Stock Exchanges–Managing Conflict of Interest

Rajnikant Patel
Managing Director & CEO
Bombay Stock Exchange Ltd.

At the entrance of the New York Stock Exchange building is a marvelous piece of sculpture by John Quincy Adams Ward titled " Integrity Protecting the Works of Man". It depicts integrity in the center and persons engaged in agriculture, mining, science and manufacturing on either side of it.

The statue brings out forcefully the central importance of integrity in the functioning of a stock exchange. All exchanges are the custodians of public's trust. While much has changed in how stock exchanges function since they first evolved in the commercial centers of Europe several centuries ago, the notion that the stock exchange is the repository of the investing public's trust has remained constant. Indeed, the ability to retain public trust is the sine qua non for a stock exchange.

Conflict of interest occurs when the interests of an individual (person or company) interfere with those of the investing public or the exchange. All stock exchanges have a code of ethics which places such restrictions as are deemed necessary for avoidance of conflict of interest. These restrictions relate to directorships, prohibition of insider trading and maintaining confidentiality of sensitive knowledge not in the public domain.

Historically, stock exchanges originated as mutual organizations owned by their member stockbrokers. To paraphrase Abraham Lincoln, the stock exchanges were of the members, for the members and by the members. It would be extremely naïve to expect any satisfactory resolution of the problem of conflict of interest in such an arrangement where those who make the rules, those who are expected to abide by them and those who implement them are the same entity, viz., members.

The traditional structure, clearly unacceptable in present times, has given way with stock exchanges increasingly becoming demutualised organizations where ownership and management of the exchange is totally divorced from the right to trade on it. Indeed, the emergence of the stock exchanges as public limited companies has been one of the most significant developments of recent times. Australian stock exchange, Euronext, NASDAQ and NYSE have all transformed into corporate entities. The demutualisation and corporatisation of BSE in August 2005 too was a step in the same direction.

Under the new dispensation, ownership, management and trading are in the hands of three different sets of people. An exchange is owned by its shareholders (financial institutions, banks, insurance companies, public) and managed by professionals who are not allowed to trade either directly or indirectly. Trading on the exchange remains the exclusive preserve of the members. This kind of structure greatly reduces the scope for conflict of interest and enables the exchange to pursue policies in public interest.

As a corporate entity, the exchange comes to be governed by a Board of Directors, which plays an important role in avoidance of conflict of interest. Comprising senior executives from promoter institutions, eminent professionals from the fields of law, accountancy, finance and banking besides representatives of regulatory bodies, the Board is ideally positioned to protect the interests of all stakeholders and formulate suitable policies to ensure that conflicts of interest are not allowed to compromise the integrity of the exchange.

A director is required to disclose to the Board any transaction in which he or any of his relatives is directly or indirectly interested. Similarly, a director is also required to disclose to the Board if any of his relatives is employed or it to be employed by the exchange. Senior management professionals are required to furnish similar information to the Managing Director of the exchange. The board deals with broad policy issues; decisions relating to market operations are delegated by the Board to various committees constituted by it. Such committees include representatives from trading members, professionals, the public and the management. The day to day affairs of the exchange are the responsibility of the Managing Director supported by a team of professional staff.

The Listing Agreement is also an instrument in avoidance of conflict of interest. All such agreements require the listing entity to lay down a code of conduct for its directors and senior management. The code lays down stipulations pertaining to fairness towards shareholders, compliance with laws, full disclosure, and confidentiality of both proprietary and financial information not in public domain. The listing department contributes to avoidance of conflict of interest by ensuring full disclosure. Serious violation of the code of conduct could result in suspension from the exchange.

In a move to strengthen corporate governance and avoid conflict of interest, it is incumbent upon listed companies to ensure that half the board members are non executive independent directors. In addition, all listed companies are required to have an audit committee comprising minimum three directors, two of whom should be independent directors. Chairman of the committee too has to be an independent director.

Looking ahead, the business of managing conflicts of interest is going to become extremely complicated. This conclusion is based on the emergence of three recent trends

1. The transition of the major stock exchanges from mutually owned non profit institutions to profit driven publicly traded ones – NASDAQ, NYSE, Euronext, London Sock Exchange and Deutsche Bourse have all undergone this fundamental transformation. This change from non profit to for profit, publicly listed entity is bound to bring forth a host of challenges in the management of conflicting interests and stock exchanges as well as regulatory authorities need to look at regulations de novo. Indeed the central issue before exchanges in the future would be how to simultaneously operate a profit driven exchange and regulate its members.

2. The way stock exchanges manage conflicts of interest in the future would also be impacted very significantly by globalisation of stock exchanges. With NASDAQ having bought a 25% stake in the London Stock Exchange and NYSE having announced its intention of merging with Euronext, the process of globalisation of stock exchanges has clearly begun and it would not be wrong to say that global integration of exchanges is only a matter of time.

   Sooner rather than later, this globalisation of exchanges would necessitate global regulation. Efficient execution of trades will eventually dictate integration of trading platforms and harmonization of trading rules across nations. Avoidance of conflicts of interest in a globalised world would require new ways of managing conflicting interests of stock exchanges and their members

3. The problem of managing conflicts of interest would be compounded by the introduction of new financial products that are designed to compete with one another but fall under different regulatory authorities. The regulatory regime may leave scope for ambivalence so far as managing conflicts of interest in regard to such products is concerned.

Clearly, the stock exchange of the future would be confronted with challenges substantially more complex than those faced today. Effective management of conflicts of interest would require harmonization of regulatory environment across countries and across products. We will see national regulations converging to a universally accepted model capable of grappling with the complexity of the problem of managing conflicts of interest successfully.

Stock exchanges would be required to do fairly skillful tight rope walking to ensure that the requirements of transparency do not become inhibiting factors in the growth of the exchange. The challenge would be to ensure growth in listings, value and volumes without compromising on requirements for market transparency. This is clearly not going to be easy as considerations of profit maximization would have to be tampered with the necessity to ensure strict compliance with regulatory standards.

Different exchanges have sought to find solutions to these problems in different ways. The Australian model is perhaps the one that all exchanges could usefully learn from. With a view to avoid potential conflicts between its commercial and supervisory interests, the Austrialian Stock Exchange as a listed company does not supervise itself – it is supervised by ASIC which is the designated authority for the oversight of ASX's own listing.

The ASX has achieved a fairly high degree of separation of commercial and supervisory activities. Physical and procedural structures (such as Chinese Walls and codes of conduct) will be required to separate commercial activities from supervisory activities, quarantine supervision decision making and prevent any suggestion of improper influence of commercial concerns on supervisory decision making.

The operational supervisory functions of ASX have been placed in a separate subsidiary. There is a chief supervision officer who reports to a separate supervisory board and not to the CEO of the exchange.

In a rapidly evolving environments where events are taking place at a breathtaking pace, the need for constant upgradation of surveillance mechanisms to ensure avoidance of conflict of interest cannot be over-emphasised. The failure of the stock exchanges to take firm and timely action in this regard is critical to ensure that the trust reposed in the exchanges by the investing public is not jeopardized. The integrity of the stock exchanges must be preserved at all costs. The alternate is too horrible to contemplate.