

# From Mutual Association to Demutualisation: A Paradigm Shift in the Ownership and Governance of Stock Exchanges in India

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**Abstract:** A group dominated by brokers prepared a platform where they can trade in securities of listed companies. Year after year that group got larger and no. of brokers associated themselves which later became stock exchanges. However, with little capital, rising competition, and almost negligible governance, investor's wealth and confidence over the stock exchanges decreased. Considering such situation, Indian Govt. came up with series of amendments in 2002-2005 to the existing laws so to inspire a sense of confidence among the investors. These amendments not only made demutualisation of stock exchanges compulsory but also streamlined the process of corporate governance. However, this was not the first time when a govt. has tried regulating Indian stock exchanges. Past record shows that even colonial govt. attempted to regulate Bombay Stock Exchange and the trading done therein. This paper attempts to do a comprehensive study of the changes in the ownership structure from a not-for-profit member-owned organization to a shareholder-owned organization and the role of governments (including the pre-independence governments) in regulating the stock exchanges in India. The primary contribution this study seeks to make is in the sphere of corporate governance related to the process of demutualisation of Indian stock exchanges. This shall not only help in improving investor's perception about the stock exchanges but shall also promote reliability and confidence of investors.

**Keywords:** Demutualization \r\n Stock exchange \r\n Investors \r\n Regulators \r\n Corporate Governance

## Introduction

Before the 1990s, stock exchanges worldwide were operating as mutual organizations regulated and run by traders and brokers, where the primary objective was to provide a platform for the trade of various securities and to regulate the securities listed on them. However, the inadequacy of proper governance system and lack of transparency in many exchanges decreased investor's confidence which not only increased conflicts b/w member's interests but also led to a reduction in exchange's wealth due to tough competition and no vision. Moreover, tough business horizons because of the advent of new information technology necessitated the move of demutualization.

Since the management of stock exchange was dominated by the brokers who tend to prioritize their interest before the larger interest of shareholders. Therefore, to avoid any other Harshad Mehta or Ketan Parikh type scams,

which came as a result of stock exchanges malicious brokers, plus to prioritize shareholder's interests, it was imperative to demutualize and corporatize the stock exchange.<sup>2</sup> This led to the introduction of the Securities Laws (Amendment) Act of 2004 and the BSE (Corporatisation and Demutualisation) Scheme, 2005. Such regulations were brought to separate the management and brokerage activity of the stock exchanges. This resulted in stock exchange becoming a corporate entity with its objectives to deal with organizational challenges in the new age competition.

This paper attempts to do a comprehensive study of the changes in the ownership structure from a not-for-profit member-owned organization to a shareholder-owned organization and the role of governments (including the pre-independence governments) in regulating the stock exchanges in India. Part I shall give an introduction to Indian stock exchanges and its activities. Part II provides for a historical background to the shift in regulatory mechanism of the Stock exchange. Part III shall discuss the evolution of a non-profit organization to a for-profit one. Part IV provides for a case study of two Indian stock exchanges i.e. Bombay Stock Exchange and National Stock Exchange. Part V provides for the conclusion.

## **I. Introduction to Indian Stock Exchanges**

A stock exchange is a marketplace that brings together buyers and sellers of marketable securities<sup>3</sup> for trading in securities. Generally, it acts as a liaison between entities who need money like companies and entities who have excess money like traders/investors by dissemination of information. Section 2(j) of The Securities Contract Regulation Act, 1956 defines Stock exchange as:

*“Section 2(j): stock exchange means –*

- (a) anybody of individuals, whether incorporated or not, constituted before corporatization and demutualization under sections 4A and 4B, or
- (b) a body corporate incorporated under the Companies Act, 1956 (1 of 1956) whether under a scheme of corporatization and demutualization or otherwise, to assist, regulate or controlling the business of buying, selling or dealing in securities”

Continuing our discussion about the nature of stock exchange being a mutual organization, as the definition shows, stock exchange as a place essentially for individuals where they assist, regulate, and control the business of securities.

Speaking of activities of an stock exchange, it can be divided into four parts<sup>4</sup>:

- i. market organizers: stock exchanges provide for a platform for trading of securities. It gives an avenue for investors to diversify and spread their risk into various securities like shares, debentures, derivatives, etc. Until recently, much of the functions were held on a physical trading floor. But after technological advance, the whole process of buying and selling of securities shifted to virtual mode.

- ii. Information Disseminators: From the definition given above, stock exchanges are also called as an authority to regulate and control the business of buying and selling of securities. Further, it also monitors whether the listed companies are complying with rules, regulations, and bye-laws of the stock exchange. In case a company fails to comply, the stock exchange has the power to impose a penalty that varies from nature to the extent of the compliance failure.
- iii. Standard setters: stock exchange facilitates the trading of securities by providing an equal-level platform for all the companies. Proper corporate governance leads to better products, continued disclosures for the benefit of the investors, and better functioning of the listed entities.

“Moving on, the Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2018 provides for various aspects with regards to regulating the recognition, ownership, and governance in stock exchanges and clear corporations.”<sup>5</sup> Following are the key features of this regulation:

- i. Number of public interest directors should not be less than the no. of shareholders director at the board meeting of the stock exchange.<sup>6</sup>
- ii. Voting in board resolutions shall be valid only when the voting made by public interest directors on resolutions is more than votes made by a shareholder.<sup>7</sup>
- iii. The regulation also provided for the qualification and disqualification of directors and key management personnel.<sup>8</sup>

Modern-day stock exchanges work in a dual capacity. Firstly, they are a business enterprise that is listed on rival's stock exchange, unlike traditional stock exchange which was mere facilitators. Secondly, stock exchanges also work under the capacity of the market regulator. This may raise eyebrows, especially on point of violation of one of the principles of natural justice - *Nemo iudex in sua causa* which says that 'no one shall judge his'. In the instant case, whether listing of securities on the stock exchange's floor and guided by rules and bye-laws made by its board. To avoid such violation, stock exchanges- cross-listing of their shares on a rival stock exchange.

## **II. The Shift in Regulatory Mechanism of the Stock Exchange**

Indian stock market is one of the oldest stock exchanges in Asia. Its glorious past includes the transaction of loan securities by the East India Company in the 18<sup>th</sup> century.<sup>9</sup> Whereas in the 1830s, a group of 22 stockbrokers started trading in stocks and derivatives under a banyan tree.<sup>10</sup> After the first world war, India saw three stock exchanges which were Bombay, Ahmedabad, and Calcutta Stock Exchange.<sup>11</sup> With the increase in trading members and activities, there grew a need of having regulations with regards to issuing of shares,

ongoing disclosures, maintenance, and listing of securities from the stock exchange. Therefore, Stock Exchanges started making their by-laws and rules for the companies which were intending to get listed over the exchange. Meanwhile, even the colonial govt., paved its way for regulating stock exchanges in India. It was reasoned that because the stock exchange is in the hands of unscrupulous members it was believed that contracts like forward contracts and ready delivery contracts wherein no time was specified<sup>12</sup> for the purchase and sale of contracts had the potency to be used for gambling purposes<sup>13</sup>. In *Madhubhai Amathalal Gandhi*<sup>14</sup>, while accepting this position, Court noted that

*“2. If the parties do not intend that there should be any delivery of the shares but only the difference in prices should be accounted for, the contract, being a wager, is void. More often than not it is difficult for a court to distinguish one from the other, as a wagering transaction may be so cleverly camouflaged as to pass off as a speculative transaction.”*

Though there were laws which regulated and governed gambling in India and its provinces<sup>15</sup> but there was not any law to regulate stock exchanges, specially transactions sharing nature of gambling.<sup>16</sup> Following are the attempts made by Governments to regulate the stock exchanges.

#### Atlay Stock Exchange Inquiry Committee, 1923

*After World war I, the then colonial govt. intended to regulate stock exchange in India even though the bylaws were framed by the Stock Exchange. This was being done to control and regulate the processes of capital markets.<sup>17</sup> This led to the constitution of the Atlay Stock Exchange Inquiry Committee on 14<sup>th</sup> September 1923 headed by Lord Atlay. Committee was tasked with codifying rules, bye-laws, and regulations of the Bombay Stock Exchange and recommended formation of a systematic and settled body of rules and regulation<sup>18</sup>. Acting on these recommendations, the Government of Bombay offered a charter to Bombay Stock Exchange under which govt. sought to assume the authority to control the rulemaking power of the exchange but also gave a monopoly to trade in securities on 21 July 1925. However, in August 1925, the Bombay Stock Exchange turned down the charter.*

#### Bombay Securities Control Act, 1925:

*After the Bombay Stock Exchange rejected the Government's charter, Govt. came with special legislation which was the Bombay Securities Control Act, 1925<sup>19</sup> which empowered the govt. to grant and withdraw recognitions to the stock exchanges and to regulate and control contracts for the purchase and sale of securities in the City of Bombay and elsewhere in the Bombay Presidency. It also created a pre-requirement of taking approval from Governor in Council body from whom stock exchanges had to take an approval before implementing any rules. Act provided that the rules, regulations and bye-laws of the stock exchange will not be operative until it get the approval of the*

*Government. Sec. 6 provided that the contracts entered after enactment of this act would be valid only when it is made in accordance with the rules given under Sec. 4<sup>20</sup>.*

*In pursuance to this act, BSE applied for recognition to Governor in council<sup>21</sup>. which was granted on 14<sup>th</sup> May 1927.*

**Bombay Forward Contract Control Act, 1947<sup>22</sup>:**

*In 1939, before the resignation of the then Congress Govt., a bill was floated which aimed to unify control of all forward markets in Bombay. It was passed in 1947 and was applied to cotton, bullion seeds making it the first law to regulate Forward markets in India<sup>23</sup>. The object of this act was to provide for the regulation and control of forward contracts, for prohibition of options and certain other purposes, in the Province of Bombay. Through Sec. 3(5)<sup>24</sup>, provincial govt. was given the power to recognize association dealing in forward contract and to sanction bye-laws of the said association under Sc. 6(4) of the said act.*

Even after bringing such legislations and partially regulating the stock exchanges, Public criticism over huge losses suffered by them during 1928-1938 compelled the Govt. to rethink its policies. In 1936, the Government of Bombay commission Morison Committee<sup>25</sup> for studying existing rules regarding the listing requirements and admission of securities for dealing on the pattern of the Bombay stock Exchange. Recommendations of this committee with regards to the “reservation by the Government of powers to impose rules on the exchange, abolition of exchanges overriding power over the governing body in certain circumstances, among others” were accepted by the government.<sup>26</sup> Again In 1948 i.e. after Independence, Govt. of India constituted Dr. P.J. Thomas Committee<sup>27</sup> and asked for submitting a report on a suitable law to regulate the stock exchanges in India. In 1954, Govt. of India prepared a draft Securities Contract (Regulation) Bill which was referred to the Gorwala Committee<sup>28</sup>, headed by Mr. A.D. Gorwala. It can be said that the current act is the brainchild of the Gorwala Committee.<sup>29</sup>

### **III. Demutualisation to Corporate Governance**

Before the 1990s, stock exchanges worldwide were operating as mutual organizations where the owners, the decision-makers and the users of the stock exchange were usually the same person<sup>30</sup>. A decision was made on a one-member-one-vote basis and the ownership rights were not freely tradable, and a member can't terminate his membership independently<sup>31</sup>. Moreover, these mutual organizations were rarely able to raise capital from anyone other than members.

However, such advantages also brought more devastating disadvantages to the existing mechanism. Practically, Stock exchanges were monopolized by stockbrokers who run mutual associations which allowed them to have a monopoly who enjoy the entire profits from the intermediation of a common man.<sup>32</sup> Further, they also imposed rights to trading and disallowed direct access

to the trading floor to any outsiders.<sup>33</sup> Moreover, the traditional stock exchanges were more of a trade facilitator than a profit-making enterprise. With an increase in competition, the advent of new technologies and to avoid losing share to the rivals, the focus of global stock exchanges shifted to profit-making.

But soon problems began to arise because of this ideological shift. Issues started to arise when the profit-making objective clashed with the regulatory function of the stock exchange.<sup>34</sup> This led to a shift in the organization structure of stock exchange from mutual organizations to for-profit corporate organizations and the whole process was called demutualization and corporatization of stock exchange.

### **Demutualisation of Stock Exchanges**

Considering all these situations, the Organisation for Economic Co-operation and Development, to have an efficient corporate governance system across the globe focused on five areas:

*“(1) the rights of shareholders, (2) the equitable treatment of shareholders, (3) the role of stakeholders, (4) disclosure and transparency, and (5) the responsibilities of the board”.*<sup>35</sup>

Elliot (2002) highlighted that “exchanges with public accountability are required to have a special focus on corporate governance on account of investors’ demand. Investors need a sound corporate governance system for better performance of their businesses. It comprises the composition of the board of directors and key committees, financial reporting requirements for the exchange.”<sup>36</sup>

To separate ownership and control of stock exchanges and to eliminate the conflict of interest between exchange and stockbrokers, the Demutualisation of stock exchanges was seen as the viable option. Before moving further, let’s get an idea of what demutualization is. Demutualising is a process of restructuring the stock exchange and changing it from a not-for-profit mutual entity to a for-profit company owned not just by trading members but also by the public.<sup>37</sup> International Organization of Securities Commissions in its working paper on Stock Exchange Demutualization defined Demutualization as “The transformation of an exchange into a for-profit shareholder-owned company is referred to as demutualization.” In most cases, the demutualized exchange becomes a for-profit enterprise.<sup>38</sup> It can be noted that the whole process required two changes:

- i. Change in the ownership structure
- ii. Change in legal and organizational form

In 1993, Stockholmsbörsen, the Stockholm Stock Exchange was the first stock exchange to demutualize where it converted the ownership pattern from member-owned entity to shareholders held company<sup>39</sup>. Later, Australian Stock Exchange, Singapore Stock Exchange, Hong Kong Exchanges and Clearing

Limited followed the lead during the 1990s. Speaking of Initial Public Offering, after being demutualized, the Australian Stock Exchange was one of the first exchanges to come out with an initial public offering (IPO)<sup>40</sup> whereas the Singapore Stock Exchange (SGX) was first to demutualize in December 1999 in Asia-Pacific region.<sup>41</sup> In early 2000, NASDAQ Stock Market Inc which was earlier a wholly-owned unit of the National Association of Securities Dealers, separated itself and went public making it the 2<sup>nd</sup> Stock Exchange in the United States to demutualize shortly after Chicago Mercantile Stock Exchange (CME).<sup>42</sup>

### *The Indian Scenario*

Even before SEBI, Indian Securities Market Regulator and the Central Govt. came with demutualization plan in the 2000s, Over the Counter Stock (OCS) Exchange of India was promoted and incorporated under Sec. 25 of the Companies Act, in 1990.<sup>43</sup> Again, in 1992, the National Stock Exchange of India Limited (NSE) was set up as a tax-paying exchange and was promoted by leading financial institutions led by IDBI and incorporated all the advancements like providing modern, fully automated screen-based trading nationwide.<sup>44</sup> However, both cases were examples of voluntary demutualization where there were no laws that mandated demutualization.

It was in 2003 when the Securities Exchange Board of India (SEBI) released a circular for the corporatization and demutualization of Indian stock exchanges upon the following recommendations by Justice M.H. Kania Committee's report<sup>45</sup>. The committee observed that:

- i. Stock exchanges work towards the private interests of members alone which had detrimental effects on the rights of other shareholders. The division of ownership between members and outsiders can help not only in removing conflicts of interest but would also lead to the creation of greater accountability in the management and would also take care of the interest of other players.
- ii. To cope with the increasing competitions, if Stock Exchanges are demutualized, then it can raise funds from capital markets as well
- iii. Keeping public shareholders and other stakeholders in the management, it can strengthen the organization by ensuring transparency, accountability, and market discipline.
- iv. Demutualizing exchanges would also lead to flexibility in responding to changes.

While accepting the recommendations, SEBI put certain pre-qualifications before listing and issuance of shares of the stock exchange. Till that time, Stock Exchanges had a choice to voluntarily go for demutualization. It was in 2004 when the Govt. vide the Securities Laws (Amendment) Act amended the Securities and Contract (Regulations) Act of 1956 and made the demutualization of stock exchanges mandatory.<sup>46</sup> It meant that stock exchanges

have to separate the ownership and trading rights, as well as at least 51% of ownership, should rest with the public.

#### **IV. Demutualisation and Corporatisation of Indian Stock Exchanges**

From its inception in 1875, the Bombay Stock Exchange was owned and regulated by big fat stockbrokers<sup>47</sup>. In fact, before demutualization, 790 broker-members held 100 % in the 131-year-old exchange.<sup>48</sup> But the lack of capital in this competitive market, alternate trading systems due to an increase in globalization, and continuous advancement of technology, it created a doubt on the existence of the Bombay Stock Exchange. Moreover, the traditional trading platform was available only to traders who were physically present, thereby limiting no. of members who can provide adequate capital to the exchange<sup>49</sup>. It was because of these reasons and reasons mentioned above, demutualization of the exchange was considered as the best option.

The concept and scope of corporate governance, as discussed above, can easily be well extended to the process of demutualization of stock exchanges. Domowitz and Steil (1999), who examined interrelationships between stock exchange automation, governance, and quality of markets, identified several benefits of the demutualized stock exchanges and believe that the primary driver for such benefits is the favorable governance structure of demutualized exchanges.<sup>50</sup>

In India, the idea of Corporate governance was conceptualized as a post-deco effect to the varieties of scams in the 1990s. Confederation of Indian Industry (CII) was among the first to introduce Corporate governance as a voluntary measure to be adopted by the Indian companies.<sup>51</sup> Later, such measure was given a mandatory status in the early 2000s through 'Clause 49' of the Listing Agreement of SEBI Act of 1992<sup>52</sup> which was implemented on the recommendations of Birla Committee and was revised upon the advice of the N. R. Narayana Murthy Committee on Corporate Governance and public comments<sup>53</sup>. 'Clause 49' came into effect on December 31, 2005, and introduced various features to the corporate governance to the stock exchange like:

- a) Board independence: Boards of listed companies must have at least one-half of the board of independent directors. In other cases, independent directors should constitute at least one-third of the board size.
- b) Audit committees: Listed companies must have audit committees of the board with a minimum of three directors, two-thirds of whom must be independent.
- c) Disclosure: Listed companies must disclose periodically the financial and other matters to ensure transparency like any other listed company.<sup>54</sup>

In the 2003-04 Budget, it was proposed by the central govt. to make amendments to the Income Tax Act, 1961 and Securities Contracts Regulation



Act, 1956 to enable corporatization of stock exchanges<sup>55</sup>. Through an amendment to the Income Tax Act, Clause (xiii) to Section 47<sup>56</sup> was added which provided for “any transfer of the capital asset, being a membership right held by a member of stock exchange for the acquisition of shares and trading or clearing rights, should not be regarded as transfer for purpose of capital gains.” In the same year, in September 2003, Securities Laws (Amendment) Bill, 2003 was introduced in Lok Sabha which was however referred to the standing committee and it later lapsed due to the dissolution of the lower house.<sup>57</sup> To overcome this, Govt. promulgated Securities Laws (Amendment) Ordinance, 2004 to facilitate the Corporatisation and Demutualisation process. Vide this 2004 ordinance<sup>58</sup> to Securities Contracts Regulation Act, 1956, Govt. made it mandatory for all the stock exchange to get demutualized and corporatized. Through this amendment, it mandated the non-corporate and mutual exchanges to submit a scheme for corporatization and demutualization of the exchange to SEBI for approval, within a notified time. Meanwhile, SEBI was also given the power to modify the scheme in case if it's not satisfied with the scheme or such scheme is detrimental to the public interest. Once the scheme is approved, it shall be published in the official gazette and two national newspapers.<sup>59</sup> SEBI was also conferred power to restrict:

- a) Voting rights of shareholders
- b) Rights of shareholders to appoint representatives at the governing board of stock exchange
- c) Maximum no. of broker directors in governing board

In case an exchange fails to submit a scheme for the same or it's rejected by SEBI, SEBI was given the power to cancel and withdraw the license of such stock exchange.

On January 07, 2005, the Securities Laws (Amendment) Ordinance, 2004 was replaced with Securities Laws (Amendment) Act, 2004<sup>60</sup>.

In the 2005-06 budget, an amendment was proposed to the Indian Stamp Act, 1899 to facilitate the corporatization process without attracting stamp duty. Under this amendment, an exemption was added to the Indian Stamp Act, 1899 under which stamp duty on the notional transfer of assets of the exchange from the mutual organization to the corporate organization, was exempted.<sup>61</sup>

### ***Bombay Stock Exchange***

Few years before the demutualization of the Bombay Stock Exchange, even London Stock Exchange got demutualized and in both cases, the legal process was nearly identical.<sup>62</sup> Thus, the process started with the conversion of a not-for-profit association (of stockbrokers) to a for-profit limited company. However, the purpose of the London Stock Exchange to opt for demutualization

created a major difference. As noted above, the demutualization process of Bombay Stock Exchange was mandated by the Indian Govt. but, the demutualization of the London Stock Exchange was a voluntary decision by its members to improve international competitiveness, speedier decision-making and enabled the exchange to form international alliances.

After the above-mentioned amendment, the demutualization process of the Bombay Stock Exchange started in August 2005. SEBI introduced The BSE (Corporatisation and Demutualisation) Scheme, 2005 on 20th May 2005 which provided for<sup>63</sup>:

- a) A for-profit company shall be incorporated with the name of Bombay Stock Exchange Ltd. limited by shares as defined under Section 12 of the Companies Act, 1956 (now section 3 of Companies Act, 2013) and shall succeed BSE
- b) Segregating ownership, management and trading rights of the members of BSE
- c) Restriction on the representation of stockbrokers to 1/4th of the governing board's strength and 3/4th of the members was to be appointed in a manner specified by SEBI from time to time
- d) Trading members and other private players hold only 49% of exchange's equity shares whereas other 51% to be held by the public.
- e) A shareholder who is also a trading member and any other person acting together in concert<sup>64</sup> would not have more than 5% of the voting rights in the exchange
- f) After this process, there shall only be one class that will have similar trading rights and privileges. Moreover, a uniform and democratic method will be followed while accepting or rejecting any application of any person as a trading member.
- g) Duty has been bestowed upon BSE Ltd. To ensure that existing assets and reserves of BSE are utilized only for operations of BSE Ltd.

Moreover, clearing and settlement functions were also required to be transferred to a recognized clearing corporation under this demutualization scheme. Once the demutualization process of BSE ended on 19<sup>th</sup> May 2007, it saw major finance companies having a stake in the BSE Ltd. In that 51% shareholders criteria, major players like SBI, LIC, and Aditya Birla group, along with other 14 players bought stake which constituted upto 41% stake and the rest 10% were taken by Deutsche Borse and Singapore Exchange (SGX) who picked up 5% each.<sup>65</sup> This also resulted in an influx of a total of \$500 million through the stake selling process.<sup>66</sup>

### *National Stock Exchange*

Unlike the Bombay Stock Exchange, National Stock Exchange got corporatized from its inception i.e. from 1992. During its initial years, it was promoted

Currently owned by a set of leading financial institutions, banks, insurance companies, etc., it incorporated demutualized structure with screen-based trading, dematerialization, and electronic transfer of securities and professionalization of trading members. Furthermore, it revolutionized the structure of board members in the stock exchange by comprising senior executives from promoter institutions; eminent professionals in the fields of law, economics, accountancy, finance, taxation, etc.; public representatives; nominees of SEBI; and one full-time executive of the exchange.<sup>67</sup>

## V. Conclusion

In 1999 Annual Meeting of the Federation Internationale des Bourses des Valeurs (FIBV), it was reported that out of 52 exchanges present, 15 have already demutualised while rest are contemplating demutualisation.<sup>68</sup> Heightened competition, changes in technology and Increasing competition were pointed out as the major factor behind such move. It was mentioned that “for building trading platform with high efficiency, significant investments were required in new technology. Corporate governance was the need of the hour, and it is equally applicable to stock exchanges. With the changing structure of stock exchanges globally towards corporatization, for competition and governance, it is hoped that with demutualization, Indian stock exchanges would also achieve that soon. The demutualization of stock exchanges offered an ample range of benefits like the abolishment of the members’ monopoly, better investors’ response, and higher level of investments. That is the reason why the demutualization of Indian stock exchanges was regulated after 2004, and therefore, all the new stock exchanges post 2004 automatically fall into this umbrella.

## Notes

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