

Corporatisation and Demutualisation of Stock Exchanges



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I. What is Corporatisation and Demutualisation?

Corporatisation and Demutualisation (C&D) is a process to change the organizational structure of the stock exchanges from non-corporate mutual form to corporate demutual form where the ownership / management rights and trading rights are segregated. These rights may be held and exercised by the same

or different sets of people depending on the objectives of the C&D.

As defined in the Securities Contracts (Regulation) Act, 1956 (SCRA), 'corporatisation' means the succession of a recognised stock exchange (RSE), being a body of individuals or a society registered under the Societies Registration Act, 1860, by another stock exchange, being a company incorporated for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities carried on by such individuals or society. This requires incorporation of a company with the main objective of succeeding a RSE, which is a body of individuals or a society. The provisions relating to issue of shares, rights of shareholders, holding of equity capital by non-trading members, etc. in the SCRA make it clear that the company needs to be a company limited by shares. Hence if the RSE is already a company, it does not require to be corporatised. It may, however, change the corporate structure to that of a company limited by shares.

As per SCRA, 'demutualisation' means the segregation of ownership and management from the trading rights of the members of a RSE in accordance with a scheme approved by SEBI. The demutualisation, thus, intends to segregate the ownership and management rights from trading (including clearing) rights. This does not propose that one set of people will have only ownership and management rights and another set of people will have only trading rights. The same set of people may have both the rights simultaneously, but these must be clearly identifiable and severable. Each of these rights can be acquired, exercised and extinguished separately. This is in contrast to the current membership rights which camouflage both the rights and can not be dealt with separately. The exchanges where these rights are not segregated will have to undergo the process of

demutualisation.

As per SCRA, all RSEs, which are not corporatised and demutualised, have to be corporatised and demutualised by an appointed date as may be specified by SEBI. Different appointed dates may be specified for different exchanges. The exchanges shall be corporatised and demutualised in terms of a scheme for C&D submitted by the exchanges and approved by SEBI. The exchanges which are already corporatised and demutualised are not required to submit the scheme for C&D to SEBI.

II. Why Corporatisation and Demutualisation?

The exchanges frame and enforce rules, which may not always, further the public interest (interests of investors and the 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 the formulation and implementation of the rules. In a mutual exchange, the trading members elect their representatives to regulate the activities of the exchange, including their own activities. As a result, in case of a dispute between trading members and the investors, investors' interests may not always receive the same utmost objective treatment. The regulatory and public interest roles of the exchange may give way to private interests of the elected directors. As the self sometimes may get precedence over regulation, mutual exchanges generally do not offer an effective model for self-regulatory organisations. On realising the limitations of the mutual structure and discovering the advantages of the demutual structure, the stock exchanges all over the world are reorganising themselves as commercial entities and undergoing a process of demutualisation. This is not to say that the demutual structure is definitely a superior model for stock exchanges.

The limitations of a mutual structure has been realised time and again by the exchanges and the regulators in India. The High Powered Committee on Stock Exchange Reforms in early 1980s, the High Powered Study Group on Establishment of New Stock Exchanges in early 1990s and the Group on Corporatisation and Demutualisation of Stock Exchanges in early 2000s observed that most stock exchanges had failed to develop good corporate governance practices and strong management teams and the conflicts of interests had bedeviled the operations of the stock exchanges in the past to the detriment of the securities market. Reforms, therefore, initially focused on reducing the dominance of trading members in the management of stock exchanges by prescribing the composition of governing council and strengthening the position of

executive director. This did not materially alter the situation. The exchanges continued to witness different types of crises from time to time. The post-mortem of these has generally revealed complicity of elected directors. The investigations into the massive rigging in prices of certain scrips during May-June 1998 revealed a number of systemic deficiencies including the composition of governing councils. Before these systemic improvements could be effected, the market witnessed a major misconduct in early 2001 involving some trading members and the banking system. These led to the inevitable conclusion that the quality of trading members-managed exchanges is far from satisfactory.

In order to reduce the dominance of trading members in the ownership and management, it was considered necessary to restrict their ownership and management rights without affecting their rights to trade. Such restriction is possible only if these rights are segregated by demutualisation. Such segregation is possible only if the exchange is corporatised. The corporatisation creates two types of members, namely shareholder members and trading members. The existing trading members of the exchange are granted shareholding rights of the company and trading rights on the Exchange. The ownership and management rights associated with shareholding are restricted in case of trading members. Thus corporatisation is a necessary condition for demutualisation and demutualisation is a necessary condition for restriction on ownership and management rights of the trading members. Hence the non-corporate exchanges need to be corporatised and demutualised, while corporate exchanges need to be demutualised.

The "Statement of Objects and Reasons (SOR)" appended to the Securities Laws (Amendment) Bill 2004 (subsequently converted to the Securities Laws (Amendment) Act, 2004), stated: *Although the SCRA aims to prevent undesirable transactions in securities by regulating the business of dealing therein, the existing mutual structure of stock exchanges (except two exchanges) failed to address the conflict of interests on stock exchanges.* It amended the SCRA to mandate structural transformation of the exchanges from mutual organization form to a demutualised form by an appointed date. It also stated: *Since demutualisation separates ownership, voting rights and management from the right of access to trading, it is imperative that the representation of trading members in board of directors of stock exchanges is either not permitted at all or kept to a minimum.*

III. Preparatory Steps

March 2001: While responding to a calling attention motion by the Leader of the Opposition on extreme volatility in stock markets, the Finance Minister proposed corporatisation of stock exchanges by which ownership, management, and trading membership would be segregated from each other.

Budget 2001-02: The Income Tax Act, 1961 was amended to provide that any transfer of capital asset from an association of persons or body of individuals to a company in the course of corporatisation ('and demutualisation' added in 2002-03) of a RSE shall not be regarded as transfer for the purposes of capital gains tax.

Budget 2002-03: The process of demutualisation would be completed during the course of the year to implement the decision to separate ownership, management and operation of the stock exchanges.

November 2002: The Group on C&D of Stock Exchanges under the Chairmanship of Justice M. H. Kania for advising SEBI on C&D of stock exchanges and to recommend the steps that need to be taken to implement the same submitted its Report to SEBI on August 28, 2002. SEBI Board broadly accepted the recommendations of the Group.

December 2002: The Joint Parliamentary Committee on the stock market scam and matters relating thereto recommended that the process of corporatisation and demutualization should be expedited and underlined the necessity for early implementation of C&D of stock exchanges. The Government, in its action taken report laid before both the Houses of Parliament, assured that legislative amendments to give effect to this recommendation will be made.

Budget 2003-04: To enable corporatisation, the budget proposed amendments to the SCRA in the same Session of the Parliament. It amended the Income Tax Act, 1961 to provide that any transfer of capital asset, being a membership right held by a member of a stock exchange for acquisition of shares and trading or clearing rights, shall not be regarded as transfer for the purposes of capital gains tax.

September 2003: The Securities Laws (Amendment) Bill, 2003 was introduced in Lok Sabha to amend the SCRA to provide for C&D. The Bill was referred to the Standing Committee on Finance. However, the Bill lapsed with the dissolution of the Lok Sabha.

October 12, 2004: The Securities Laws (Amendment) Ordinance, 2004 was promulgated to amend the SCRA to facilitate the C&D of exchanges.

January 07, 2005: The Securities Laws (Amendment) Act, 2004 was enacted which replaced the Securities Laws (Amendment) Ordinance, 2004.

Budget 2005-06: In order to facilitate corporatisation / change of corporate structure without attracting stamp duty, the Indian Stamp Act, 1899 was amended to grant a one-time exemption from stamp duty on the notional transfer of assets of the exchanges in connection with corporatisation and/or demutualisation of an exchange pursuant to a scheme approved by SEBI.

2001-2005: All parties concerned such as Government, SEBI, Exchanges and Brokers debated over various approaches to C&D to evolve the most suitable model in the Indian context.

IV. Securities Laws (Amendment) Act, 2004

The Act made 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 obligated the non-corporate and mutual exchanges to submit, within such time as may be specified by SEBI, a scheme for C&D 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 two 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 C&D if the issue of shares for a lawful consideration or provision of trading rights in lieu of membership cards 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. 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.

V. Three Pillars of C&D

As stated in the SOR, the C&D aims to address the conflict of interest. The strategy envisaged is segregation of trading rights and ownership/management rights and restricting the ownership and management rights of the trading members. This essentially means that the C&D scheme must deal with the following three major aspects:

- a. Acquisition (initial and subsequent), transfer and extinguishment of ownership rights,
- b. Acquisition (initial and subsequent), transfer and extinguishment of trading rights, and
- c. Management of the stock exchanges.

a. Ownership Rights: Through the process of C&D, the exchanges would have the structure of a company limited by shares. Hence the ownership rights shall be represented by the equity shares and such shares shall be acquired, transferred or extinguished in the manner prescribed in the Companies Act, 1956, unless it is provided differently in the scheme. The scheme may provide a different manner only if it justified in the public interest or in the interest of trade. While these can be left to the Companies Act, 1956, the scheme needs to provide as to who would be the initial shareholders, because on the day one these shareholders will be indirect owners of the assets of the company and can sell the shares to realize the so far unlocked value of the exchange. While the SCRA does not directly specify who would be the initial shareholders, the provision relating to contents of the scheme and the holding of equity by non-trading members within 12 months indicate that only the existing membership card holders would become initial shareholders. In case the exchange is an association of persons, the members (membership card holders who have both trading right and management right) of the exchange will become shareholders initially. The limited trading members who do not have management right will not become initial shareholders. In case the exchange is a company limited by guarantee, the trading members will become initial shareholders. In case the exchange is already a company limited by shares, no shares will be issued at the time of C&D. The membership card holders will be entitled to shares in proportion to the number of membership cards held by them in the exchange and they will pay for the shares in cash only. Since the allotment of the initial shares will be made only to the identified people, and all will get equal number of shares and the process of C&D needs to be completed in a time bound manner, such initial allotment may not be considered as being an invitation to offer, offer, issue or allotment to the public.

b. Trading Rights

The objective of C&D is to segregate the trading rights and ownership / management rights associated with the membership cards. The holders of membership cards need to be given shares in lieu of their ownership / management rights and given trading membership in lieu of trading rights. Any other person who is having only trading rights (like limited trading member or trading member on derivative segment) needs to be granted trading membership. Hence all existing trading members of the exchange shall become trading members of the respective segments of the demutualised exchange initially. All trading members,

whether they were membership card holders or limited trading members of the mutual exchange, shall have similar rights and privileges, as the membership card holders have been granted shares in lieu of their ownership right. Thereafter, acquisition, transfer and extinguishment of trading rights will be governed by the bye-laws of the exchanges in compliance with the securities laws. A person desirous of becoming a trading member at any time would be admitted if he complies with the requirements and brings in specified fees and deposits and the exchange will have no limitation on the number of trading members. Similarly, a trading member wanting to exit the system would do so by surrendering his trading membership as per prescribed procedure and get back his refundable deposits from the exchange. While trading members may sell / transfer trading right in the market, they would also have an option to surrender the same to the exchange. This would ensure free entry and exit of trading members. In order to ensure that the trading rights and management / ownership rights remain segregated, it shall not be necessary for a person to acquire trading rights and ownership rights together.

C. Management

The objective of C&D is to reduce the influence of trading members in the ownership and management of the exchange. The influence needs to be reduced in the general body and in the governing body. Though the trading members would be exclusive shareholders initially, the SCRA requires the exchange to ensure that, either by fresh issue of equity shares to the public or in any other manner as may be specified by SEBI, at least 51% of its equity shares are held by public other than shareholders having trading rights. In order to ensure that no trading member has undue influence in the general body, the scheme may restrict the voting right of those shareholders who are trading members of the exchange. The SCRA also requires that the representation of trading members does not exceed one-fourth of the total strength of the governing body. The balance three fourth of the governing body may be constituted in the manner as may be prescribed by SEBI from time to time depending on the changing circumstances.

VI. BSE (C&D) Scheme, 2005

Vide notification dated 20th May, 2005, SEBI has approved the BSE (C&D) Scheme, 2005 with certain modifications. The broad features of the scheme are as follows:

- A for-profit company limited by shares under section 12 of the Companies Act, 1956, in the name and style of Bombay Stock Exchange Limited (BSE Ltd.) shall be incorporated to succeed BSE.
- The ownership and management rights and trading rights associated with membership cards of the BSE shall be segregated.

- The membership cardholders of the BSE shall become initial shareholders of BSE Ltd. which shall ensure that at least 51% of its equity shares are held by public other than shareholders having trading rights within 12 months.
- No shareholder, who is a trading member, shall have voting rights (taken together with voting rights held by him and by persons acting in concert with him) exceeding 5% of the voting rights in BSE Ltd.
- The Governing Board of BSE Ltd. shall be so constituted that the representatives of the trading members do not exceed one-fourth of the its total strength and the remaining directors shall be appointed in the manner as may be specified by SEBI from time to time.
- The membership card holders, limited trading members and trading members of derivative segment shall be trading members of the respective segments of BSE Ltd. initially.
- After C&D, there will be only one class of trading members with similar rights and privileges and uniform standards shall be followed in terms of capital adequacy, deposits, fees, etc while admitting any person as a trading member or accepting his surrender.
- The trading members shall clear and settle trades till the clearing and settlement functions are transferred to a clearing corporation which shall happen within one year.
- BSE Ltd. shall ensure that the existing assets and reserves transferred from BSE are utilised only for the operations of the corporatised and demutualised exchange.

VI. Next Steps

It is expected that the principles underlying the BSE (C&D) Scheme, 2005 will be applied while approving the C&D schemes submitted by other exchanges. With approval of these schemes and their successful implementation, all the exchanges in the country will be corporatised and demutualised, which would constitute a very important institutional reform in the securities market in India.

The approved C&D scheme provides that the representatives of trading members shall not exceed one fourth of the total strength of the governing body. The balance will be composed in the manner as may be specified by SEBI from time to time. Hence SEBI needs to issue the guidelines to govern composition and appointment of balance two third directors and the exchanges need to compose the boards accordingly. The scheme requires the exchanges to ensure that the non-trading members hold at least 51% of equity in the manner prescribed in the Regulations to be framed by SEBI. Hence SEBI needs to frame Regulations to provide for the manner of increasing shareholding of non-trading members on the exchange and the exchanges need to do so in compliance with the Regulations. The

scheme also requires that the clearing and settlement functions will be transferred to a recognized clearing corporation. This requires Government / SEBI to lay down a regulatory framework for governance of clearing corporations through the Securities Contracts (Regulation) Rules, 1957. The clearing corporations

will seek recognition from SEBI in terms of the said Rules and the exchanges will transfer the clearing and settlement functions to such recognized clearing corporations. Only after these are completed, the process of C&D of the exchanges shall be complete.

¹ Chief General Manager, SEBI. The views expressed in this paper are of the author and not necessarily of his employer.
