Managing Conflicts of Interest

Sebi's regulation to prevent conflict of interests associated with listing needs changes

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The conflict of interests is inherent in the business of a stock exchange, as it pursues multiple interests simultaneously. It pursues broadly two sets of interests: public interests such as market integrity encompassing the interests of investors, the market and society, and private interests such as turnover encompassing the interests of trading members, shareholders and employees. A measure — commercial or regulatory — undertaken by an exchange may not always further both interests simultaneously. Or, an exchange may adopt measures that give precedence to one interest over the other.

When conflict of interests become acute and an exchange becomes dysfunctional, it undergoes structural reengineering to eliminate, or at least to minimise, such conflicts.

About a decade ago, the exchanges used to be mutual organisations where trading members owned and managed the exchange, used its services and regulated their own activities. Consequently, the public interests of the exchange occasionally gave way to the private interests of the trading members and the market witnessed sporadic disruptions. This led to the inevitable conclusion that the quality of an exchange, owned and managed by trading members, is far from satisfactory. Hence, it was considered necessary to reduce the influence of trading members in the ownership and management of the exchange.

In 2004, the law brought in demutualisation which put restrictions on their representation in the general body and governing board of the exchange. It did not eliminate their role consciously in order to have continued access to their knowledge and expertise, which are critical for framing rules and to ensure better compliance.

While undergoing the process of demutualisation, the exchanges converted themselves to for-profit companies. This brought another kind of conflict of interest: the public interest of the exchange may give in to the private interests of shareholders and employees. For example, an exchange may be lenient in enforcing rules to encourage the volume of business and thereby return for shareholders. However, since demutualisation there has not been any untoward incident which has brought to the fore the conflict of interests arising from the representation of trading members or shareholders in the general body or governing board of the exchange.

An exchange, as a company and its shareholders have certain legitimate expectations. The recent past has witnessed a clamour for listing of exchanges. There is an apprehension that the listing may accentuate focus on short terms gains and a race to the bottom in regulatory standards. The regulator has recently proposed a framework to resolve the conflict of interests associated with listing.

The framework says that one, heads of departments dealing with regulations relating to trading members, listing of companies, and trading shall report to the managing director and to a board committee that has a majority of independent directors. Two, the governing board of an exchange shall not have any representation of trading members. This is expected to ensure that the exchange does not give precedence to the interests of the trading members and shareholders over the interests of general investors and the market.

A listed exchange can have a regulations committee comprising independent directors of governing body to administer regulation

Why repair a system which is not broken? The presence of trading members in the governing board has not contributed to conflict of interests leading to any market disruption since demutualisation. Listing does not accentuate conflict of interests from presence of trading members in the governing board. So, there is no need to remove them from the board. Besides, it may not be legally possible to do so.

It sounds odd that trading members can hold up to 49% of equity shares, but will not have any representation in the governing board of the exchange. In any case, the listing accentuates conflict of interests, if any, on account of presence of shareholders in the governing board. It is not necessary to remove them either from the governing board.

Sebi's prescription may not be workable. It is practically difficult for a board committee to exercise oversight over half a dozen heads of regulatory departments daily. It is also naïve to expect that the heads of regulatory departments, while under the administrative control of and reporting to the managing director, would report honestly to the committee. The standard remedy to deal with the conflict of interests is to assign different sets of empowered people to pursue different interests. This can be achieved by a minor modification of Sebi's framework to eliminate conflict of interests.

A listed company is required under the listing agreement to have various committees for things like audits and remuneration. A listed exchange can have an additional committee, called regulations committee, comprising of independent directors of the governing body, responsible for approving and administering regulations. It can have two managing directors — one responsible for regulatory affairs and the other for commercial affairs — who will report to the governing board.

The heads of departments dealing with regulations relating to trading members, listing of companies, and trading will report to the managing director for regulations who, in turn, will report to the regulations committee of the governing board. The decisions of the regulations committee shall be final and binding on the exchange. This would avoid the need for Sebi or a SRO taking over the regulatory functions and keep the stock exchange, as an institution, intact.

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