Understanding the Securities Laws (Amendment) Ordinance, 2004

M.S. SAHOO*

Article

The Securities Laws (Amendment) Ordinance, 2004 was promulgated on 12th October 2004 to insert/amend provisions in the Securities Contracts (Regulation) Act, 1956 (SCRA) and the Depositories Act, 1996 (DA) to: (a) enable demutualization and corporatisation of the stock exchanges, (b) fill up certain identified regulatory gaps such as units of mutual funds (MFs), delisting of securities, clearing corporation, for which there were no statutory provisions, (c) allow a broker of one exchange to trade with that of another so as to consolidate the market of the small exchanges, and (d) strengthen the penal framework for violation of securities laws. This paper is an attempt to understand these provisions and suggest minor changes, which could be incorporated in the Bill, to make these easily implementable.

A. DEMUTUALISATION OF EXCHANGES

Historically the exchanges were formed as 'mutual' organisations. They are generally "not-for-profit" and tax exempted entities. The trading members who provide broking services, also own, control and manage such exchanges for their common benefit, but do not distribute the profits among themselves. In contrast, in a "demutual" exchange, three separate sets of people own the exchange, manage it and use its services. The exchanges frame and enforce rules, which may not always further the public interest (interests of investors and society) and the private interest (interests of trading members) simultaneously. Theoretically public interest gets precedence in a demutualised exchange while private interest gets precedence in a mutual exchange in formulation and implementation of the rules. As the self (private interest) sometimes gets precedence over regulation (public interest), mutual exchanges do not offer an effective model for self-regulatory organisations. Besides addressing this malaise, the demutualisation offers several advantages. The limitations of a mutual structure has been realised time and again by the exchanges and the regulators. Recent happenings, particularly the 2001 stock market scam, made it clear that failure of the 'mutual' stock exchanges to resolve conflict of interest satisfactorily contributed to undesirable transactions in securities, which the SCRA aims to prevent. In order to address the malaise, the Finance Minister in March 2001 proposed corporatisation of stock exchanges by which ownership, management, and trading membership would be segregated from each other. The Joint Parliamentary Committee on the Stock Market Scam called for expeditious corporatisation and demutualisation of the stock exchanges. The implementation of this proposal, however, required certain amendments in the SCRA. The Securities Laws (Amendment) Ordinance, 2004 proposes these amendments.

The SCRA permitted different structures for stock exchanges. That is why some exchanges are association of persons, some are company limited by shares, and some others are company limited by guarantee. Since the law permitted any structure of organisation for a stock exchange, it was not possible to mandate a particular structure (corporate form) for all exchanges. Similarly, the SCRA did not prohibit brokers from owning and managing an exchange. That is why most of the exchanges are mutual exchanges which are owned

*Shri *M.S. Sahoo, Chief General Manager, SEBI. The views expressed are those of the author only and not of SEBI. Email id:msahoo@sebi.gov.in*

and managed by brokers. Only two exchanges, on their volition, have adopted demutual structure. Since the SCRA permitted either structure, it was not be possible to mandate only demutual structure for all exchanges. In order to mandate these, the Ordinance has amended the SCRA to specify that all exchanges, if not already corporatised and demutualised, shall be corporatised and demutualised.

The process of demutualisation involves segregation of ownership and management from the trading rights of brokers. However, the process of corporatisation involves offering shares to public, including brokers. It is possible that the brokers subscribe for the shares and in terms of their rights under the Companies Act, get themselves elected to the Board of Directors. It may so happen that a stock exchange has only broker shareholders in the general body and broker directors in the governing body. Thus, even though an exchange is corporatised, it would not be demutualised, as the same set of people would be owning and managing the exchange and also trading on the exchange. The Ordinance, therefore, restricts the participation of broker-shareholders in the general body as well as in the management of the exchange to ensure that the corporatised exchange is really demutualised.

The Ordinance makes it mandatory that all stock exchanges, if not corporatised and demutualised, shall be corporatised and demutualised on and from the appointed date so notified in the official gazette by SEBI. It obligates the non-corporate and mutual exchanges to submit within such time as may be specified by SEBI a scheme for corporatisation and demutualization to SEBI for its approval. The scheme should provide for issue of shares and provision for trading rights, restriction on voting rights, and transfer of property, business and employees etc. SEBI may approve the scheme with or without modification if it is satisfied that it is in the interest of trade and also in the public interest. If a scheme is approved, it shall be published immediately by SEBI in the official gazette and by the Exchange in the newspapers. On such publication, the scheme shall have effect and shall be binding on all persons and authorities. SEBI shall not approve any scheme of demutualization and corporatisation if the issue of shares for a lawful consideration or provision of trading rights in lieu of membership card of the members of an exchange or payment of dividend to members is proposed out of any reserves or assets of the exchange. While approving the scheme, it may, by order, restrict (a) voting rights of the broker shareholders, (b) the rights of shareholders or brokers to appoint the representatives on governing board of the Exchange, and (c) the maximum number of broker directors on the governing board, which shall not exceed one fourth of the total strength of the governing board. Such order shall be published in the official gazette. Within 12 months of such publication, the stock exchange concerned shall, either by fresh issue of equity shares to the public or in any other manner, as may be specified by the regulations made by SEBI, ensure that at least 51% of its equity shares is held by public other than shareholders having trading rights. SEBI may extend this period by another 12 months in public interest. SEBI may reject a scheme if it is satisfied that it would not be in the interest of trade and also in the public interest, after giving a reasonable opportunity of hearing to all the persons and the exchange concerned. Any person aggrieved by an order of SEBI approving/rejecting the scheme can prefer an appeal before the Securities Appellate Tribunal (SAT). If an exchange is not corporatised and demutualised or fails to submit a scheme for the same or the scheme is rejected by SEBI, the recognition granted to such exchange shall stand withdrawn. The central government shall notify such withdrawal of recognition in the official gazette.

The Ordinance envisages that entire assets/reserves of the exchange shall remain with the exchange even after demutualization. The shareholders/brokers can get full value through divestment of their holding only after the exchange is demutualised. They cannot get any value if the exchange is not demutualised. This is a tremendous incentive for brokers to go for demutualization.

B. REGULATORY GAPS

In view of so many regulators and so many statutes governing securities market, it is quite natural that there are a few regulatory gaps. The Ordinance seeks to remove a few such regulatory gaps.

a. Units of Mutual Funds : Units of MFs resemble securities. They represent the interest of the unit holder in the specific scheme just as securities represent the interest of the holder in the issuer. The unit holder has similar rights as a security holder has on the future performance of any underlying asset or group of assets. Special kinds of units (units of assured return schemes), which represent the rights of investors on a fixed income flow over the future years or a fixed maturity value at the end of a specified period, are similar to debentures issued by companies. The units are issued, dematerialised, listed, and traded on exchanges in a manner similar to any other security. These are transferred from one holder to another or sold back to the issuer, at pre-specified or market determined values, just like shares, debentures and other securities are. The holders of units and securities have the same need for safety, liquidity and return. Despite such close similarities between units and securities, they were not explicitly treated legally at par. While the trading of securities issued by corporates is governed by SCRA and regulatory framework developed thereunder, trading of units were not subject to similar regulatory framework. In fact, trading of units was not subject to any regulatory framework. This presented a case of regulatory gap and this is one of the reasons why the secondary market for units has not developed appreciably. The easiest way to develop the market for units of MFs and protect the investors investing in them was to consider the units to be securities so that the regulatory framework applicable to trading of securities would also apply to trading of units and SEBI which has the responsibility to protect the interests of investors in securities, can protect the interest of holders of units of MFs also. Since the jurisdiction of SEBI is limited to securities market and the units of MFs were not explicitly recognised as securities in law, the actions of SEBI in protecting the interests of investors in units of MFs and developing a market for them was being challenged before the courts of law. In an appeal before SAT, an appellant contended that he was not covered by the Rules as he was not dealing in securities, but in units of MFs which were not securities and hence the SEBI had no powers, authority or jurisdiction to conduct any enquiry or impose any penalty on him. While disagreeing with this, the SAT considered the units of MFs to be securities in view of the object and purpose underlying the SEBI Act. This judicial pronouncement needed to be codified in law. The Ordinance, therefore, expanded the definition of 'securities' to include units or any other such instrument issued to the investors under any mutual fund scheme.

b. Delisting of Securities : Listing and delisting are two sides of the same coin. There is a substantial body of law that governs listing. The Companies Act makes it mandatory for a company issuing shares to public to list its securities on a stock exchange. The SCRA obliges the company to comply with the conditions of listing. It also allows a company to prefer an appeal before the SAT if a stock exchange refuses listing. The SCRA prescribe requirements for listing on a stock exchange. It also regulates suspension and withdrawal of trading. So much of care and concern about listing; there are provisions about suspension of listing in statutes, rules and regulations. Unfortunately, delisting did not find place in any statute, rules or regulations. It was so far being regulated through a circular of government/SEBI, and recently by the guidelines of SEBI. Since the delisting is at least as important as listing, it was necessary that both have same level of legal backing.

Since no such statutory provision existed, doubts were raised if delisting was at all permissible under the laws. It was argued in some circles that delisting should not be permitted at all. They argued that it was the intention of legislature, as there were statutes and rules to govern listing, but no statute/rule provided for delisting. It was probably considered that listing was so sacrosanct that once a security was listed, it should not be delisted. An investor subscribes to an issue on the basis of the contents in the prospectus which may state that the security would be listed on stock exchanges. Once he subscribes to the issue, he takes an irreversible decision, as the promises in the prospectus are irreversible. Hence if one considers investors interest to be the predominant and sole factor, there should not be any delisting of securities. Another school argued that listing agreement was essentially a contract between a company and an Exchange. Like any contractual relations, it must have also a way to terminate the relationship in certain circumstances. If there was a way to get in, there must be also a way to get out. Should the exchange and the company consider terminating their relationship, after taking care of interest of the affected third parties (investors), they should be permitted to do so. In view of pros and cons of delisting, it may not be desirable to put an absolute ban on delisting but it may be regulated. The statute and rules must provide a framework for delisting, as it provided for listing. If it is in the interest of investors, it must be permitted. If it is not in the interest of investors, delisting may be allowed only if investors are adequately protected.

The Ordinance, therefore, incorporates a new provision to allow delisting of securities. A stock exchange may delist securities on any of the grounds as may be prescribed in the rules, after giving the company concerned an opportunity of hearing. A listed company or an aggrieved investor can file an appeal before SAT against the decision of the exchange delisting the securities.

c. Clearing Corporation : The securities laws did not explicitly recognize existence of clearing corporation. They talked about trading and not much about settlement, which was left to byelaws of the exchanges. The byelaws are supposed to provide for clearing house (not clearing corporation) for settlement of securities transactions. However, clearing house has limitations in the age of anonymous order book ushered in by screen based trading system. The current trading system does not allow participants to assess the counter party risk and, therefore, requires the exchanges to use a clearing corporation to provide novation and settlement guarantee.

The Ordinance inserted a new section in the SCRA to provide that an exchange may, with the approval of SEBI, transfer the duties and functions of a clearing house to a clearing corporation for the purpose of the periodical settlement of contracts and differences thereunder, and the delivery of and payment for securities. SEBI shall approve such transfer if it is in public interest or in the interest of trade. Every clearing corporation must be a company and its byelaws must be approved by SEBI. The various provisions in the SCRA such as grant and withdrawal of recognition, supersession of management, suspension of business etc. applicable to stock exchanges shall, *mutatis mutandis,* apply to clearing corporations. This means that the clearing corporations must be recognized and subjected to the same regulatory framework as the stock exchanges are.

C. INTEGRATION OF TRADING PLATFORM

As a matter of practice, the central government used to make two additional notifications while notifying the recognition of a stock exchange. One notification specified that section 19 of the SCRA shall come into force in the area earmarked for the recognized stock exchange. This notification prohibited trades in the earmarked area outside the exchange. The other notification specified that section 13 shall apply to the said area. This notification prohibited trades otherwise between the members of the recognized stock exchange in that area. These provisions/notifications fuelled the mushrooming of exchanges in the nook and corner of the country as it ensured a geographical monopoly for them. However, with the advent of NSE and intensive use of IT in trading, these provisions worked to their disadvantage, as they could not expand their area of operation. In course of time SEBI allowed them to expand their operations to anywhere in the country making notifications under section 19 irrelevant.

21 small exchanges put together reported only 0.36% of turnover during 2003-04 while the two big exchanges accounted for the balance. Thus many exchanges have in course of time lost *raison d'être* for their existence. They have been generating innovative ideas which can extend their life line.

These included setting up of the Interconnected Stock Exchange and floating subsidiaries to become members of big exchanges. The market participants, exchanges, and authorities now realize that no single exchange on its own can compete with the two big exchanges. They have been toying with an idea of *indonext* which would consolidate the trading platforms of small exchanges and provide an alternative to trading platforms of the two big exchanges. It would be accessible to all brokers of small exchanges and would provide business indirectly to small exchanges. In line with this thinking, small exchanges and one of the big exchanges, namely BSE, have come up with a variant of *indonext* in the name and style of BSE Indonext Segment where small cap companies listed on small exchanges or on BSE will be traded initially and only small and medium companies will be listed in this segment in future. This complements the Finance Minister's proposal in the last budget to create an alternative trading platform for small and medium enterprises to raise equity and debt from the market. This segment will be accessible to the members of the BSE and of the small exchanges. Since such a segment inevitably meant trading between members of two different exchanges, this was not possible in view of restrictions in section 13 of the SCRA. The Ordinance has, therefore, amended section 13 to allow trades within notified area among the members of recognized stock exchanges. With this amendment, it will be possible for trades to be executed on BSE Indonext Segment between a broker of Jaipur Exchange and a broker of Gauhati Exchange. In such a case, the issue arises is: the rules and byelaws of which exchange would govern trading and enforce settlement. This has been clarified in the Ordinance that the contracts between two brokers of two different exchanges shall be subject to terms and conditions of respective exchanges with the prior approval of SEBI. This means that the trades on BSE Indonext Segment will be regulated in the manner specified by SEBI.

D. SCHEME OF PENALTY

The securities market is an integral part of the economy. It has the potential to destabilise other sectors. It is, therefore, necessary that the penalty for offences in the securities market is deterrent. This is possible if the statutes identify the offences, prescribe stringent associated penalties and provide a fair and objective mechanism for imposition of such penalties. The Ordinance has inserted/modified provisions in the SCRA and the DA to make the penalties really deterrent, mostly in sync with the provisions in the SEBI Act, 1992.

If an offence is cognizable, it is less likely to be committed. The offences which have potential to destabilize the system or have serious implications otherwise have been declared cognizable under the Code of Criminal Procedure to reduce the likelihood of their occurrence. In view of their gravity, a few offences in the securities market, as listed in section 23(1) of the SCRA, were cognizable. The Ordinance has made all the offences listed in section 23 of the SCRA cognizable. It has further provided that these offences and all offences listed in section 23M(1) of the SCRA and section 20 (1) of the DA, on conviction, shall attract punishment in terms of imprisonment and/or fine, without prejudice to any award of penalty by the adjudicating officer.

The penalty prescribed under the SCRA and the DA was ridiculously low. Many of the offences under the SCRA attracted a penalty of Rs. 1,000 on conviction. For example, non-compliance of listing agreement, which can put investors to untold miseries and make a mockery of corporate governance norms, could be punished only up to Rs. 1,000. If listing agreement is to be effectively used to discipline a listed company, its non-compliance must invite a stringent punishment. Accordingly, the Ordinance has increased the penalty to an imprisonment up to 10 years or fine up to Rs. 25 crore or both for all the offences listed in sections 23 and 23M (1) of the SCRA and section 20 of the DA.

Only a few offences were listed in the SCRA and the DA. These offences attracted punishment on conviction through prosecution. For obvious reasons, prosecution is not always the most efficient means of punishing the accused. Besides, a large number of offences were not listed in the statutes and hence there was no means to deal with such offences. For example, the failure to dematerialize or rematerialise securities within specified time or failure to segregate the assets of clients was not listed as an offence. It was therefore necessary to identify all possible violations and prescribe a mechanism to deal with them. Further, certain entities like exchanges/depositories could not be punished adequately for violations by them. Only recourse available to the regulator in such cases was to withdraw the recognition of the exchange or supercede its management or cancel or suspend the registration of a depository. Such penalty leads to cessation of business and affects innocent third parties, often adversely, who deal with the exchange/depository. Monetary penalty is more efficient to deal with such violations. In order to address these infirmities, the Ordinance has identified various possible violations, created a mechanism to establish the violation and, if warranted, impose monetary penalties.

The Ordinance inserted provisions in the SCRA and the DA to empower SEBI to appoint adjudicating officers to adjudicate a wide range of offences, as listed under sections 23A to 23H in the SCRA and 19A to 19G in the DA, and impose monetary penalties for such offences. The adjudicating officer shall not be an officer below the rank of a division chief of SEBI. He will hold an inquiry after giving a person reasonable opportunity of hearing for the purpose of determining if any violation has taken place and imposing penalty. He will hold inquiry in the manner prescribed in the Rules made by the government. He shall have powers to summon and enforce the attendance of any person acquainted with the facts and circumstances of the case to give evidence or produce any document relevant for the inquiry. While adjudging the quantum of penalty, he shall have due regard to amount of disproportionate gain or unfair advantage wherever quantifiable made as a result of the default, the amount of loss caused to an investor or any group of investors as a result of default, and the repetitive nature of the default.

The following table presents the penalties envisaged in the Ordinance for different violations in the SCRA and in the DA:

Penalties Provided in the Securities Laws (Amendment) Ordinance, 2004

Sections	Violations	Penalty
	Violations under the Securities Contract (Regulations) Act, 1956	
23(1)&(2)	Various violations such as trades in contraventions of various sections of the Act, operating non-recognised exchanges, non-compliance with the orders of SAT, non-compliance with the conditions of listing etc.	Imprisonment up to 10 years or fine up to Rs. 25 crore or both
23A(*a*)	Failure by any person to furnish any information, document, books, returns or report to a stock exchange required under the Act or any rules made thereunder within specified time	Rs. 1 lakh for each day during which such failure continues or Rs. 1 crore, whichever is less
23A (*b*)	Failure by any person to maintain books of accounts or records as per listing agreement or conditions	
23B	Failure by any person to enter into agreement with his client under the Act or any byelaws of stock exchange made thereunder	
23C	Failure by a broker/sub-broker/listed company/proposed to be listed company to redress the grievances of investors after having been called upon by SEBI to do so	
23D	Failure by a broker/sub-broker to segregate the assets of client(s) or uses the assets of a client(s) for self or any other client(s)	Penalty not exceeding Rs. 1 crore
23E	Failure by a company or any person managing collective investment scheme or mutual fund to comply with listing/delisting conditions	Penalty not exceeding Rs. 25 crore

Sections	Violations	Penalty
23F	Any person dematerialized securities more than the issued securities or delivers unlisted securities in the exchange	Penalty not exceeding Rs. 25 crore
23G	Failure or neglect by an exchange to furnish periodical returns to SEBI or make or amend its rules/byelaws as directed by SEBI or comply with directions of SEBI	
23H	Failure by any person to comply with any provision of the Act, the rules or articles or byelaws or the regulations of the exchange or directions issued by SEBI for which no separate penalty has been provided	Penalty not exceeding Rs. 1 crore
23M(1)	Contravenes or attempts to contravene or abets the contravention of the provisions of the Act or of any rules or regulations or byelaws made thereunder	Imprisonment up to 10 years or fine up to Rs. 25 crore or both
23M(2)	Failure to pay the penalty imposed by adjudicating officer or to comply with any of his directions or orders	Imprisonment up to 10 years (not less than one month) or fine up to Rs. 25 crore or both
	Violations under the Depositories Act, 1996	
19A(*a*)	Failure by any person to furnish any information, document, books, returns or report to SEBI required under the Act or any rules or regulations or byelaws made thereunder within specified time	Rs. 1 lakh for each day during which such failure continues or Rs. 1 crore, whichever is less
19A(*b*)	Failure by any person to file any return or furnish any information, books or other documents required under the Act or any rules or regulations or byelaws made thereunder within the time specified	
19A(*c*)	Failure by any person to maintain books of accounts or records required under the Act or any rules or regulations or byelaws made thereunder.	
19B	Failure by an intermediary, including depository and depository participant, or an issuer to enter into agreement required under the Act or any rules or regulations made thereunder	
19C	Failure by an intermediary, including depository and depository participant, or an issuer to redress the grievances of investors after having been called upon by SEBI to do so	
19D	Failure by an intermediary or an issuer to dematerialize or rematerialize the securities within specified time in the Act or regulations or byelaws or abets delay	
19E	Failure by an intermediary or an issuer to reconcile the records of dematerialized securities with all the securities issued by the issuer as specified in the regulations	
19F	Failure by any person to comply with the directions issued by SEBI under section 19 within specified time	
19G	Failure by any person to comply with any provision of the Act, the rules or regulations or byelaws made or directions issued by SEBI thereunder for which no separate penalty has been provided	Penalty not exceeding Rs. 1 crore
20(1)	Contravenes or attempts to contravene or abets the contravention of the provisions of the Act or of any rules or regulations or byelaws made thereunder	Imprisonment up to 10 years or fine up to Rs. 25 crore or both
20(2)	Failure to pay the penalty imposed by adjudicating officer or to comply with any of his directions or orders	Imprisonment up to 10 years (not less than one month) or fine up to Rs. 25 crore or both

The Ordinance, however, provides that all sums realised by way of penalties imposed by adjudicating officers would be credited to the Consolidated Fund of India. This is probably to avoid conflict of interest that the beneficiary of the penalty should not determine if penalty is to be levied and if so, the amount of penalty. It further provides that non-payment of penalty imposed by an adjudicating officer or non-compliance with any of his orders or directions would be an offence punishable with imprisonment for a term between one month and ten years, or with fine up to Rs. 25 crore or with both.

To ensure fair inquiry and penalty, the Ordinance provides that appeal against the orders of adjudicating officers would lie to the SAT. Any person aggrieved by an order of SAT can prefer an appeal before Supreme Court only on a question of law.

The Ordinance empowers the SAT and the Courts to compound offences. They can compound any offence under the SCRA or the DA, not being an offence punishable with imprisonment only, or with imprisonment and also with fine, either before or after the institution of the proceeding.

In order to reduce delays, avoid unnecessary litigation and get cooperation of the accused, the Ordinance empowers the central government to grant immunity, before institution of prosecution, to any person from prosecution for any offence under the SCRA/DA or the rules or the regulations made thereunder or from the imposition of any penalty under these Acts with respect to alleged violation. Such immunity can be granted only if SEBI recommends it and the person makes a full and true disclosure in respect of the alleged violation. If any person to whom immunity has been granted does not comply with the conditions on which immunity was granted or had given false evidence, the immunity can be withdrawn and on such withdrawal, the accused would face normal prosecution/penalty.

Any offence punishable under the Acts or any rules or regulations or byelaws made thereunder shall be tried by a 'court of session' instead of 'a metropolitan magistrate or a judicial magistrate of the first class' as provided earlier. The court can take cognizance of the offences only on a complaint made by the central government or state government or SEBI or a stock exchange or any person.

The Ordinance has inserted section 12A in the SCRA to empower SEBI to issue appropriate directions in the interest of investors and securities market to any stock exchange, clearing corporation, such other person or agency providing trading, clearing or settlement facility in respect of securities or to any company whose securities are listed or proposed to be listed in a stock exchange. It can issue such directions if it is satisfied that it is necessary (a) in the interest of investors or orderly development of the securities market, or (b) to prevent the affairs of any stock exchange, clearing corporation, such other person or agency providing trading, clearing or settlement facility being conducted in a manner detrimental to the interest of investors or the securities market, or (c) to secure the proper management of any such entity.

The Ordinance empowers central government to make rules under section 30 of the SCRA to provide for (a) the grounds for delisting of securities, (b) the manner of appeal before the SAT, and (c) the manner of inquiry by the adjudicating officer. It also empowers government to make rules under section 24 of the DA to provide for the manner of inquiry by the adjudicating officer. These provisions are similar to those existing in the SEBI Act.

E. MINOR IRRITATIONS

The objectives of the Ordinance are laudable. Many of the provisions in the Ordinance can be implemented only if the corresponding rules are framed. These rules and the additional rules proposed in this section need to be framed immediately so that the initiatives proposed in the Ordinance can see the light of the day. Further, it may be desirable that these aspects are provided in the regulations to be framed by SEBI instead of rules to be framed by government. A Bill is expected in the coming session of Parliament to replace it. The Bill may incorporate a few minor editorial/consequential changes in the Ordinance to ensure its smooth implementation. This section proposes such changes and identifies the rules to be framed. It does not talk about substantive issues or issues relating other areas which need amendments in securities laws.

a. Corporatisation and Demutualisation

The provisions relating corporatisation and demutualisation are incomplete. These need to be toned up in the Bill by addressing the following issues:

i. The Ordinance envisages that the reserves/ assets of a non-corporate mutual recognized exchange will be transferred to a corporate demutual stock exchange. It does not say who will incorporate the corporate stock exchange or who will be its initial shareholders. Will it only be existing brokers of the recognized exchange or any other person? This is important because these initial shareholders will hold the entire equity of the corporate exchange even after transfer of assets/liabilities. This means that these shareholders will be the ultimate beneficiaries of the reserve and surplus of the erstwhile exchange for all practical purposes. If the corporate is listed, these shareholders can theoretically encash the reserve and surplus on the day after assets/liabilities are transferred. The reduction of their stake to 49% within 12 months does not really make any difference to them as they will get value for their holding when they divest it. If it is not listed, these shareholders can wind up the exchange and share the proceeds from the assets. The Bill may clearly indicate who would be the beneficiaries.

ii. The demutual exchanges would inherit the accumulated reserves and surplus which has grown because of so many concessions and tax benefits. In order to ensure that this remains with the organization even after conversion and is not taken away by anybody, there is a restriction on distribution of this accumulated reserve and surplus and assets inherited by the demutual exchange, as these belonged to erstwhile not-for-profit exchange. This means that the exchange may continue to have the non-distribution clause prohibiting distribution of profits/dividends out of the inherited reserves and surplus. Hence the exchange would be corporatised and demutualised, but may continue to be a not-for-profit organisation. This reserve and surplus may be deployed by the exchange separately for common benefit of investors/exchange/market. Or, if the exchange becomes a for-profit organization, the reserve and surplus may be capitalised and issued as equity shares to a public agency (representing all stake holders) which can disinvest in due course and all future profits of the organization may be subject to normal taxation. Or, these assets/reserves may be locked in permanently as long as the exchange in existence and the assets pass on to another exchange if it is wound up. These aspects may be dealt in the Bill.

iii. People may like to incorporate a new company to take over the business of a good exchange. It may not so happen if an exchange does not have any reserve and surplus or has negative net worth. In such a case, corporatisation will not take off and the exchange will eventually be derecognized.

iv. The Ordinance provides that a recognized stock exchange shall be derecognized if it does not submit a scheme of corporatisation/ demutualization or if the scheme is rejected. It, however, does not provide if an exchange is derecognized, how the exchange would be wound up, and particularly how the reserve and surplus would be distributed. If it is possible to share the reserve and surplus even without demutualization, many exchanges may prefer this approach.

v. SEBI is expected to frame regulations to reduce the stake of brokers to 49% within 12 months. It is possible that the corporate exchange is incorporated with less than 49% stake with brokers. In such a case there would be no need to reduce the stake of brokers. If, however, an exchange is not doing well, it may be impossible to get people to take 51% stake within 12 months. In such a case, the stake of the brokers cannot be reduced. The Bill may provide solution for such an eventuality.

vi. The Ordinance grants powers to central government to frame rules for various purposes. It does not empower SEBI to frame regulations, even though it expects SEBI to do so for reducing the stake of brokers. In fact, the SCRA does not contemplate making of any regulations. The Bill may specifically empower SEBI to frame regulations and may require the regulations to be laid on the table of the Parliament. SEBI may, thereafter, frame regulations immediately. Alternatively, the central government may frame rules for this purpose.

vii. SEBI is expected to ensure demutualisation and corporatisation of exchanges. It will approve the scheme and make all the required notifications. However, in case a recognized exchange does not demutualise/corporatise, does not submit a scheme for the same or the scheme is rejected by SEBI, the recognition of the exchange shall stand withdrawn and central government shall notify withdrawal of recognition in the gazette. In the interest of operational convenience, the Ordinance should have empowered SEBI to make such notification. Otherwise, central government will delegate this power to SEBI by another notification.

viii. With corporatisation, the exchanges shall have two categories of members namely, trading members and shareholder members. Since "member" under the SCRA means a member of the recognised stock exchange, it would cover both the categories and create confusion. It is necessary that these two categories are identified specifically in the SCRA and their rights and obligations are clearly defined in the Rules.

ix. The scheme may provide for issue of shares for lawful consideration or provision of trading rights in lieu of membership card. However, SEBI shall not approve any such scheme if it proposes issue of shares for lawful consideration or provision of trading rights in lieu of membership card or payment of dividends out of reserves and assets of the exchange. These provisions are contradictory.

x. The Ordinance says that the non-corporate and mutual exchanges shall be corporatised and demutualised from an appointed day. It does not, however, say that only corporate and demutual exchanges shall be recognised in future. Otherwise exchanges of any form will be recognized in future and thereafter they have to go through the process of demutualization and corporatisation.

xi. The corporatisation would involve transfer of assets from an association of persons to a corporate entity. This may attract stamp duty which can be prohibitive. It is necessary that the stamp duty is completely waived of as the demutualization is imposed on the exchanges in public interest.

b. Delisting

The provisions in the Ordinance relating to delisting need to be touched up as follows:

i. Instead of 'grounds' for delisting, it should enable central government to prescribe the requirements of delisting, as it specifies the requirements of listing of securities.

ii. The delisting framework should cover units of collective investment scheme (CIS). These are listed like security of any company and the rules provide for requirements of their listing.

iii. Now that the units of MFs are securities, the Rules must also provide for the requirements of their listing and delisting.

iv. The rules providing for requirements of delisting of securities, including units of MFs and of CIS, and requirements of listing of units of MFs, need to be framed immediately.

v. SEBI has issued delisting guidelines which provide for both voluntary and compulsory delisting. The Ordinance only sanctifies the delisting by the exchange. Since the listing by exchange is generally compulsory, the voluntary delisting will not have any legal basis. The bill may enable voluntary delisting explicitly. Or, at least, the rules should provide the requirements of both compulsory and voluntary delisting.

vi. The SCRA talks about listing by an exchange, while SEBI has the Central Listing Authority (CLA) under the SEBI Act, 1992 to issue letter precedent to listing. It is ironical that there is a Central Listing Authority, but it has no powers to grant/refuse listing. The SCRA may clearly provide for the CLA and transfer all listing functions from the exchanges to CLA.

c. Clearing Corporation

The provisions relating to clearing corporation need to make allowance for the following:

i. The Ordinance provides that an Exchange may transfer the clearing functions to a clearing corporation with the approval of SEBI and SEBI shall allow such transfer in the interest of trade and public. It gives an impression that the settlement through clearing corporation may not always be desirable. It is just an enabling provision and the exchange and SEBI are at liberty not to transfer settlement function to a clearing corporation. Even without such enabling provision, we have clearing corporations and hence such provision does not serve any useful purpose. If we consider that settlement by clearing corporation is desirable and better than that through clearing house, the Bill must mandate it in no uncertain terms.

ii. The Ordinance states that various provisions in the SCRA shall apply to clearing Corporation as they apply to an exchange. These provisions empower central government to frame rules in respect of exchange. The Bill must enable government to frame rules in respect of clearing corporation and the central government must frame the rules immediately.

d. Market Integration

The SCRA now permits contracts between members of the exchanges. This cannot take off unless corresponding amendments are made in the Rules. Besides, the participating exchanges need to formalize an understanding particularly about the responsibilities of each exchange and adjudication and settlement of disputes, with the approval of SEBI, relating to operations on the BSE *indonext* Segment.

e. Editorial Changes

i. Three sub-clauses namely (*hb*), (*hc*) and (*he*) of sub-section (2) of section 30 of the SCRA empower central government to make Rules to provide for the form of appeal under sections 21A, 22A and 23L respectively before the SAT. Only one clause would have been sufficient to provide for these in the SCRA. In fact, only one Rule, not three different Rules, should be notified.

ii. Section 13, as amended by the Ordinance, enables contracts in securities between members of different exchanges subject to (*i*) such terms and conditions as may be stipulated by the respective exchange, and (*ii*) prior permission from the respective stock exchanges if so stipulated by the stock exchanges. These (i) and (ii) are not essentially different and only one of these would have been sufficient.

iii. The offences listed under sub-sections 23(1) and 23(2) invite the same penalty. There was no need of having two different sub-sections. One section would have been sufficient.

iv. Complaint under section 26(1) of the SCRA and section 22 of the DA can be made by the central government, a state government, SEBI, a recognised stock exchange or by any person. If any person can make a complaint, there is no need to specify that it can be made by the central government, a state government, SEBI, a recognised stock exchange or by any person.

v. The violations of securities laws are harmful to the securities market and the economy and should attract deterrent punishment. The violations listed in the SCRA have been made cognizable by the Ordinance, while the violations under the SEBI Act or the DA continue to be non-cognizable.

vi. Failure to comply with directions of SEBI under section 19 of the DA is adjudicable. The failure to do so under the comparable provisions in section 12A of the SCRA or 11B of the SEBI Act is not adjudicable.

These minor changes may be incorporated in the Bill and the necessary Rules may be framed quickly so that the objectives of the Ordinance can be realised at the earliest.