REGULATORY RECAST

THEIR STATUTORY ROLE RISKS COMING FULL CIRCLE, RAISING FUNDAMENTAL QUESTIONS ON MARKET REGULATION

Curious case of stock exchanges

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THE SECURITIES MARKETS Code (SMC) Bill, 2025, recasts stock exchanges, the bedrock of market infrastructure, as instruments of the state. It explicitly vests them with quasi-legislative, executive, and quasi-judicial powers—functions unmistakably public in character. Their rule-making is subject to parliamentary scrutiny and civil court jurisdiction is expressly barred.

The regulator may now delegate to exchanges the authority to register specified classes of intermediaries and investors and to regulate defined segments of market participants. In discharging these functions, exchanges are bound by the same due process—fairness, transparency, non-discrimination, confidentiality, and natural justice—that bind the regulator itself. In effect, the Bill positions exchanges as "mini-states" within the securities ecosystem, broadly analogous to the regulator.

This, however, revives a familiar dilemma: Can a for-profit commercial entity exercise sovereign authority, amplifying earlier debates over member-driven associations, without compromising market integrity? Can an exchange ensure that the private interests of shareholder-members do not eclipse its public mandate? In other words, can an exchange truly operate as a "regulatory chimera", simultaneously policing listed companies and intermediaries and the bulls and bears of the market, on which it relies for the creation of shareholder value?

The trajectory of India's exchanges resembles the story of the movie *The Curious Case of Benjamin Button*. Indian exchanges appear to age in reverse, not biologically, but statutorily—gradually reclaiming powers once ceded. Before Independence, they were self-regulatory broker associations that effectively governed the securities market through their own rules. The first, set up in 1875 as the Native Share and Stock Brokers' Association, framed and enforced its own norms. The Securities Contracts (Regulation) Act, 1956, later accorded this model formal recognition.

Each exchange functioned within a demarcated territory approved by the central government. Within this domain, it listed companies, admitted members, conducted trading, and oversaw clearing and settlement through its bye-laws, operating, in effect, as a compact democratic forum. Reporting obligations were modest—annual reports and occasional disclosures upon requisition. This regime of "distant supervision" allowed exchanges to function as member-driven institutions—of the members, by the members, and for the members.

That model endured for decades, but steadily eroded between 1990 and 2025, driven primarily by three interrelated developments. First, its limitations became evident—self-regulation gradually degenerated into insular "clubs", often privileging member interests at the expense of investors. Inherent conflicts of interest in the mutual structure, where members were both regulators and participants, undermined credible self-regulation. Episodes of misconduct, lenient enforcement, and collusive behaviour weakened investor confidence, prompting a shift of core functions to the regulator.

Second, the rise of an empowered statutory regulator, Sebi, between the government and exchanges led to a steady migration of regulatory functions. In pursuit of comprehensive oversight, Sebi absorbed key areas such as listing, disclosures, and corporate governance, leaving exchanges with a narrower remit.

Third, as markets diversified with participants, activities, and borders, exchanges lacked the reach and capacity to regulate beyond their immediate domain. The regulator, with expanding and even extra-territorial authority, filled this gap, progressively diminishing the regulatory centrality of exchanges.

In parallel, core exchange functions were unbundled. Clearing and settlement, once integral to the exchange, shifted to specialised clearing corporations, while the custody and transfer of securities moved to depositories via dematerialisation. These entities, along with exchanges, are classified as market infrastructure institutions, effectively disaggregating what was once a unified exchange-centric architecture.

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Governance reforms reinforced this hollowing out. Demutualisation diluted member control; over time, trading members disappeared from boards, and shareholder influence got moderated. While addressing conflicts, these measures distanced exchanges from both owners and users, leaving them with attenuated authority over markets they once ruled over. The 2019 amendment empowering the regulator to impose penalties of up to ₹25 crore on exchanges for non-compliance further inverted the earlier regime, where exchanges penalised constituents but were themselves largely immune.

Regulatory centralisation reduced exchanges to implementation arms. The listing agreement gave way to the Sebi (Listing Obligations and Disclosure Requirements) Regulations, 2015, with substantive norms prescribed directly by Sebi. Amendments to exchange bye-laws increasingly emanate from Sebi, while boards, dominated by public interest directors, decide matters with limited shareholder involvement. Even key managerial appointments, at times including the process, require prior regulatory approval. Collectively, these measures render exchanges akin to attached offices of the regulator, with constrained autonomy.

Yet, the SMC 2025 reverses this trajectory. Paradoxically, exchanges are being re-empowered when their for-profit, listed status makes them more susceptible to conflict. Delegating sovereign functions to a profit-seeking entity differs fundamentally from delegation to traditional broker associations or member institutes like the Institute of Chartered Accountants of India that do not pursue any bottom-line motive. The regime risks a dual regulatory state—the principal constantly disciplining the agent even as both exercise concurrent authority and parallel enforcement by exchanges and Sebi for the same violations, despite the intent to reduce overlap.

Reforms must reckon with this Benjamin Button scenario. One option is to shift regulatory functions to a separate not-for-profit entity, promoted by exchanges, Sebi, or third parties, on the lines of the Securities Exchange Commission—Financial Industry Regulatory Authority model in the US. Another alternative is to verticalise functions, with strict Chinese walls not just between business and regulation but also among the exchange's own legislative, executive, and adjudicatory roles. A third option is clearer jurisdictional demarcation, with surveillance and enforcement largely centralised in Sebi, or even a full transfer of regulatory functions to Sebi. A fourth (more structural) alternative is to revisit the for-profit model itself, reverting exchanges to not-for-profit entities with robust governance safeguards aligned to their regulatory role.

Operationalising the Sebi-exchange principal-agent framework under the SMC requires substantially more precision and legal certainty than currently evident in the Bill. Absent this, the regime risks overlapping proceedings and diffused accountability. If for-profit exchanges are mandated to perform quasi-state functions, the enabling law must also graft the wisdom of elders and the neutrality of judiciary into their souls. Lest they become an institutional mismatch—powerful in statute but conflicted in spirit.