

SEs on a path of self-extinction?

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Synopsis

Legal vacuum is a major constraint in the growth of stock exchanges.

Innovations in exchange architecture should be aimed at not only preserving their legitimacy but also for warding off questions on their relevance. This probably calls for judicious unbundling.

Stock exchanges (SEs) occupy a prime and elitist position amongst the varied institutions of capitalism. They are at the centre of modern capital markets.

Many of them are global landmarks: often the whole city shining in their hallowed company. Of late, they are on a roll through mega mergers, vaulting valuations and high ambitions.

Then, it is ironic that their very *raison d'être* is under threat; that too, in this age of high finance when market infrastructure is looked upon with a reverence rarely seen in the past.

For the past few years SEs have been in the process of shedding their old skins to look young and to remain vibrant. Organisational innovations (corporatisation and demutualisation), institutional innovations (emergence of regulators and self-regulatory organisations - SROs, clearing corporations), market innovations (alternate trading systems — ATSS), outsourcing and technological changes have been making the SE horizon too narrow prompting questions on their very relevance.

Interestingly, some of these have been autonomous changes, willingly adapted and adopted by the SEs.

Electronic communication networks (that facilitates trading of securities among its subscribers), crossing networks (that matches orders for execution without first routing to a SE), negotiated dealing system (which matches orders in government securities) are market innovations that challenge the core functions of the SE.

Similarly, there are electronic systems which display buy-sell quotes of counter-parties to enable the buyers and the sellers in the corporate bond market to strike deals either at the SE or bilaterally. These ATSSs, some of which are called 'dabba trading' in Indian context, are diverting trades from SEs.

The unbundling bandwagon has made heavy inroads into SE operations. Many specialised service providers have taken up core functions of the SE. Specialised securities settlement systems have come up the world over to handle post-trading activities.

The law in some jurisdictions require clearing and settlement functions to be discharged by a clearing corporation. National Securities Clearing Corporation Ltd and Clearing Corporation of India Ltd provide central counter-party guarantee and clear and settle trades in corporate and government securities respectively in India.

Technology has completely changed the architecture of securities transactions. Apart from 'creating' new ATSSs, it has made the trading platform accessible to clients through the internet and mobile devices. It would continue to play a much bigger role in the days to come in the execution of trades and monitoring of positions in the market.

Organisational innovations have resulted in the SEs losing part of their self-regulatory status. This is both because of the perceived conflict of interest between commercial aspirations and regulatory tasks as well as the search for new turfs by the greatly empowered statutory regulators. Statutory regulators have taken over substantial part of regulation of markets as well as regulation of listed companies and brokers.

Rules of trading, the obligations of listed companies, service standards of brokers, etc., which used to be traditionally handled by SEs, have been substantially taken over by the regulators. There were even attempts to transfer listing and supervision of listed companies to agencies outside SEs.

In fact, regulators world wide have been following the dictum of 'freer markets and more rules' in imposing new rules on every traditional activity of an SE. In addition, Brokers' Associations and other interest groups are trying to adorn the angel's role of SROs, often with the blessings of the regulators.

Thus trading, clearing, settlement, market regulation, listing and broking are no more the exclusive prerogative of SEs. There is no function which is core or exclusive to a SE. While core functions of a SE are being taken over by/transferred to other agencies, the definition of 'stock exchange' in the Securities Contracts (Regulation) Act (SCRA) in India hardly protects the turf of the exchange.

The SE under the law is a body corporate, incorporated under the Companies Act, for the purpose of assisting, regulating or controlling business of buying, selling or dealing in securities. Thus, all corporate intermediaries in securities market, all of whom assist in dealing in securities, are SEs while the negotiated dealing system which provides trading platform for government securities is not.

Are the SEs only to implement the regulations made by statutory regulators? That too, when they have limited enforcement powers and they operate in competition with the less regulated new world of ATSSs? Or else, do the 'traditional' SEs still perform an essential function in capitalism?

Yes, they do. SEs are legal entities having full statutory backing in all jurisdictions, while ATSSs are far from achieving such an overarching statutory backing even in the jurisdictions they are permitted.

Legal vacuum is a major constraint in the growth of markets and organisations such as exchanges that fill up the void become institutions. The cost of regulation of a market with no exchange like central facilitator and with overcrowded, thinly legalised multiple commercial entities, will be too high and impractical.

SEs, with their substantial wealth are in a better position to embrace the best technology available for a globalised market. Though initially reluctant, due to organisational inertia or legacy constraints, all major SEs in the world have moved on to the electronic platform and restricted the unbridled growth of just electronic platforms like ECNs.

The SEs are better equipped not only to pluck the low hanging fruits but the high hanging ones as well!

While unbundling follows more a piecemeal approach, exchange is still an organic whole, providing convergence and thereby a meaning to the very process of unbundling.

Above all, SEs are probably, the first example of a public-private-partnership model of carrying the policy objective of market development and regulation to fruition which only institutions are expected to perform.

This embedded institutional ethos is the hallmark that distinguishes the SEs from other market functionaries, particularly the pure commercial entities.

Innovations in exchange architecture should be backed by this cardinal principle not only for preserving their legitimacy but also for warding off questions on their relevance, though emanating from the sidelines. This probably calls for judicious unbundling.

(The authors are civil servants. Views are personal.)