledged in most modern day credit based finance is inextricably linked to the public good that these MIIs produce.

These are but a few of the numerous ways in which the efficient functioning of these institutions underpins a modern financial market. These institutions, though recognised for providing the markets with the necessary infrastructure, cannot be treated mechanically merely as suppliers of 'infrastructure', however, they are to be viewed more as institutions which are suppliers of an indispensable public good for modern society. Needless to say, the 'public good' product that is supplied collectively by the MIIs is exclusively dependent on the quality and integrity of the process that accompanies the production of the same. Hence, to ensure dependability of the process to the fullest extent possible, certain degree of regulatory powers have to necessarily reside in each of the MIIs, albeit in varying degrees. Therefore, the Committee is of the view that it is not possible to sever the regulatory role of the MIIs from their more obvious role of serving as providers of infrastructure of the market.

Having observed this, it will be useful, in this context, to examine the characteristics and function of each class of MII first, before taking up the governance and ownership structures appropriate to them.

## **1.5. STOCK EXCHANGE**

Stock exchanges provide transaction facility to investors and thus discover the price of securities traded on them. Prices provide the signal for efficient allocation of financial resources across corporations. In this sense, the role of stock exchanges in efficient allocation of resource in the economy is of great significance.

A “stock exchange” under the Securities Contracts (Regulation) Act, 1956 (hereinafter referred to as ‘SCRA’) means:

- (a) *“any body of individuals, whether incorporated or not, constituted before corporatisation and demutualisation under sections 4A and 4B, or*
- (b) *a body corporate incorporated under the Companies Act, 1956 whether under a scheme of corporatisation and demutualisation or otherwise, for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities. ”*

Traditionally, under the open outcry system, a stock exchange was understood to be a place where buyers and sellers met in order to buy/sell securities. Over time, technology has replaced the open outcry system and automated trade engines execute trades based on a price time priority or any other algorithm. To trade through a stock exchange, the investor has to become a client of a registered trading member of a particular stock exchange. Stock exchanges have been entrusted with various regulatory responsibilities for ensuring market integrity and for protecting the interest of investors. Stock exchanges therefore cannot be seen only as providers of electronic platforms for executing trades.

A stock exchange apart from providing electronic platforms for executing trades performs a number of other functions such as:

- issuer regulation (listing, monitoring listing compliances, dissemination of information)
- member regulation (registration of members, inspection and enforcement action)
- trading regulation (setting and enforcing trading rules, market surveillance) and
- investor protection (dispute resolution, grievance redressal, investor protection fund)

- product design

Stock exchanges also undertake support functions such as training and education, technology solutions, data/information services and index services.

### **Evolution**

Stock exchanges in India have a history of more than 160 years and have evolved over a long period. The first and oldest stock exchange in Asia was set up in 1850s, as the records reveal, by indigenous brokers under a Banyan tree which later on in 1875 became what is known today as Bombay Stock Exchange (BSE). National Stock Exchange of India Ltd. (NSE) was recognised in the year 1993. Recently, two stock exchanges – MCX Stock Exchange Limited (MCX-SX) (2008) and United Stock Exchange of India Limited (USE) (2010) have been recognised and have been permitted for trading in currency derivatives. In addition, there are 17 regional stock exchanges that have negligible or no trading, at present.

The governance of stock exchanges has also undergone significant changes over time. Except for NSE, OTCEI, MCX-SX and USE, all other stock exchanges in India were initially set up as associations of persons. These four stock exchanges were set up *ab initio* as companies with limited liability. During the period 2000-06, stock exchanges worldwide underwent a process of corporatisation and demutualisation. Mutual stock exchanges that were owned by its members were restructured in order to reduce the trading member's influence over the management of the stock exchange and open up stock exchanges to greater public ownership. It was felt that diversified public ownership is the way forward. These mutual stock exchanges were formed as associations of persons, wherein the membership card bestowed both ownership and trading rights on the brokers; the brokers because of their ownership rights invariably exercised control over the management of the stock exchanges too. The stock exchanges



were in dire need of professional and independent management. The corporate structure was therefore chosen because it is intrinsically a form that allows wider participation of shareholders, is backed by an established legal framework under the Companies Act, 1956 and above all enables a clear-cut three-way segregation of ownership, management and trading rights.

The SCRA was amended in the year 2004 for mandating corporatisation and demutualisation of stock exchanges in India. The Securities Contracts (Manner of Increasing and Maintaining Public Shareholding in Recognised Stock Exchanges) Regulations, 2006 (referred to as 'MIMPS' hereinafter) was notified, wherein, shareholding limits were *inter alia*, prescribed in order to ensure diversified ownership (including public shareholding) of stock exchanges, and the manner in which such diversification has to be achieved were also laid down.

MIMPS prescribed representation of various participants on the board of stock exchanges and restricted the collective representation of trading members on the board of a stock exchange upto a maximum of 25%.

## **1.6. CLEARING CORPORATION**

As per the draft<sup>5</sup> Rules, "clearing corporation' means a company incorporated under the Companies Act, 1956 (1 of 1956) for the purpose of-

- (i) the periodical settlement of contracts and differences there under;
- (ii) the delivery of, and payment for, securities;
- (iii) any other matter incidental to, or connected with, such transfer and recognised as a clearing corporation under these rules. "

A clearing corporation performs the functions of clearing and settlement of trades that are executed on the stock exchange platform. Settlement of trades involves ensuring that the net obligations that have been determined at the

clearing member level (a clearing member clears and settles trades on behalf of self and other trading members) are settled. As per the terms of the transaction executed on the stock exchange, the clearing corporation interposes itself between the buyer and the seller and undertakes to fulfill the obligations on behalf of the counterparties to the transaction. For ensuring settlement, the clearing corporation adopts stringent risk management practices to ensure settlement of obligations. The risk management function aims to reduce the chances of default during settlement. However, no system howsoever robust it may be, is fail proof. By its role, even if there is failure/default by any member to meet its liability, the clearing corporation has to meet its liability to all others. In such an eventuality, it makes pay-out of funds on behalf of the defaulter (in case of funds shortage) and obtains securities through auction buy-in (in case of securities shortage). Thus ensuring that the system does not have any counterparty risk.

A well functioning clearing corporation is the most important element of risk management in the securities markets. The regulatory responsibilities of a clearing corporation include:

- settlement guarantee/ novation
- sound risk management
- member regulation (registration of members, inspection and enforcement action)

### **Evolution**

Under the open outcry system, the stock exchange was a place where buyers and sellers used to negotiate the terms of trade and the transactions were bilaterally settled between the parties to the trade. With the emergence of technology and sound risk management measures, multilateral clearing and settlement and guaranteeing of trades is now carried out by the clearing corporation/clearing

house, while the stock exchange provides electronic, anonymous, order driven platforms for execution of trades.

Presently clearing and settlement for trades executed on stock exchanges is undertaken either by a clearing house or by a clearing corporation. Sound risk management practices have been adopted by both clearing houses (of functioning stock exchanges) and clearing corporations in India. However, since the clearing corporation/ clearing house guarantees the settlement of the trades, its net worth can also be utilized in the event of insufficiency of funds during a default. In extreme scenarios, the impact on the networth could be very high. Such depletion of networth may call for infusion of new capital or otherwise may lead to winding down of the entity. In such an event, if the clearing function is vested with a separate independent entity, it can facilitate usage of its net worth in extreme scenarios without having an adverse impact on the stock exchange. Whereas, in case it is part of the stock exchange, the net worth of stock exchange is directly and automatically impacted under such extreme scenarios of default. This will affect normal operation/functioning of stock exchange. If the clearing corporation is a separate legal entity, the risk to the capital of the clearing corporation will be segregated and will not spillover to the stock exchange, which appears to be a distinct improvement over the clearing house model.

Traditionally, stock exchanges in India set up their own clearing houses for clearing and settlement of their trades. NSE and MCX-SX have set up independent entities for clearing their trades. BSE has also recently set up an independent entity for clearing and settlement of certain classes of securities traded at BSE and clears and settles for USE too.

The SCRA was amended in 2004 for providing for recognition of clearing corporations. The Securities Contracts (Regulation) Rules, 1957 (hereinafter

referred to as 'SCRR') are in the process of being amended. Comprehensive legal framework in being put in place for prescribing the eligibility criteria, procedure for recognition, terms of recognition, membership conditions, etc for clearing corporations.

### **1.7. DEPOSITORY**

A "Depository" is an entity facilitating holding securities in electronic form and enables transfer of securities by book entry. It interacts with its clients through a 'Depository Participant', with whom the client is required to open a demat account. The main objective of depository is to provide maintenance of ownership or transfer records of securities in an electronic book entry form resulting in paper-less trading rather than paper-based trading and to ensure transferability of securities with speed, accuracy and safety.

*As per the Depositories Act, 1996, a "depository" means a company formed and registered under the Companies Act, 1956 and which has been granted a certificate of registration under sub-section (1A) of section 12 of the Securities and Exchange Board of India Act, 1992 (15 of 1992);"*

A depository performs the following regulatory functions;

- depository participants' regulation (registration, inspection and enforcement action)
- admission of securities, dematerialisation, rematerialisation
- maintenance of register of beneficial owners, record keeping / book entry of transfers
- investor protection (dispute resolution and grievance redressal)

#### **Evolution**

Limitations and problems associated with paper based ownership of securities and settlement necessitated setting up of depositories. The paper based trading

system was neither investor friendly nor scalable and was riddled with problems of bad deliveries, delays, forgery and failure of settlements occasionally. Movement of large volume of papers required longer settlement cycles and was not cost effective.

The enactment of the Depositories Act, 1996 paved the way for the establishment of depositories for the purpose of electronic record of ownership. Following the notification of the SEBI (Depositories and Participants) Regulations, 1996, National Securities Depository Ltd (NSDL), a company sponsored by the NSE, IDBI and UTI was granted a certificate of registration as a depository on June 7, 1996. Central Depository Services (India) Ltd (CDSL), the second depository, which was promoted by BSE along with financial institutions and banks, was granted certificate of registration on August 19, 1998. Inter-depository transfer through on-line connectivity between CDSL and NSDL was established in 1999. With the introduction of the depository system, problems associated with the paper based trading and settlement system were resolved and it paved way to growth in the securities market and was a step forward in making the market place safe and secure.

## **1.8. APPROACH**

Functionally, MIIs provide the basic network of equipment, facility, system or services for the securities market, hence, MIIs are seen as “public utilities”. As regards ownership of MIIs, all of them are privately owned and structured as companies with limited liability. Although MIIs are seen as public utilities, most MIIs are profit-oriented. In addition, being in direct proximity to the market, MIIs are treated as ‘first-level’ regulators and have been vested with regulatory responsibilities by various statutes. Countries differ in the manner in which they view MIIs in their jurisdictions. Many jurisdictions across the world see these MIIs as regulatory institutions, which have to be economically viable as well.

Other jurisdictions that see them more as commercial entities, also exercise an incidental regulatory role. It would appear that these differences are rooted in the history of the evolution of individual securities markets, the governance mechanisms, the levels of transparency and integrity that a jurisdiction has inherited historically and the evolution of legislative action and jurisprudence pertinent to institutions. These differences are more discernible in the case of stock exchanges and clearing corporations and less so in the case of depositories.

While the Committee agrees that the MIIs are economic entities that have to be capable of sustaining themselves, the core facets to MIIs are as follows:

1. In general, MIIs are in the nature of public utilities.
2. All of them are vested with regulatory responsibilities, in varying degrees.
3. They have systemic importance to the economy.

The three attributes listed above have differing and sometimes conflicting goals. As a public utility, an MII becomes an organization that maintains the infrastructure (the trading avenues and platforms and other services incidental to this) for a public service (running a market for securities trading). Clearly<sup>6</sup>, the goals of profit maximization for an MII and that of welfare maximization for the public (in this case, the investors that make up the securities market) may not always run parallel and the MII may be tempted to charge prices well in excess of costs from its users. Moreover, at least in the short run, the regulatory goals may be in conflict with the economic interests <sup>7</sup> of a stock exchange. As it may, in many instances, be required to discipline its members and issuers who are the source of its income. However, in the long run, it may actually be economically prudent for the MII if it establishes itself as a provider of safe and reliable market place.

A concern has been expressed that post-demutualization, stock exchanges have become for-profit companies and have therefore, become free to pursue their economic interest objectives and hence, their focus on regulatory activities have been diluted. However, this view does not go uncontested as there are persons who believe that the demutualization of a stock exchange is not necessarily incompatible with self-regulation. The ability of the stock exchange to meet the standards set for it and deliver key regulatory and public interest objectives depends on a range of factors including the overall regulatory framework, the stock exchange's obligations under the law, the formulation, administration and enforcement of its listing and trading rules, its formal and informal arrangements with the statutory regulator, its management structure, the de facto versus de jure control within it, the transparency of its decision making processes, its allocation of resources for particular regulatory functions and the experience and quality of its staff. In addition, the capacity and the willingness of the statutory regulator to perform its supervisory role are key to the success of the regulatory framework<sup>8</sup>.

Nevertheless, the multiple roles played by the stock exchange could pose conflicts of interests in its operations. Regulators across the globe have adopted different methods<sup>9</sup> to address these conflicts.

- (i) Government (Statutory) Model: Regulation is performed by a public authority. Formal SROs do not exist. Stock exchanges are responsible for very limited supervision of their markets. Examples: UK(FSA), France (AMF).
- (ii) Limited Exchange SRO Model: A public authority is the primary regulator; it relies on stock exchange(s) to perform certain regulatory functions tied to the operation of its market. The function of regulating its members is not performed by the stock exchange. The stock exchange

only performs surveillance functions. Examples: Hong Kong, Singapore, Dubai, Sweden.

- (iii) Strong Exchange SRO Model: A public authority is the primary regulator, it relies on Exchange(s) to perform extensive regulatory functions that extend beyond its market operations, including regulating member's business conduct. Examples: US (CME), Australia (ASX), Japan (TSE, OSE), Malaysia (Bursa Malaysia).
- (iv) Independent SRO Model: A public authority is the primary regulator, it relies extensively on an independent SRO (a member organization that is not a market operator) to perform extensive regulatory functions. Examples: US (FINRA & NFA), Canada (IDA & MFDA), Japan (JSDA), Columbia (AMV).

These four models represent various points along a continuum. The specific choice is governed by several factors including the size of the market and the history of development of markets and financial institutions.

India has adopted the strong exchange SRO model. It is premature to think of the 'independent SRO model' in the Indian context given its evolution over a period to its present state; the government model may not be entirely possible in the Indian context considering the size of the market. **However, due to the potential conflict of interest in the strong exchange SRO model, the Committee is of the view that SEBI must take a more active role in setting a level playing field with regard to fees, entry, etc. of members of MIIs.**

## **1.9. DESIRABLE FEATURES OF MIIs**

Market outcomes that are desirable should be the guiding parameters for formulating the ownership and governance norms for MIIs. The discussion in



the preceding paragraphs leads one to believe that the following outcomes are desirable:

1. National interest and economic security should be safeguarded
2. The MIIs should serve as elements of vital economic infrastructure for efficient resource allocation in the economy
3. MIIs should serve as instruments of managing market risks and to the extent possible prevent market failure
4. There should be desire/motivation/incentives for the operators of MII to support orderly market development that provides long term market stability
5. The MIIs should reduce the regulatory burden of the market by effectively supporting the market regulator
6. The systems adopted by the MII should provide transparency and equal access to its participants.

In line with the approach outlined above on the nature of MIIs, the Committee feels that in the current state of market development in India, following are the appropriate features of a well functioning MII:

- (i) Self-financing: A well managed MII should be capable of financing itself and providing for its sustenance in the near future.
- (ii) Make reasonable profits: The MII should endeavor to generate reasonable profits in order to be self-sustaining. The MII should levy reasonable charges on its users without abusing its dominant or regulatory position.
- (iii) Regulatory function: The MII should be capable of undertaking adequate level of regulatory activities in an unbiased manner. The MII should not shy away from investing adequately in its regulatory activities. The MII must establish itself as a fair and strong regulator and

earn the trust and goodwill of the marketplace so that it is actually profitable for the MII to be a good regulator in its domain of business.

- (iv) Settlement guarantee fund/investor protection fund: The MII should provide adequate safety to the market place by having a sufficiently capitalized settlement guarantee fund/investor protection fund. This fund should be adequate to meet perceived contingencies and “black swan” events.
- (v) Net worth: The MII should be a well-capitalized entity so that the net worth of the MII is available as a last resort to meet exigencies and ensure that it is able to remain as a going concern.
- (vi) Professional standards and competitive practices: The MII must maintain the same professional standards in all its dealings including dealings with its competitors, its technology providers and related entities. It must be able to maintain its integrity by being unbiased while dealing with all such entities.
- (vii) Transparency: The MII should maintain utmost transparency in its operations. The MII on its website should at least make disclosures that are mandated for a listed company.
- (viii) Technology: All the three MIIs are heavily dependent on technology. The MII should be willing to invest in technology for increasing efficiency, reach and economies of scale.

#### **1.10. CONCERNS**

The regulatory framework for the securities market in India has evolved over the years. However, in this progression, the markets have seen two events of significant market failure. Parliament has intervened in both these instances to constitute a Joint Parliamentary Committees (JPC) to look into various aspects, regulatory and otherwise. The recommendations of these committees have contributed to further strengthening the regulatory framework associated with

securities markets. Certain fundamental issues need to be revisited in the light of existing market scenario to ensure that the regulatory framework keeps pace with the challenges posed by developments of securities markets.

1. Need for strategic investors/owners in the MIIs:

There is no established opinion in the literature to arrive at what would be the optimum number of each class of MII in a given securities market. However, as mentioned before, MIIs share several characteristics of 'natural monopolies'. Hence, it is very important to create enabling conditions that allow new entrants to enter the market, albeit, after satisfying regulatory preconditions. At present, the shareholding rights are restricted to 5% for a single entity and extended to 15% for specific classes of institutions. This was done to obviate the possibility of concentration of ownership in a few hands. The cap on shareholding (at 5 and 15 %) has led to a situation where a single entity may not be interested in furthering the growth of the stock exchange because of its limited ownership interest in the stock exchange. Due to relatively low shareholding limit, the incentive (in terms of management control and commercial benefit) that is available to a single investor may not be sufficient for it to devote the requisite time and energy to further the operational interests of the stock exchange. Consequently, this could hinder the growth of the securities market. At the same time, the need to encourage strategic investors has to be balanced against the need for ensuring the profit maximization behavior of the MII or any shareholder does not jeopardize the safety of the market.

2. MIIs as 'for profit' organizations:

As elaborated earlier, the role of the MII as a public utility and 'first level' regulator may sometimes not be in harmony with its

economic interests of maximizing its profits. On the contrary, the motivation of the owners of MIIs should be to make only reasonable profits. Motivation should arise from the desire to establish the market infrastructure and run it in a clean, efficient fashion. This calls for credible players, willingness to remain invested for long periods, expectation of reasonable dividends/returns, inclination to reinvest excess profits in the MII with a view to provide a safety net to the market to meet even the most adverse market disturbance. It is also necessary to ensure that no shareholder dominates the MII in terms of ownership or management control. There should be predominance of desire on the part of the shareholders of an MII to play an institutional role rather than seeking commercial gains in the short/long run. Given the importance of the MIIs as components of social infrastructure, national interest should be safeguarded in specifying ownership/management control.

Recently, new products such as currency derivatives and interest rate derivatives have increased the number of players in the MII space and the competition among these players. In an increasingly competitive environment, stock exchanges may even be tempted to misuse their regulatory powers while regulating/dealing with its competitors (when the competitor is registered as its member or is a potential technology provider, etc), under-invest in regulatory activities, use its regulatory income for unrelated commercial purposes<sup>10</sup>, etc. The question under consideration is whether the governance structure of the MII needs to be altered for ensuring that it serves the purpose for which it was created.

Further, the following developments also raise questions on the suitability of the existing organizational structure:-

- new market structures involving alliances of stock exchanges,
- outsourcing of clearing and settlement,
- proposals to bring OTC transactions on to the stock exchange platform,
- stock exchanges setting up technology and other related businesses

3. Separation of clearing function of a Stock Exchange and entrusting it to an independent clearing corporation:

It is to be examined whether the close relationship between the stock exchange and clearing corporation is an issue. Other questions related to a clearing corporation are its eligibility criteria such as net worth requirements.

4. Self listing by a stock exchange and possible conflicts of interest:

Privately held stock exchanges seek to be listed in order to provide an exit route to its shareholders. However, listing of stock exchange gives rise to a host of other issues, the most pertinent one being the issue of who would be responsible for monitoring the listing compliances. The committee deliberated on the issue as to whether an MII be allowed to list in view of the inherent conflict of interest.

5. Likelihood of unfair practices in allowing selective access to price sensitive data to market participants and stock exchange resources:

The present board composition for stock exchanges permits up to 25% of the board of the stock exchange to be represented by trading members. At least 25% of the board is to be comprised of public interest directors (PID) and the balance is to be represented by shareholder directors. The trading members on the board of the

stock exchange are in a privileged position as compared to other trading members and may gain access to confidential information, which is not available to others. The Committee deliberated on the governing board structure prescribed for stock exchanges and felt that it needs to be reviewed.

6. Management compensation and accountability of senior management:

There is a general belief that among others, the compensation practices at financial institutions was one of the factors that contributed to the global financial crisis. Certain compensation related incentive structures encouraged excessive risk taking, particularly those of senior management, without adequate regard to the resultant longer-term risks on the institutions. This incentive structure had the effect of privatizing profits while socializing losses. This excessive risk-taking left institutions with lower levels of resources to absorb losses as risks actually devolved. It has to be examined in the context of MIIs as to whether the incentive structures for key management personnel needs to be regulated by specifying certain broad parameters / guidelines.

### **1.11. ISSUES**

Based on the above concerns, the Committee has identified the following issues for deliberation with respect to the ownership and governance norms for MIIs:-

1. What is a stock exchange? Does the definition of stock exchange need any modification?
2. Do the present ownership restrictions on MIIs need review? Do FII/FDI norms on ownership in an MII need to be reviewed?

3. Which is a better model for ownership? – (a) Diversified ownership (as in the case of stock exchanges) or (b) anchor/strategic investor approach (as in the case of depositories)
  - a. In case (b) is suitable for MIIs, what classes of entities can be permitted to be anchor investors?
  - b. Should there be lock-in stipulations for anchor investor?
  - c. What are the conflicts arising out of private entities becoming anchor investors?
4. Does the present Board composition (including manner of appointment of the Board) prescribed by SEBI for stock exchanges need a review? Should the same be extended to other MIIs?
5. Trading Members on the Board of the Stock Exchange can potentially have access to confidential information with respect to trading information pertaining to other members as well as sensitive information. Should there be any trading member representation on the Board of the Stock Exchange, or alternatively, can they be put on a separate Advisory Board to the main Board?
6. What should be the organizational structure for an MII that is suitable for fulfilling the objectives of an MII including its regulatory goals? Can the conflicts of interest be eliminated through specific stipulations of structure and governance of MIIs? (For e.g., erection of Chinese wall between the two functions or hiving it off to a subsidiary or transferring to a regulatory body)?
7. What other businesses should an MII be allowed to perform? Can they set up another MII with 100% shareholding? What kind of non-MII businesses can they perform? Can they set up related businesses such as independent software vendors?
8. In the light of the recent global financial crisis and the debate on management compensation, is there a case for enunciating principles for

management compensation of MIIs? What should the management be accountable for – profitability, regulatory efficiency, etc.?

9. What should be the process of appointment of senior management in MIIs? What other safeguards are to be put in the management structure?
10. What will be an optimal number of MIIs for the Indian Securities Market? What should be entry and exit norms applicable to MIIs?
11. There are twin dangers for all MIIs – ‘regulatory race to the bottom in the face of competition’ or ‘becoming too big to fail’. What safeguards can be built to prevent the same?
12. Are there any regulatory issues arising out of competition such as discrimination by an MII against a competing MII or any intermediary or technology provider that needs to be regulated? What should be the norms to regulate the relationship of MII with technology providers and intermediaries?
13. To what extent should commercial functions of an MII be regulated? Specifically, should charges and fees levied by MIIs be regulated in a competitive environment? Is there a case for capping the charges on a ‘cost plus’ basis and/or for capping distribution of profits?
14. Whether listing of an MII should be permitted? If so, what would be best model that may be permitted – self-listing, cross listing or dual listing? What are the alternatives to achieve these objectives? Are there any issues arising out of listing of a subsidiary of the MII on the same MII?
15. Should clearing corporations be subsidiaries of stock exchanges or should they be completely separate entities? What should be the ownership restrictions for clearing corporations?
16. What should be net worth requirement for a clearing corporation?
17. Is it desirable to allow Stock Exchanges, by virtue of being a sponsor of the depository to own more than 50% of the ownership of Depositories, thus



leading to a situation where the depository becomes a subsidiary/ group company of the Stock Exchange?

### **1.12. STRUCTURE OF THE REPORT**

The above issues have been grouped under the following chapters in this report:-

- I. Ownership norms: This chapter reviews the existing ownership norms including foreign participation in stock exchanges and depositories and also proposes norms for clearing corporations.
- II. Governance norms: The board composition for the three MIIs is examined in this Chapter.
- III. Measures for conflicts resolution: This chapter deals with appointment and compensation for senior management, measures to ensure autonomy of regulatory departments and requirements for a compliance officer.
- IV. Other issues: This chapter deals with listing of MIIs, net worth requirements , requirement on MIIs to generate only reasonable profits , related businesses that can be entered into by MIIs, replacement of MIMPS Regulations and powers to SEBI in matters relating to MIIs.

In each of the following chapters, the three MIIs are dealt with separately so that issues can be examined in context to the specific nuances of each MII. The recommendations of the Committee on each issue are stated at the end of the relevant section.

## **Chapter II**

### **Ownership norms**

#### **2.1 MARKET STRUCTURE**

A discussion on ownership norms for MIIs has necessarily to be placed in the backdrop of the broad market structure that determines the inter-MIIs linkages in terms of their ownership and control.

Generally two types of market structures are observed i.e., vertical silos or horizontal integration. Silo models imply vertical integration across the trading and post-trading value chain (trading systems, clearing houses and central depositories). Historically, in most markets, this has been the case in the initial stages of their evolution. This was so because the stock exchanges took the first steps in building post-trade infrastructures to replace bilateral and paper based settlement arrangements for formalized and multilateral clearing and settlement schemes. Horizontal models in most cases, have been the result of the merger of institutions providing the same layer of services in the trade value chain (e.g. trade matching, clearing, settlement, central depository). The distinctive feature is that they are designed to interact with multiple providers of trade and post-trade services<sup>11</sup>.

Competition between stock exchanges may be precluded if potential new entrant stock exchanges and trading systems are restricted from having the same access to clearing and settlement facilities as incumbent stock exchanges. This may occur if competition for the provisions of clearing or settlement services is limited or non-existent and the incumbent stock exchange operates a vertical silo, in which it owns the clearing corporation and the depository. If an incumbent stock exchange operates a vertical silo, but competition at both the clearing and

settlement level is viable, then a new entrant stock exchange has the option of creating its own vertical silo with a clearing corporation and a depository or alternatively seek the services of a clearing corporation and depository other than those owned by the incumbent stock exchange. If an incumbent stock exchange operates a vertical silo and the provision of clearing and settlement services is not competitive, it may choose to be restrictive in offering access to its clearing corporation and depository to a competing stock exchange thereby hindering competition at the trading level<sup>12</sup>.

However, the question as to whether a vertically integrated stock exchange will seek to restrict access to its clearing corporation to another stock exchange is debatable. A major concern expressed by many market participants is that in a world where outsourced clearing is becoming increasingly common, there is a real fear that a clearing corporation may be biased toward its dominant stock exchange customers. This concern is arguably greater for those clearing corporations that remain captive to one major stock exchange or group of stock exchanges but provide outsourced clearing on a selective basis to outsiders. A captive clearing corporation, for example, might be tempted to approve new contracts much faster for its primary stock exchange affiliate than for its outsourcing customers. This would suggest that there is merit in encouraging setting up of a fully independent clearing corporation that caters to more than one stock exchange<sup>13</sup>.

In practice, however, the concerns expressed above have not manifested in any significant manner as seen from several instances in the securities markets in different jurisdictions.<sup>14</sup> It has also been argued<sup>15</sup> that if one were to assume that execution is potentially highly competitive and if clearing were a natural monopoly, then the monopoly clearing entity would encourage competition in execution rather than insist that market users use the trading system of the

associated stock exchange. If other execution venues are more efficient and if competition between them drives down the price of execution services, the clearing monopolist would be better off not integrating execution and clearing and instead allowing customers to obtain execution services from the lowest-cost provider.

Vertical integration – the combination of both clearing and execution activities in a single firm as a vertical silo – eliminates double markups and can be a means to economize on transaction costs<sup>16</sup>. Thus, typically, fundamental economic considerations appear to make vertical integration a more prevalent route in comparison to the alternative of trading and post-trading services being provided by separate for-profit entities.

In India, vertical silos have so far emerged in both clearing and depository services. NSE has a 100% owned subsidiary NSCCL for clearing and settlement services. NSE also holds 25% in NSDL. Similarly, BSE has a clearinghouse for clearing and settlement of its products. It has also set up an independent 100% owned clearing corporation, ICCL, for clearing and settlement of some of its segments. BSE has 54% shareholding in CDSL. However, this arrangement has not precluded access to the respective depositories. Inter-connectivity between NSDL and CDSL has been achieved in 1999, albeit through regulatory intervention. MCX-SX has also set up a 100% owned subsidiary MCX-SX'CCL for clearing and settlement. However, USE, the latest stock exchange in the securities market, has outsourced clearing and settlement to ICCL. BSE holds 15% of the paid up equity capital of USE .

From the above, it is evident that both trade execution and post-trade services have proven to be competitively viable in the Indian scenario<sup>17</sup>. Moreover, outsourcing of clearing and settlement is also gradually emerging in the Indian

market. It appears that there is no pressing need to alter the exiting market structure of arrangement between stock exchanges, clearing corporation and depository solely to address the issue of competition.

The ownership requirements of each MII are examined below.

**2.2 STOCK EXCHANGES:** The ownership requirements for stock exchanges were notified by Government of India vide SCR (Manner of Increasing and Maintaining Public Shareholding) Regulations, 2006 (“MIMPS”). The following limits are applicable as per the MIMPS Regulations:-

Category	Maximum Permitted Holding
Person resident in India - individual limit	5%
Stock exchange, depository, clearing corporation, banking company and a public financial institution defined under Sec. 4 A of the Companies Act 1956 <sup>18</sup>	15%
Persons residing outside India - individual limit	5%
Limit on cumulative holding by trading members	49%
Persons residing outside India - cumulative limit	49%, subject further to the following:- a) 26% through the FDI (via FIPB approval) b) 23% for FII's (No initial allotment through an IPO/FPO) <ul style="list-style-type: none"> <li>• If the stock exchanges are not listed, acquisition by FII is permitted through off market transactions but not through initial allotment.</li> <li>• If the stock exchange is listed, acquisition by FII is permitted only through on market.</li> </ul>

Annexure - C & Annexure -D of this report depict the ownership restrictions in select countries and details of ownership of stock exchanges in select countries, respectively. It is seen that the existing shareholding restrictions in India generally are similar to that of most other countries. However, from the tables in Annexure -D, it is seen that in most of the other stock exchanges, at least one shareholder has been permitted to hold more than 15% but less than 30% of the equity share capital.

Imposing restrictions on ownership is one of the ways of exercising regulatory control over a stock exchange. Dispersed ownership structure has been adopted for stock exchanges so that no single entity becomes a dominant shareholder in an entity that is entrusted with vital economic and regulatory functions. It has been felt that for public policy reasons<sup>19</sup>, it is desirable to encourage widespread ownership, encompassing both institutional and retail investors. This helps to reduce the likelihood of decisions being made in the interests of any one particular segment of the market.

However, there have also been contrary views expressed in this regard. Demutualization was aimed at allowing a stock exchange to operate as an entity in its own right - rather than as an extension of its members/users business. Ownership and control in the stock exchange of the trading members has been restricted severely. This in a sense has shifted the governance fulcrum away from the trading members to the shareholders and public interest directors. But some observers<sup>20</sup> have noted that limiting the maximum permissible holding by other entities (to limits as low as 5 percent of share capital of that stock exchange) might have led to the lack of interest on the part of shareholders to take adequate interest in the management and governance of the stock exchanges. Thus the limits on shareholding of a stock exchange, could defeat the purpose of

demutualization. Indeed, in the case of some stock exchanges, it appears that in spite of demutualising, they have been unable to shake the conflicts between members who have different interests.

It has also been suggested<sup>21</sup> that there are number of factors that could influence a stock exchange to seek to limit diversified ownership, including:

- (i) Very widely dispersed ownership, where investors are more likely than not, to suffer from “rational apathy” in their decision-making, which may possibly have adverse consequences on occasions when a requisite level of extant shareholders is needed, for example, where a change to a stock exchange’s constitution is required, and
- (ii) Relatively large shareholder bases are likely to impose significant on-going costs on stock exchange which arise from the need to service shareholders, for example, by providing them with annual reports, general meeting venues and so on;

On examining the above arguments, the Committee is of the opinion that the concept of dispersed ownership is to be favored for the well functioning of the stock exchanges. However, institutions fulfilling stringent eligibility criteria may be permitted to hold a higher percentage of shareholding in stock exchanges. In India, the shareholding restrictions prescribed under MIMPs were increased from 5% to 15% for certain class of investors in 2008. The question now under consideration is whether a further step in that direction is warranted. This issue is being considered mainly because there may be certain shareholders fulfilling stringent eligibility, fit and proper criteria, who take an interest in the working of the stock exchange, and may be interested to obtain higher shareholding. Further, possibly there is still scope for new stock exchanges to be set up in India,

given the huge expected potential of its markets. It is desirable to ensure that fair competition is available to avoid perverse monopoly. At the same time, the Committee is of the opinion that the optimal number of stock exchanges required in India cannot be arrived at with any degree of precision. Moreover, entry of a large number of stock exchanges will fragment liquidity to such an extent that this might stifle growth and innovation in the process. Also, too frequent exits of stock exchanges will jeopardize the interests of the investors and disrupt the stability of the markets themselves. Further, technology has altered the market place so much that need for multiple stock exchanges has been reduced largely.

The concept of anchor investors is not alien to Indian securities market, as it has been introduced by SEBI on July 9, 2009, in public issues, to help the issuer to raise funds. The Committee therefore proposes to support the concept of 'Anchor Institutional Investor' who will take the lead role of setting up a stock exchange. However, the implementation of the above proposal should not result in the dilution of dispersed ownership norms for stock exchanges. Therefore, it is suggested that there should be a cap on the maximum shareholding held by all anchor institutional investors put together. In addition, the anchor institutional investor should bring down his shareholding within a prescribed period.

At present, the MIMPS Regulations permit the following entities to hold up to 15%, after seeking prior approval from SEBI:-

- (i) Stock Exchange
- (ii) Depository
- (iii) Clearing corporation



- (iv) Banking company as defined under clause (c) of section 5 of the Banking Regulation Act, 1949
- (v) Insurance company as defined under sub-section (8) of section 2 of the Insurance Act, 1938
- (vi) Public financial institution defined under section 4A of the Companies Act, 1956

Of the above entities, well-capitalized public financial institutions and banks may only be permitted to be anchor institutional investors for stock exchanges. While in Section 5.5 of the report the Committee has proposed the replacement of the MIMPS Regulations by a comprehensive set of regulations on the ownership and governance of stock exchange, the following changes are recommended to the current set of provisions of the MIMPS Regulations applicable to stock exchanges:-

#### **I. ANCHOR INSTITUTIONAL INVESTOR (AII)**

##### **a) Domestic institutions registered in India having a net worth of ₹ 1000 crores or more and falling under the category of:**

- (i) Public Financial institutions defined under section 4A of the Companies Act, 1956 and with national jurisdiction,**
- (ii) Banking company as defined under clause (c) of section 5 of the Banking Regulation Act, 1949**

**may be permitted to be anchor institutional investors for stock exchanges for a period of 10 years from the date of recognition as an AII of the exchange.**

- b) **Public financial institutions and banking companies fulfilling the conditions prescribed under (a) above can be anchor institutional investors even if their subsidiary/ associates have trading interests.**
- c) **A single anchor institutional investor may be permitted to hold up to 24% of the total equity capital of an exchange, along with persons acting in concert.**
- d) **Every anchor institutional investor will have to bring down its holding to 15% or less in ten years from the time it is recognised as an anchor. During the allowed holding period of ten years, if an AII desires to offload the stake to another eligible AII, the holding period for new AII would be deemed to have commenced from the date when original AII acquired shares and became AII. In summary, the total holding period allowed will be only 10 years for the initial AII and its subsequent AII's. SEBI may extend such period in case the AII makes an application for the extension in time and the same is a fit case for extension.**
- e) **Anchor Institutional Investor for new stock exchanges: At the time of filing the application for recognition as a stock exchange, anchor institutional investors shall be identified, by the entity seeking recognition, from amongst the shareholders holding more than 15% and up to 24% of the equity capital of the exchange.**
- f) **Anchor Institutional Investor for existing stock exchanges: Entities at (a) above desirous of holding more than 15% and up to 24% for becoming anchor institutional investors in a recognised stock exchange will have to make an application to SEBI for the same after getting the approval of**

the shareholders in the AGM of the stock exchange through a special resolution.

- g) All anchor institutional investors put together shall not hold more than 49% of the total equity capital of an exchange.
- h) The present procedure of obtaining 'fit and proper' approval from SEBI, for entities holding more than 5% shall continue.

## II. OWNERSHIP AND CONTROL OF AN MII IN ANOTHER CLASS OF MII

In the securities market in India, the evolution of vertical silos with stock exchanges holding stakes in clearing corporation and depositories has become quite prevalent. The Committee is of the view that clearing corporations and depositories perform specialized post-trade services. It is ideal for these MIIs (clearing corporations and depositories) to function as public utilities and focus on improving the safety of the market and reducing the costs to users. The Committee is of the view that on account of the discussions in section 2.1 above, there is no need to permit a clearing corporation or depository to invest in other class of MIIs. **Hence, clearing corporations and depositories may not be allowed to invest in other class of MIIs .**

To sum up, the model proposed for restriction on shareholding of stock exchanges is as follows:-

Upto 5%	>5% and upto 15%	<b>ANCHOR INSTITUTIONAL INVESTOR</b> >15% and upto 24%
Any person both resident in India and outside India including those having trading interests	<p>a. Stock Exchange b. Banking company c. Insurance company d. Public financial institution defined under section 4A of the Companies Act, 1956</p> <p>(It is proposed that depositories and clearing corporations shall not be allowed to invest in stock exchanges)</p>	<p>Domestic institutions<sup>22</sup> having a net worth of ₹ 1000 crores or more and falling under the category of;</p> <p>a. Public Financial institutions defined under section 4A of the Companies Act, 1956 and with national jurisdiction, b. Banking company as defined under clause (c) of section 5 of the Banking Regulation Act, 1949</p> <p>All anchor institutional investors put together may not hold more than 49% of the total equity capital of an exchange.</p> <p>Every anchor institutional investor will have to bring down its holding to 15% in ten years from the time it is recognised as an anchor.</p>

The category based restrictions for trading members, FII, FDI and cumulative foreign holding will continue as before.

**2.3 CLEARING CORPORATIONS:** Clearing corporations / clearing houses are the most important link for orderly settlement and risk containment. A single independent clearing corporation is ideal for obtaining the benefits of netting and for position monitoring purposes as well. However, it would also increase the systemic risk in the market. A mid-way would be to have multiple independent clearing corporations, which are connected to each other and to the exchanges and depositories. This would necessitate interoperability among clearing corporations. As established by the example of depositories in India, a majority holding by a stock exchange does not preclude successful linkages between the depositories. Moreover, from a market power perspective, a single clearing corporation may levy excessive charges on its users.

As regards ownership issues, while stock exchanges are required to increase penetration and turnover, the business of a clearing corporation is only a function of the turnover at the exchange(s). The primary objective of a clearing corporation is to ensure orderly settlement of trades and to safeguard the security and stability of the settlement system. Keeping in mind the pivotal role of clearing corporations in settling the trades and risk management of the stock markets, it would be detrimental to place the commercial objectives of the shareholders of the clearing corporation in the forefront. Therefore, while private participation is permitted for stock exchanges, it is felt that clearing corporations being at the core of the settlement system must continue to be promoted by stock exchange(s), whose interest would also be to ensure orderly clearing and settlement of trades executed on their platforms. Moreover, the processes of trade matching, margining, clearing and settlement are so interlinked with each other that separating the entities may lead to an increase in legal and operational risks.

One view that has been held by some experts in this field is that stock exchanges and clearing corporations should be completely separated. This view would entail that stock exchanges thereafter should be freed without any restrictions on their ownership. It has also been argued in this context that the surveillance functions of SEBI as the regulator should be strengthened further instead of the regulator having to depend on the surveillance mechanisms of the stock exchange. The Committee noticed a few difficulties with these arguments. It has to be first recognised that on a value chain consideration, from the trading transaction to clearing and all the way to settlement of the trades, the most risky element (and therefore, the highest in value as a proportion of the total transaction costs) would have to be attached to the clearing and settlement function. Shorn of the clearing and settlement function, the stock exchange is merely a provider of an electronic trading platform. Hence, the first difficulty that the Committee sees in this arrangement is that clearing corporations being at the core of the clearing and settlement function of the exchange, such a separation between the stock exchange and clearing corporation would simply shift the debate of ownership and governance to the level of clearing corporations, without achieving commensurate benefits to the marketplace. Secondly, divesting the stock exchanges of their surveillance function and treating them on the same level as any other financial intermediary, would mean that the market loses the benefit of a second layer of surveillance. Thirdly, entrusting the stock exchanges with a surveillance (regulatory) function means that surveillance begins right at the interface between the client (through the broker) and the trading and settlement system – clearly a sounder basis for a well-regulated marketplace. Finally, when any regulatory role is attached to a profit making public utility like the stock exchange, despite the conflicts of interests we have referred to herein, it confers a certain status to it as a defender of the market thereby making the market more secure for the investor. Hence, the Committee is not in favor of a complete separation of the clearing corporation

from the stock exchange. The Committee favours a situation where stock exchanges have a significant relationship with the clearing corporation as anchor investors.

**The Committee therefore, recommends that at least 51% of the paid-up equity capital of the clearing corporation should be held by one or more recognised stock exchanges.**

**2.4 DEPOSITORIES:** In the case of depositories, the concept of anchor investors has already been adopted. Such investor(s) are called as sponsors in the context of depositories. "Sponsor", as per the SEBI (Depositories and Participants) Regulations, 1996, means *"any person or persons who, acting alone or in combination with another proposes to establish a depository and undertakes to perform the obligations of a sponsor under these regulations."*

Presently, sponsors belonging to any of the following categories, are required to hold at least 51% of the equity share capital in the depository, either alone or together:-

- (i) A public financial institution as defined in section 4A of the Companies Act, 1956 (1 of 1956);
- (ii) a bank included for the time being in the Second Schedule to the Reserve Bank of India Act, 1934 (2 of 1934);
- (iii) a foreign bank operating in India with the approval of the Reserve Bank of India;
- (iv) a recognised stock exchange within the meaning of clause (j) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956);
- (v) a body corporate engaged in providing financial services where not less than seventy-five per cent of the equity capital is held by any of

the institutions mentioned in sub-clause (i), (ii), (iii) or (iv) jointly or severally;

- (vi) a body corporate constituted or recognised under any law for the time being in force in a foreign country for providing custodial, clearing or settlement services in the securities market and approved by the Central Government;
- (vii) an institution engaged in providing financial services established outside India and approved by the Central Government; or
- (viii) the applicant is a fit and proper person.

Besides sponsors, no person whether resident in India or not, including depository participants, are allowed to hold more than 5% of the equity share capital in the depositories.

The higher shareholding (of at least 51%) by sponsors, including stock exchanges in depositories was permitted in the initial stages for facilitating the setting up of depositories. Therefore, currently, when two depositories have successfully established themselves, it is felt that the independence of depositories has to be ensured by reducing the holding of stock exchanges in depositories. Moreover, depositories in India perform only record keeping activity, unlike some Central Securities Depositories (CSDs) abroad that undertake both settlement and electronic record keeping of securities. The activities performed by depositories in India are therefore, not entwined with the stock exchange (unlike that of clearing corporations). Most importantly, the Committee recognises that stock exchanges and depositories both have a surveillance and regulatory function. Each, in its own way serves as a surveillance layer in the market. The Committee has been apprised of the fact that SEBI as the market regulator often uses records of depositories for its surveillance function, independent of the data



collected from stock exchanges. For obvious reasons, one surveillance mechanism desirably should not be in control of another surveillance mechanism. While, in the context of just two depositories and three or four exchanges in India, this problem may not appear grave in line. However, the Committee is of the opinion that the integrity of the surveillance mechanism in each entity should be maintained and in the process insulate the market from systemic risks to the extent possible. The Committee therefore, feels that a stock exchange should not be allowed to take a position of control in a depository. **It is recommended that the holding of stock exchanges in depositories may be restricted to a maximum of 24%.**

**Further, the sponsors shall be subject to a 'fit and proper' approval from SEBI in the manner similar to the shareholders of stock exchanges holding more than 5%.**

**2.5 FOREIGN PARTICIPATION:** At present, the combined holding of all persons residing outside India in the equity share capital of an MII is capped at 49% subject to the following:

- The combined holding through FDI and FII routes are capped at 26% and 23%, respectively.
- FIIs can acquire the equity shares of an MII only through the secondary market.
- An FII cannot have representation on the board of an MII.
- No person outside India, either individually or with persons acting in concert with him can hold more than 5% of the equity share capital of an MII.

The Government has clarified that with respect to exchanges that are not listed, FII purchase of shares of such exchanges can only be through transactions

outside of the exchange provided it is not an initial allotment and that however, if the exchange is listed, transactions by FIIs should be done on the exchange alone. Therefore, technically, it would follow that an FII cannot be a part of the group that applies for a new exchange but immediately after SEBI approves the exchange, the FII can take ownership up to 5% through a direct purchase from any one of the promoters of the exchange. It is felt that there is no ostensible justification for retaining this distinction. It may also be noted that all MIIs are at present unlisted and the question of FIIs purchasing shares of stock exchanges through a stock exchange transaction does not arise.

**Therefore, it is recommended that in the case of all MIIs, an FII should be allowed to acquire the shares through off market transactions including through initial allotment, as allowed for other shareholder, subject to the limits specified by the Government from time to time. The same may be suggested to the Government by SEBI.**

**2.6 ALL EXPOSURES TO BE COUNTED:** The shareholding limits described above shall be inclusive of all exposures (both on and off the balance sheet) of the shareholder to the MII. The Committee feels that it would be counter intuitive to prescribe shareholding limits and allow participation of a shareholder through other means as a creditor or holder of other instruments issued by the MII. In other words, the maximum permissible limit will be computed based on the equity share capital of the MII and in case the entity (along with persons acting in concert) has any other direct or indirect exposure in the MII, such exposure in value terms shall be included while determining the total exposure of the shareholder to the MII. This would help maintain a transparent and cleaner separation of ownership and governance – an essential consideration for avoiding conflicts of interests referred to above.

**2.7 TIME FOR COMPLIANCE:** New stock exchanges must comply with the ownership restrictions *ab initio*. Similarly, the ownership restrictions for clearing corporations are in line with market practice, therefore, they must comply with the same *ab initio*. In case of existing depositories, stock exchanges may be given a time limit of 3 years for reducing their holding in depositories to 24%.

## **Chapter III**

### **Governance norms**

An institution's board of directors plays a central role in its governance. In the case of MIIs, the board decides on important aspects such as:

1. Investments in critical functions such as surveillance, risk management, up-gradation of systems for exchange/depository operations, testing of disaster recovery sites, etc
2. Nomination/ selection of Public Interest Directors/Independent directors
3. Some of the directors may be part of the selection committee that selects key personnel, including the ED of the Exchange/Depository.
4. Tightening of norms such as imposition and collection of margins, member/ depository participant compliance, and resolution of investor grievances, which may lead to deployment of more resources by the member/ depository participant.
5. Surveillance matters such as shifting of scrips from Trade for Trade to Normal Segment, relaxation of filters, etc
6. Financial matters such as security deposit collected from members/depository participants, charges levied upon members/depository participants, investments and deployment of surplus funds in property/building/ land.
7. Matters pertaining to inspection, selection of members/ depository participants for the same.
8. Investor related issues such as increasing arbitration centers, increasing manpower for redressal of investor grievances, etc

9. Penalty structure, collection of penalty etc
10. Appointment/ composition of various executive committees, statutory committees, including the arbitration panel
11. Amending rules/byelaws/regulations of the MII

By being on the board of an MII, the directors can potentially influence the decisions of the board and in extreme circumstances may even prevent the MII from fulfilling the primary objectives for which it was created.

**3.1. BOARD COMPOSITION FOR STOCK EXCHANGES:** Pursuant to corporatisation and demutualisation, SEBI, has prescribed that in the case of stock exchanges, not more than 25% of the board can be composed of trading member directors, a minimum of 25% is to be comprised of public interest directors and balance should consist of shareholder directors.

Trading members on the board of a stock exchange are privy to confidential information. This therefore can give rise to conflict of interest when the entity regulated by the stock exchange is also on the board of the stock exchange. Conflict of interest also arises when shareholders with commercial motives form a majority in an entity which also has regulatory functions to perform.

Moreover, in institutions which are subject to dispersed shareholding requirements or where the shareholders consist of mainly public sector financial institutions, the board may end up being a little more than a 'rubber stamp' for management's decisions.

Internationally, the appointment of independent directors (previously public interest directors)<sup>23</sup> to the board of a market infrastructure institutions SRO is

undertaken typically to ensure that the board responds to inherent conflicts that is a consequence of the entity pursuing both private and public interests simultaneously. In order to effect this, such directors need to be independent both of the market infrastructure institution on whose board they sit and also of other relevant parties, including participants using the facilities of the market infrastructure institution and issuers listed or whose stock is traded on the exchange.<sup>24</sup> More number of PIDs on the Board of the exchange would enable the PIDs to have a stronger voice in the governance of exchanges.

**It is therefore, recommended that no trading /clearing member (irrespective of exchange where he operates) shall be allowed on the board of any of the stock exchange and the number of public interest directors on the board of a stock exchange shall at least be equal to the number of shareholder directors without trading/ clearing interest. The appointment of the Chairperson of the Board shall be with prior approval of SEBI. Terms and conditions of appointment of Chairperson should be subject to SEBI's approval. The sitting fees payable to the PIDs shall be as per the Companies Act, 1956. They shall not be paid any commission or any other remuneration.**

The committee feels that trading members bring rich practical experience and the same should be utilized in a manner which doesn't conflict with governance. Therefore in order to utilize the experience and expertise of trading members in the securities market, an advisory committee shall be constituted by the board of the stock exchange, comprising of trading members. Trading members shall not be permitted participation in any other committee of the exchange. The advisory committee to the board may deal with non-regulatory, operational matters such as product design, technology, etc. The board of the exchange shall consult the advisory committee on these issues. The Chairman of the board shall head the advisory committee. The

advisory committee shall meet a minimum of 4 times a year. The recommendations of the advisory committee shall necessarily be placed before the ensuing meeting of the board of the exchange and shall be disclosed on exchange's website.

**3.2. BOARD COMPOSITION FOR CLEARING CORPORATIONS:** The existing board structure at NSCCL, ICCL and MCX-SX'CCL are as follows:-

NSCCL	ICCL	MCX-SX 'CCL
Chairman - 1	MD/CEO - 2	Shareholder directors - 3
MD/CEO - 1	Independent	Independent directors - 3
Other non executive directors - 5	directors - 2 BSE executive officers - 3	Executive director - 1

As of now, there is no directive for board composition of clearing corporations. It may be because few outside experts are available given the complex nature of activities performed by clearing corporations. As G30 recommends, clearing and settlement institutions may seek to appoint senior managers from their users who have proven managerial experience, wide industry expertise, an ability to assess complex situations and make key strategic decisions.<sup>25</sup>

In order to utilise the expertise of clearing members, it is recommended that the model adopted for stock exchanges may be extended to clearing corporations as well. **It is therefore recommended that the number of public interest directors on the board of a clearing corporation shall at least be equal to the number of shareholder directors without trading/clearing interest. Further, an advisory committee shall be constituted by the board of the clearing corporation, comprising mainly of clearing members. Clearing members shall not be**

permitted participation in any other committee of the clearing corporation. The advisory committee to the board shall deal with non-regulatory, operational matters such as procedure related to clearing and settlement, technology, etc. The board of the clearing corporation shall consult the advisory committee on these issues. The Chairman of the board shall head the advisory committee. The advisory committee shall meet a minimum of 4 times a year. The recommendations of the advisory committee shall be placed before the ensuing meeting of the board of the clearing corporation and shall be disclosed on clearing corporation's website.

**3.3. BOARD COMPOSITION FOR DEPOSITORIES:** The existing board structure at NSDL and CDSL are as follows:-

NSDL	CDSL
Independent Directors - 5	Independent directors - 2
Shareholder directors - 5	Shareholder directors - 5
MD/CEO - 1	Whole-time directors - 1

Both internationally and in India, the board structure for depositories is not subject to stringent norms as compared to those of stock exchanges. It has been felt that the conflicts of interests faced by depositories are not same as those faced by stock exchanges. Moreover, only financial institutions/banks/stock exchanges, etc. can be sponsors of a depository and these are mostly nominated as shareholder directors.

However, in order to ensure that depositories are also subjected to sound corporate governance norms, **it is recommended that the board composition in depositories should be the same as prescribed for listed companies under clause 49 of the listing agreement.**



**3.4. DISCLOSURES BY BOARD MEMBERS:** All transactions in securities of the board members of the MII and their family have to be disclosed to the board of the MII.

**3.5. EMPLOYEE(S) ON THE BOARD OF THE MII:** The MD/CEO of the MII shall be ex-officio member on the board of the MII. The MD/CEO shall not be included in either the category of public interest directors or shareholder directors. In case the MII wishes to appoint any other official on its Board in addition to the MD/CEO, the same shall be subject to the approval of shareholders and SEBI, in that order. The additional official shall be counted in the category of shareholder directors.

**3.6. TIME FOR COMPLIANCE:** All MIIs may be given time until the next AGM for implementing the recommendations on board composition. In case the next AGM falls within three months, the recommendations shall be implemented before the subsequent AGM.

## **Chapter IV**

### **Measures for conflicts resolution**

SEBI has so far restricted the trading member representation on the board of stock exchanges and has prescribed the minimum number of public interest directors on the board as a means of reducing the conflicts of interests in the governance of stock exchanges. These governance arrangements are intended to ensure that decisions taken by the board have the benefit of unbiased advice and to prevent the concentration of decision-making power in a few hands. However, it must also be realized that conflicts of interests may also permeate to the lower levels of hierarchy in an MII, which may impair the regulatory efficiency of the organization.

Internationally, as a best practice, stock exchanges have chosen to segregate the regulatory functions from their commercial functions and have put in place measures to ensure autonomy to the regulatory departments. The degree of separation ranges from outsourcing the regulatory function to an independent SRO, hiving off those departments to a separate subsidiary and putting in place measures such as 'Chinese walls' between the commercial and regulatory departments.

Ideally, from a regulatory perspective, it is felt that it is important to have complete segregation of commercial activities from the regulatory activities. However, it is not an easy task to identify cases where commercial and regulatory functions are joined or overlapping. Especially in the case of conflicts that arise due to competition, the commercial activities are sometimes so commingled with the regulatory function that they are difficult to separate into watertight compartments. For instance, the competitor may not register himself

as a member of the exchange; instead, the competitor may even be a technical provider, in which case such measures may fail.

The following measures are therefore, suggested as means to address some of the conflicts arising from commercial and regulatory activities of an MII:

**4.1. MECHANISM TO ENSURE AUTONOMY OF REGULATORY DEPARTMENTS:** In order to ensure that regulatory functions are carried out satisfactorily, it is recommended that;

**The senior executives heading risk management, surveillance, listing, registration, compliance, inspection, enforcement, arbitration, default, etc. shall report directly to an independent committee of the board consisting of a majority of public interest directors and also to the MD/CEO (dual reporting).**

**The remuneration of such executives, including the annual increment indexed for inflation, should be a fixed sum without any variable component linked to the commercial performance of the MII. Further, the compensation should not include any form of equity / equity linked or stock options in the MII. It should also be ensured that the remuneration is determined after giving due regard to the average levels of compensation given to employees in similar rank. The remuneration package will be subject to review of the remuneration committee/management compensation committee.**

**The initial appointment of the above employees shall be for a fixed tenure, as may be decided by the independent committee. In case any action against such senior executives is taken, it should be subject to appeal to the independent committee, up to two years after being relieved from such department.**

Chinese walls in terms of work area, infrastructure, personnel etc, shall be maintained between the regulatory and commercial departments. The definition and details regarding 'Chinese walls' shall be as per SEBI (Prohibition of Insider Trading) Regulations, 1992. The MII should have an internal manual covering the management of conflicts for both commercial and regulatory functions of the MII, supported by comprehensive training and awareness. Further, the entire conflict management framework should periodically be reviewed and be strengthened based on the observations of such review.

**4.2. APPOINTMENT OF MD/CEO:** At present, the appointment of MD/CEO of a stock exchange is subject to approval by SEBI; however, the terms and conditions, including remuneration of such MD/CEO are decided by the board of the stock exchange. No such requirements have been prescribed for depositories. The present procedure for appointment of MD/CEO of a stock exchange shall continue and the same shall be extended to the MD/CEO of clearing corporations and depositories. SEBI shall ensure that the CEO is appointed for a reasonable tenure, say between 3-5 years.

**4.3. COMPENSATION OF KEY MANAGEMENT PERSONNEL:** The compensation of key management personnel, including the MD/CEO/ED and others as may be identified by the board, should be decided by a remuneration committee/management compensation committee appointed by the board. It should also be ensured that the remuneration is determined after giving due regard to the industry standards for the same. The remuneration of such executives, including the annual increment indexed for inflation, should be a fixed sum without any variable component linked to the commercial performance of the MII. Further, the compensation should not include any form of equity / equity linked or stock options in the MII.

**4.4. APPOINTMENT OF COMPLIANCE OFFICER:** The Committee noted that SEBI has mandated various registered intermediaries to appoint a compliance officer to ensure that the intermediary complies with the rules, regulations, circulars and directives of SEBI. Similar requirements have also been mandated for depositories.

**It is recommended that appointment of compliance officer shall be mandatory for stock exchanges and clearing corporations.** The compliance officer shall be responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines, instructions etc. issued by SEBI or the Central Government and for redressal of investor's grievances. The compliance officer shall immediately and independently report to SEBI any instance of non-compliance observed.

## **Chapter V**

### **Other issues**

**5.1. LISTING:** Listing of an MII brings with it advantages and disadvantages. On one hand, listing of an MII provides an exit route to its shareholders, bringing transparency and better governance to the functioning of the MII. However, on the other hand, listing may also usher in more conflict of interests for the stock exchange, since monitoring its own listing related compliances or that of a related/competing MII will be an issue.

On balance, shareholders of an MII need to be long-term investors who are sufficiently motivated to take a keen interest in the functioning of the MII and to contribute to its growth by providing the necessary value addition in terms of technology, market/product design, managerial inputs, etc. An MII should not become a vehicle for attracting speculative investments. Further, MIIs being public institutions, any downward movement in its share prices may lead to a loss of credibility and this may be detrimental to the market as a whole. **Therefore, the Committee is not in favor of permitting listing of MIIs. However, the disclosures and corporate governance requirements of the listing agreement applicable to listed companies shall be made applicable to MIIs too. The information required to be disclosed shall be posted on the website of the MII.**

**Further, if there is an entity, which chooses to get itself listed on a stock exchange and is substantially owned (i.e. 24% or more of equity capital) by that stock exchange or by an MII in which that stock exchange holds shares, then such entity shall seek prior approval from SEBI before listing.**

**5.2. NET WORTH REQUIREMENTS:** MIIs by their very nature necessitate huge, long-term, sunk investments. Hence, net worth is one of the important eligibility criteria for setting up an MII. It is required for meeting the initial capital required towards infrastructure and ensures that only serious players enter this arena.

SEBI has already prescribed a net worth requirement of ₹ 100 crores for depositories. Further, SEBI Board in its meeting held on December 22, 2009, stipulated a net worth requirement of ₹ 100 crores for setting up a new stock exchange, while a net worth requirement of ₹ 100 crores is being contemplated for clearing corporations. The committee deliberated and recommended the following:

**5.2.1. Stock Exchanges:** Stock exchanges shall be required to have a net worth of ₹ 100 crores at all times. From the date of notification of the net worth requirement, exchanges not meeting the said net worth requirement, i.e., exchanges not having nationwide trading terminals / as may be decided by SEBI may be given a period of 10 years to comply with the same. **While computing the net worth, investments in MIIs can be included, whereas, all other non-core investments in related, unrelated/other business shall be excluded.**

**5.2.2. Depositories:** The present net worth requirement of ₹ 100 crores for depositories may be retained. However, all other investments in related, unrelated/other business shall be excluded while computing the net worth.

**5.2.3. Clearing Corporations:** A Clearing Corporation provides clearing and settlement to the trades executed on a stock exchange by becoming the counter party for every buy and sell transaction. It provides novation and guarantees the settlement of every trade. While in the equity segment, the guarantee extends

only for a few days over the settlement period, in the derivatives segment, it extends for months and even years (as in the case of long term options).

In the event of a major default, if the clearing corporation is unable to meet its obligations, it could even lead to a systemic collapse of the financial market. Keeping in view the clearing and settlement function, a need is felt to prescribe a higher net worth requirement for clearing corporations, as compared to stock exchanges and depositories. The Committee is of the view that net worth requirement of ₹ 100 crores for a clearing corporation is inadequate. **It is recommended that the net worth requirement for a Clearing Corporation may be fixed at ₹ 300 crores. The clearing corporation shall meet relevant networth criteria on an ongoing basis.**

It is also suggested that while initially a clearing corporation may be permitted to be set up with a net worth of ₹ 100 crores, they may be required to increase it to ₹ 300 crores within a period of 3 years (or any other time limit as may be prescribed by SEBI). **Further, in order that such a net worth is available, in a worst case scenario, it is suggested that it may be maintained in the form of liquid assets at all times. Liquid assets would be those assets that are permitted to be deposited by a stockbroker in a stock exchange (clearing corporation) towards margin obligations. Until such time the clearing corporation achieves the prescribed net worth, it shall not be permitted to pay any dividend to its shareholders.**

**5.3. MIIs TO GENERATE ONLY REASONABLE PROFITS:** The MII being a public utility should endeavor to earn only reasonable profits at par with average earnings of the corporate sector in India. Therefore, it is recommended that a cap may be fixed on the maximum return that can be earned by MII on its net worth and can be distributed / allocated to the shareholders of MII out of the total



returns earned by MII. Any return/profits above such maximum attributable amount would be transferred to IPF or SGF as the case may be and the same would not form part of shareholders funds/ net worth for the purposes of determining returns and book value of the shares. This would strengthen the MII to withstand shocks, make them robust and may lead to reduction of the charges levied by MIIs on the users. The cap may be fixed by SEBI after taking into consideration 'risk free return' based on the yield on a 10 year GOI bond and a 'risk premium' to account for the risks faced by MIIs including equity risk premium and liquidity risk due to non listing of MIIs. It should also take into account differential tax rate applicable to unlisted entities as the Committee has recommended that the MIIs should not be permitted to list.

It is therefore, recommended that maximum profit available for distribution / allocation to shareholders which can be utilized for payment of dividends and for appropriation to general reserves, balances of profit & loss account should be capped at a certain percentage of annual return on net worth of the previous year. This cap will be determined by SEBI based on factors enumerated above. Net worth for this purpose would mean paid-up capital, balance of general reserves, profit & loss account and share premium account. The MII will be free to pay dividend to shareholders out of profit earned or out of free reserves/balance of profit and loss account and share premium account in accordance with Company's act 1956. Any profit earned over and above the prescribed return on net worth shall be transferred to IPF or SGF as the case may be and shall not be available for distribution to shareholders nor will it become part of shareholder's funds. The ceiling on rate of return in all cases will be on profits after providing for taxes. The rate of return may be reset by SEBI considering the change in risk free rate of return, inflation etc.

**5.4. RELATED BUSINESS OF MIIs:** The SEBI (Depositories and Participants) Regulations, 1996, provides that;

*“the depository shall not carry on any activity other than that of a depository unless the activity is incidental to the activity of the depository:*

*provided that a depository may carry out such activity not incidental to its activities as a depository, as may be assigned to the depository, by the Central Government or by a regulator in the financial sector, through the establishment of Strategic Business Unit(s) specific to each activity with the prior approval of the Board and subject to such conditions as may be prescribed by the Board, including transfer of such activity to a separate company within such time as may be specified by the Board, having regard to the matters which are relevant to the efficient and orderly function of the depository as mentioned in regulation 13.*

*Explanation – For the purposes of this clause, a strategic Business Unit shall be an organizational unit of a company with its own mission, objectives and business strategy that is given the responsibility to serve the particular demands of one business area with appropriate technological, financial and other segregations.”*

It is felt that the risks of taking up activities that are not incidental or those that are unrelated to the activities of the MII must be segregated to a separate legal entity or as may be permitted by SEBI. Such restrictions shall be made applicable to all MIIs.

**Further, when a related business of an MII delivers a service to another MII, it should be ensured that there is equal, unrestricted, transparent and fair access to all without any bias towards its affiliated entity. SEBI should step in to investigate complaints in this regard and fasten liability on the MII who owns the related business. SEBI should even go as far as prohibiting an MII from using services supplied by its related business, should it detect any discriminatory practices. Further, all commercial arrangements such as listing**

of international indices, etc. which provide for exclusive rights should be subject to prior approval of SEBI. SEBI may grant its approval for such exclusivity for a limited period on a case-to-case basis, after examining the proposal.

**5.5. REPLACEMENT OF SCR(MIMPS) REGULATIONS:** The MIMPS Regulations were notified at the time of corporatisation and demutualisation and Regulation 3 of the MIMPS Regulations reads as under:-

*“These Regulations shall be applicable to all recognised stock exchanges in respect of which the scheme of corporatisation and demutualisation has been approved by the Board under section 4B of the Act.”*

In order to make the chapters on ownership norms applicable to other Stock Exchange, SEBI has issued separate notifications to those stock exchanges (NSE and OTCEI) which did not undergo a process of corporatisation and demutualisation. Further, for new stock exchanges, SEBI has adopted the practice of imposing the compliance with MIMPS Regulations as a condition while granting recognition.

Moreover, the MIMPS Regulations were framed with the objective of increasing the public shareholding in the stock exchanges. With all the exchanges having increased their public holding to meet the prescribed limit, the Committee feels that the MIMPS Regulations have served their purpose. It is therefore, recommended that a new regulations may replace the MIMPS Regulations for regulating ‘Ownership and Governance Regulations for Stock Exchanges and Clearing Corporations’ and consequent amendments (as required) may also be carried out. The concept of ‘persons acting in concert’ also needs to be separately defined in the new Regulations for the purpose of ownership norms. The

existing Regulations for depositories may continue and be suitably amended to give effect to the recommendations of the Committee.

**5.6. EXIT NORMS:** The exit norms for stock exchanges have already been prescribed by SEBI; it may be examined by SEBI in light or recommendation of this report whether these norms needs to be reviewed. Exit norms may also be prescribed for clearing corporations and depositories to provide for orderly exit of these important institutions.

**5.7. POWERS TO SEBI IN MATTERS RELATING TO MIIs:** The Committee noted that SEBI has powers to regulate the MIIs. However, it felt that powers of SEBI needs to be further augmented since it has to discharge the responsibility of regulating MIIs by way of direct supervision and monitoring of their activities. The Committee reviewed Section 3(1) of the Securities Contracts (Regulation) Act, 1956, which reads as under:

*“Any stock exchange, which is desirous of being recognised for the purposes of this Act, may make an application in the prescribed manner to the Central Government.”*

The Committee was of the view that SEBI must be invested with more powers for accepting/rejecting applications for recognition of stock exchanges. The Committee therefore, recommends that the above provision may be rephrased explicitly to the effect that unless and until SEBI grants recognition, an entity cannot call itself a stock exchange. SEBI should have the discretion to limit the number of MIIs operating in the market, in the interest of the market and in public interest. It is pertinent to note that this would be similar to the treatment afforded by the Reserve Bank with respect to new banks.

Further, the SC(R)R prescribes the procedure for seeking recognition, period for recognition, form of application for recognition, etc. for stock exchanges. The Committee is of the view that detailed requirements for clearing corporations should be prescribed by SEBI under its own regulations, so that it is in a position to regulate effectively and carry out amendments in a timely manner to keep pace with the needs of the market. SEBI may undertake this exercise and take it up with the Ministry of Finance. A similar exercise may be undertaken with regard to stock exchanges as well.

**5.8 REVIEW AFTER FIVE YEARS:** Finally, the Committee recommends that the working of the MII should be reviewed again by SEBI after five years, once the suggestion made by this committee is implemented. The stock market is evolving and a review may be inevitable in the light of the new technological developments, introduction of new products, growth of financial markets, trade and capital flows and global integration.

In light of the above, it would be desirable to keep a close watch on the working of the MII so that the gains from well-tuned markets result in the growth of the real economy and maintenance of financial stability.

**Annexure -A**

**Sample Questionnaire**

**Part -A**

**(Applicable to all three categories of MIIs)**

**Functions**

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

5. What other businesses should a MII be allowed to do? Can they set up another MII with 100% shareholding? What kind of non-MII businesses can they perform? Can they set up related businesses such as independent software vendors?

### **Ownership and governance**

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

which reports to the Board of the MII and/or to the Regulator? What should the management be accountable for – profitability, regulatory efficiency, etc? Please specify.

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

#### **Market structure for MIIs**

12. Do you perceive an optimal number of MIIs (Number of stock exchanges; number of depositories; number of clearing corporations), for the Indian Securities Market, taking into account the present status as well as growth possibilities in the future?
13. What should be entry and exit norms applicable to MIIs?
14. Are there any regulatory issues arising out of competition such as discrimination by a MII against a competing MII or any intermediary or technology provider, that needs to be regulated? What should be the norms to regulate relationship of MII with technology providers and intermediaries?



15. To what extent should commercial functions of a MII be regulated? Specifically, should charges and fees levied by MIIs be regulated in a competitive environment?
16. Is there a case for capping the charges on a 'cost plus' basis and/or for capping distribution of profits?
17. There are twin dangers for all MIIs - 'regulatory race to the bottom in the face of competition' or 'becoming too big to fail'. What safeguards can be built to prevent the same. In the case of clearing corporations, are rigorous 'stress tests' adequate to address the same?

### **Listing**

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

### **Part - B**

#### **(Only for Stock Exchanges)**

1. Should separate requirements be put in place for QIBs participating in the primary issue of stock exchanges and should they be granted positions on the Boards of Exchanges?
2. Should foreign stock exchanges be permitted to hold upto 15% or more of the equity shares in the Indian stock exchanges?

3. Whether the current limit for FII in stock exchanges need a review? What should be the manner of participation of FIIs in the equity of stock exchange?
4. Should FIIs also be permitted to participate in IPO or FPO of stock exchanges?
5. What are the issues arising out of the listing of shares of a stock exchange on itself?
6. What are the issues arising out of an MII which has a substantial stake in a stock exchange listing on the same stock exchange?
7. Should dual listing (including listing of shares of the stock exchange on itself) of shares may be considered?
8. Whether cross listing is desirable?

In respect of the above queries on listing, suggestions/comments may be provided after considering the various models viz: committee model, company model<sup>26</sup> etc used internationally to address the issue of 'conflict of interest'.

9. SEBI broadly prescribes the Board composition in the case of stock exchanges. Currently there is a restriction on the extent of representation by trading members on the Board (maximum 25%). The PIDs (minimum 25%) are empanelled by SEBI. The balance are shareholder directors.

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

**Part - C**

**(Only for Clearing Corporations)**

1. Should clearing corporations be subsidiaries of exchanges or a completely separate entity? What should be the ownership restrictions for clearing corporations? Which model is preferred and why?
2. Is there a case for stipulating the same networth requirement for clearing corporation and exchanges and depositories (i.e., ₹ 100 crores) or is there a

case for it to be higher? Alternatively, a minimum amount of ₹ 100 crores may be prescribed plus an additional multiplier based on the number of exchanges or volumes or products that are cleared and settled through the clearing corporation. If the second alternative is preferred, kindly suggest a suitable formula for determining the same.

**Part - D**

**(Only for Depositories)**

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

**Annexure - B**

**Number of responses received**

Stock Exchanges	Nation-wide	3
	Regional	2
Depositories		2
Associations	Of regional stock exchanges	1
	Depository Participants	1
	Brokers	3
	Of Industry bodies	2
Intermediaries (including foreign institutional investors)		4
Consultancy firm/academic body		2
Individuals		6
Investor association		1
Domestic institutional investor		1
Shareholder of MII		1
<b>Total</b>		<b>29</b>

## Annexure - C

Shareholding Restrictions in select countries<sup>27</sup>

Country	Exchange/ Exchange Operator	Shareholder disclosure requirement*	Shareholder ownership restriction	Notification/ disclosure of change in ownership*
Australia	SFE <sup>28</sup>	5%	15%	Written notice when a person has, or ceases to have, 15%.
	ASX	5%	15%	Written notice when a person has, or ceases to have, 15%.
Canada	TSX Group Bourse de Montréal	5% The Bourse shall submit to the AMF a list of its shareholders on a semi- annual basis	10% 10%	Notice and approval by regulator to own more than 10%. The Bourse shall inform the AMF immediately if it becomes aware that any person owns or exercises control, either directly or indirectly, over more than 10% of any class or series of voting shares of the Bourse and shall take the necessary steps to immediately remedy the situation.
France	Euronext Paris Additional requirements apply under Dutch law to EuronextNV, the Dutch holding company listed on Euronext Paris.	10%	Fitness and propriety	Disclosure to regulator when thresholds reached.
Germany	Deutsche Borse	5% (first threshold)	10%	After notification of thresholds, regulator has discretion to prohibit acquisition.
Hong Kong	HKEx	5%	5%	Disclose where increase or decrease is across a whole percentage (e.g. 6%, 7%, etc.).
India	BSE Limited	More than 5%	5%	Persons acting in concert cannot hold more than 15%.

*Securities and Exchange Board of India*

Country	Exchange/ Exchange Operator	Shareholder disclosure requirement*	Shareholder ownership restriction	Notification/ disclosure of change in ownership*
Italy	Borsa Italiana	5%	fitness and propriety requirements	Notification to regulator of 5% threshold reached
Japan	TSE, OSE, NSE, Jasdaq	5%	20%	Person who retains shares in excess of 20% require approval of regulator <sup>29</sup> ; notification if 5% ownership.
Malaysia	Bursa Malaysia	5%	5%	Approval by Minister of Finance to own 5% or more.
Mexico	Mexican Stock Exchange	10%	10%; foreign investors that have government powers; or individuals that directly or indirectly possess more than 10% of a financial institutions equity.	N/A
Singapore	SGX	5%	5%	A substantial shareholder (5%) must advise the listed entity and the exchange of change in percentage or it ceases to be a substantial shareholder.
Spain	BME	1% (first threshold)	1% (significant shareholding)	Notified at certain thresholds above 1%.
U.K.	All listed exchanges	3% (and additional 1% increments)	Not required by law. Restrictions would be likely to contravene UK listing rules.	Notification of all changes affecting governance.
U.S.	CHX, ISE, Nasdaq, NSX, NYSE Group (NYSE and NYSE Arca,Inc.) Phlx	Exchanges have different standards that have been approved by the SEC. If the exchange is a publicly- traded company, a shareholder that owns more than 5% of any class of equity securities must file a disclosure report with the U.S. Securities and Exchange Commission pursuant to Section 13(d) of the Exchange Act.	Exchanges have different standards that have been approved by the SEC.	Exchanges have different standards that have been approved by the SEC. If the exchange is a publicly-traded company, shareholders also must file amendments to initial disclosure reports filed with the Commission under Section 13(d) of the Exchange Act. <sup>30</sup>

*\* Please note that, in some jurisdictions, the disclosure requirements may not be specific to exchanges but may apply generally to all listed companies.*

## Annexure - D

Details of shareholding in select countries<sup>31</sup>

<b>Bursa Malaysia</b>	
<b>Top 10 Shareholders</b>	<b>% of total</b>
Capita Market Development Fund	18.58
Miniser of Finance Incorporate	14.30
Citigroup Nominees (Asing) Sdn Bhd Exempt AN for Mellon Bank (ABNAMRO mellon)	5.00
CIMSEC Nominees (Tempatan) Sdn Bhd Minister of Finance Incorporated (ESOS Pool Account)	4.75
Kumpulan Wang Persaraan (Diperbadankan)	4.17
Employees Provident Fund Board	3.73
Valuecap Sdn Bhd	2.98
Lembaga Tambung Angkatan Tentara	1.43
HSBC Nominees (Asing) Sdn Bhd TNTC for Saudi Arabian Monetary Agency	1.36
Citigroup Nominees (Asing) Sdn Bhd Exempt AN for Mellon Bank (Mellon)	1.18
<b>Total</b>	<b>57.48</b>
<b>Singapore Exchange Limited</b>	
<b>Top 10 Shareholders</b>	<b>% of total</b>
Sel Holdings Pte Ltd	23.51
DBS Nominee Pte Ltd	17.63
Citibank Nominees Singapore Pte Ltd	9.89
HSBC (Singapore) Nominees Pte Ltd	5.50
Nomura Singapore Limited	4.99
DBSN Services Pte Ltd	4.29
United Overseas Bank Nominees Pte Ltd	3.10
Raffles Nominees Pte. Ltd.	2.68
DB Nominees (S) Pte Ltd	2.68
Philip Securities Pte Ltd.	0.71
<b>Total</b>	<b>74.98</b>



<b>Tokyo Stock Exchange</b>	
<b>Top 10 Shareholders</b>	<b>% of total</b>
Govt. & Local Govt.	0.00
<b>Financial Institutions</b>	0.28
City & Regional Banks	0.05
Trust Banks	0.11
Life Insurance Cos.	0.06
Non-Life Insurance Cos.	0.01
Other Finances Inst.	0.06
Securities Companies	0.18
Business Corporations	1.89
Foreigners	0.68
Individuals	96.68
<b>Total</b>	<b>100.00</b>

<b>Australia Stock Exchange</b>	
<b>Top 10 Shareholders</b>	<b>% of total</b>
HSBC Custody Nominees (Australia) Limited	12.28
National Nominees Limited	9.03
JP Morgan Nominees Australia Limited	7.56
Citicorp Nominees Pty Limited	4.92
RBC Dexia Investor Services Australia Nominees Pty Limitex	3.33
ANZ Nominees Limited	2.78
UBS Nominees Pty Limited	2.54
Cogent Nominees Pty Limited	2.21
Bond Street Custodians Limited	1.43
UBS Wealth Management Australia Nominees Pty Limited	0.97
<b>Total</b>	<b>47.05</b>

<b>NYSE EURONEXT</b>	
<b>Name</b>	<b>% age</b>
Legg Mason Capital Management, Inc.	3.84
Barclays Global Investors, N.A.	3.71
State Street Global Advisors (USA)	3.51
Horizon Assets Management, Inc.	3.16
Vanguard Gropu, Inc.	2.67
General Atlantic LLC	2.21
Aronson + Johnson + Ortiz, L.P.	1.81
Fred Alger Management, Inc.	1.62
Legg Mason Value Trust, Inc.	1.39
Atticus Capital, L.P.	1.38

<b>NASDAQ OMX GROUP</b>	
<b>Name</b>	<b>% age</b>
Borse Dubai, Ltd.	29.87
Horizon Assets Management, Inc	5.67
Wellington Management Company, LLP	4.38
Clearbridge Advisors	4.28
Barclays Global Investors, N.A.	3.80
Vanguard Group, Inc.	3.63
State Street Global Advisors (US)	2.60
Alliance Bernstein I.P.	1.57
BNP Paribas Assets Management S.A.S.	1.52
Aletheia Research and Management, Inc.	1.47

<b>LONDON STOCK EXCHANGE</b>	
<b>Name</b>	<b>% age</b>
Borse Dubai Limited	20.60
Qatar Investment Authority	15.10
Horizon Asset Management Inc.	7.20
Unicredito Italiana SPA	6.00
Intesa Sanpalo SPA	5.30
Kinetic Asset Management Inc	3.10

**Annexure – E**

**Abbreviations**

Annual General Meeting (AGM)  
Association of National Exchange Members of India (ANMI)  
Australian Securities Exchange (ASX)  
Autorité des marchés financiers (AMF)  
Bombay Stock Exchange Limited (BSE)  
Central Depository Services (India) Limited (CDSL)  
Central Securities Depositories (CSDs)  
Chicago Mercantile Exchange (CME)  
Chief Executive Officer (CEO)  
Depository Participants Association of India (DPAI)  
Executive Director (ED)  
Federation of Indian Stock Exchanges (FISE)  
Financial Services Authority (FSA)  
Follow-on Public Offer (FPO)  
Foreign Direct Investment (FDI)  
Foreign Institutional Investor (FII)  
Foreign Investment Promotion Board (FIPB)  
Indian Clearing Corporation Limited (ICCL)  
Industrial Development Bank of India (IDBI)  
Initial Public Offer (IPO)  
Investment Dealers Association (IDA)  
Japan Securities Dealers Association (JSDA)  
Life Insurance Corporation of India (LIC)  
Managing Director (MD)  
Market Infrastructure Institution (MII)

MCX Stock Exchange Limited (MCX-SX)  
MCX-SX Clearing Corporation Limited (MCX-SX'CCL)  
Ministry of Finance (MoF)  
Mutual Fund Dealers Association (MFDA)  
National Association of Securities Dealers (NASD)  
National Futures Association (NFA)  
National Securities Clearing Corporation Limited (NSCCL)  
National Securities Depository Limited (NSDL)  
National Stock Exchange of India Limited (NSE)  
Osaka Securities Exchange (OSE)  
OTC Exchange of India (OTCEI)  
Public Interest Director (PID)  
Qualified Institutional Buyers (QIBs)  
Securities and Exchange Board of India (SEBI)  
Securities Contracts (Manner of Increasing and Maintaining Public Shareholding  
in Recognised Stock Exchanges) Regulations, 2006 (MIMPS)  
Securities Contracts (Regulation) Act, 1956 (SCRA)  
Securities Contracts (Regulation) Rules, 1957 (SCRR)  
Self Regulatory Organisation (SRO)  
Tokyo Stock Exchange (TSE)  
Unit Trust of India (UTI)  
United Stock Exchange of India Limited (USE)

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<sup>1</sup> From the Indian Competition Act, 2002 and from “The Governance of Financial Market Infrastructure”, Ruben Lee, January 2010

<sup>2</sup> [http://www.competition-commission-india.nic.in/advocacy/Booklet\\_AbuseOfDominance11032008.pdf](http://www.competition-commission-india.nic.in/advocacy/Booklet_AbuseOfDominance11032008.pdf)

<sup>3</sup> Shy (2001)

<sup>4</sup> Shy (2001)

<sup>5</sup> Rules are yet to be notified.

<sup>6</sup> Agenda note for SEBI Board meeting Agenda note for SEBI Board meeting held on December 22, 2009 available on [www.sebi.gov.in](http://www.sebi.gov.in)

<sup>7</sup> OICU-IOSCO Report on ‘Regulatory issues arising out of Exchange evolution’, November 2006

<sup>8</sup> Demutualisation of Exchanges – The conflicts of Interest (Hong Kong), by William Pearson, 2001

<sup>9</sup> World Bank Note: India: Role of Self-Regulatory Organizations in Securities Market Regulation, June 2007

<sup>10</sup> OICU-IOSCO Report on ‘Regulatory issues arising out of Exchange evolution’, November 2006

<sup>11</sup> World Bank Discussion paper titled, ‘Institutional Organization of Securities Clearing Houses: Finding the Balance between Diverse Industry Objectives and Public Policies’ dated August, 2009

<sup>12</sup> “The Governance of Financial Market Infrastructure”, Ruben Lee, January 2010

<sup>13</sup> ‘Clearing: A Risk Assessment’, by Christopher L. Culp, Futures Industry Magazine, July/August 2002

<sup>14</sup> Deutsche Börse has aggressively pursued an integration strategy in which its own exchanges clear and settle through clearing organizations owned and operated by Deutsche Börse. This does not mean that Deutsche Börse clearing affiliates eschew clearing for hire. On the contrary, Clearstream International is still a dominant settlement agent for cross-border cash market transactions conducted outside the Deutsche Börse organization - ‘Clearing: A Risk Assessment’, by Christopher L. Culp, Futures Industry Magazine, July/August 2002

<sup>15</sup> “Clearing up misconceptions on clearing”, Craig Pirong, Regulation Fall 2008

<sup>16</sup> “Clearing up misconceptions on clearing”, Craig Pirong, Regulation Fall 2008

<sup>17</sup> As per the World Bank Discussion paper titled, ‘Institutional Organization of Securities Clearing Houses: Finding the Balance between Diverse Industry Objectives and Public Policies’ dated August, 2009, India is the only case with several clearing houses for the same assets (for private securities) among the group that includes developed market and the largest emerging markets.

<sup>18</sup> The limit was increased from 5% to 15% to the specified entities vide amendment dated December 23, 2008

<sup>19</sup> From “The Structures of a Demutualized Exchange” by David Holthouse, National Manager, International Affairs, Australian Stock Exchange

<sup>20</sup> IMF working paper, “Demutualization of Securities Exchanges: A Regulatory Perspective”, Jennifer Elloitt, 09/18/02

<sup>21</sup> From “The Structures of a Demutualized Exchange” by David Holthouse, National Manager, International Affairs, Australian Stock Exchange

<sup>22</sup> Institutions registered in India

<sup>23</sup> For demutualised exchanges, especially listed companies, the concept of public directors has been supplanted by independent directors in most jurisdictions. This is more suitable for a business corporation as the concept of a “public director” is arguably foreign to a commercial company where directors represent the shareholders. But Hong Kong, Singapore and India have

retained the category of public interest directors appointed by Government or the regulator even after demutualisation and listing; in recognition of the Exchanges' express public interest obligations - World Bank Note: India: Role of Self-Regulatory Organizations in Securities Market Regulation, June 2007

<sup>24</sup> "The Governance of Financial Market Infrastructure", Ruben Lee, January 2010

<sup>25</sup> "The Governance of Financial Market Infrastructure", Ruben Lee, January 2010

<sup>26</sup> *For details regarding various models, please refer to Annexure V of the agenda note available at <http://www.sebi.gov.in/boardmeetings/129/corpgovern.html>*

<sup>27</sup> Table taken from OICU-IOSCO Report on 'Regulatory issues arising out of Exchange evolution', November 2006

<sup>28</sup> ASX and SFE merged, effective July 25, 2006 and ASX obtained the necessary approval to acquire all of the issued capital of SFE.

<sup>29</sup> Holding 20% or more will be, in principle, prohibited in Japan when the 2006 law amendment is in force in 2007.

<sup>30</sup> If the exchange is a publicly-traded company, the rules and regulations of the U.S. Securities and Exchange Commission require a shareholder of the exchange who owns more than 5% of a class of equity security to promptly file with the U.S. Securities and Exchange Commission notice of any material increase or decrease in the percentage of the class beneficially owned, unless at the time of the initial filing the shareholder satisfied certain passive investor requirements, in which case the shareholder only would need to file annually (unless such shareholder's ownership increases to more than 10% of the class of securities outstanding).

<sup>31</sup> Agenda note for SEBI Board meeting Agenda note for SEBI Board meeting held on December 22, 2009 available on [www.sebi.gov.in](http://www.sebi.gov.in)