The Role of Stock Exchanges in Corporate Governance

1Subin Abraham and 2M. Kannappan
1Saveetha School of Law, Saveetha Institute of Medical and Technical Sciences, Saveetha University, Chennai.
subinkaranikulam98@gmail.com
2Saveetha School of Law, Saveetha Institute of Medical and Technical Sciences, Saveetha University, Chennai.
kannappan.ssl@saveetha.com

Abstract

The Role of the Stock Exchanges in Corporate Governance. This article is based on a paper discussed and released by the Steering Group. It serves the dual purpose of, first, providing an initial stocktaking of some of the commonly agreed main aspects of stock exchanges' influence on corporate governance; and, secondly, suggesting a number of issues arising from recent changes in the role of the exchanges. The role of stock exchanges in corporate governance has been already addressed by the work of the Steering Group. In particular, a 2004 Survey of Corporate Governance in OECD Countries (OECD, 2004) identified and discussed corporate governance codes and recommendations in a number of OECD countries. The role of exchanges in corporate governance has also been examined in work with non-member countries and further work on this topic is foreseen in the context of the Asian and Latin American Corporate Governance Roundtables.

Key Words: Corporate governance, Stock exchange, governance codes, roundtables, recommendations.
1. **Introduction**

Corporate Sectors want a wide market for trading of securities. The investors want liquidity for their investments. The securities which they hold should easily be sold when they need cash. Thus, there should be a place where the securities may be purchased and sold. Stock exchange provides such a place where securities of different companies can be purchased and sold. Stock exchange is a body of persons, whether incorporated or not formed with a view to hold, regulate and control the business of buying and selling securities. Stock exchanges provide services to the investors, corporate sectors and also to the society.\(^1\)

This project is concerned with the role of Stock exchanges in Corporate Governance. Role of exchanges in Corporate Governance has been listing and disclosure standards and monitoring compliance. Demutualisation has raised issues on the role of exchanges. After demutualisation the role of stock exchanges in Corporate Governance has changed. This project focuses on the impact of demutualisation of stock exchanges on Corporate Governance. The project is structured in following manner. Chapter-I describes the concept of stock exchange. Chapter-II is role of stock exchange in Corporate Governance. This chapter deals with the traditional role of stock exchanges that was listing, disclosure standards and monitoring compliances. Chapter-III is impact of Demutualisation of stock exchanges in Corporate Governance. This chapter deals with the changing scenario of the stock market and also corporate Governance after demutualisation of exchanges. Chapter-IV deals with the Role of SEBI in case exchanges failing short of its disclosure requirements.

2. **Research Problem**

This research paper deals with related corporate governance requirements has several disadvantages

3. **Review of Literature**

The journal discusses about the role of stock Exchange in corporate governance standards (Richard O brien ).The stock Exchange continues in its evolution from a planned economy to a market economy and includes the issues arising from corporate governance and labour resource(Stoyan tenet).\(^2\)It places recent developments in broader contexts of gradual changes in modern patterns of capitalism common to all industrial societies(Ronald Philip dore). It provides practical and succinct advice that practitioners need in field of corporate governance (Aswath Damodaran).It connoted that effective regulations of

---

corporate governance requires an assessment of how different business models of stock exchanges affect their incentives AND ability to carry out these functions (Deborah leipziger). The themes and sustainability of corporate governance argues that a better system of governance on number of levels holds the key (Dexter dunphy). The stock exchanges have played an important role corporate governance in other settings that are shaped by local context (Abdul Rasheeda). The director guidelines for improved corporate governance was also published (Gregory Francesco 1994). It also analyses the complex relationships between corporate governance and economic development by focusing on reforms of corporate governance (Thankom Arun). The role of stock exchanges is also fascinating, accessible and informative (Chris A Mallin). It enunciates the need of organisational learning and lessons of several specific recent transformations in governance practice (Robert cobbaut).

4. Objectives

To study the role of stock of exchanges in corporate governance

To examine the impact on the role of stock exchanges in corporate governance after its demutualised .

To analyse impact of demutualised of stock exchanges in different countries in corporate governance.  

Hypothesis

HO: The stock exchanges are not playing vital role in the protection of corporate governance norms.

HA: The stock exchanges are playing vital role in protection of corporate governance norms.

Research Question

Whether the role of stock exchanges is helpful in corporate governance norms or not?

5. Research Method

This study deals with the secondary data that has been collected from various books, journals, magazines, web pages, articles. This study is also non doctrinal in nature.

3 Investopedia Staff, Stock basics how stocks trade?, Investopedia. www.invetopedia.com
Chapter I

Stock Exchange

Stock exchanges are organised and regulated markets for various securities issued by corporate sector and other institutions. The stock exchange enables free purchase and sale of securities as commodity exchanges allow trading in commodities. Stock exchanges provide a platform for the buyers and sellers to purchase and sell of their stocks. Stock exchanges itself does not own shares. Instead it acts like market where stock buyers connect with their stock sellers. Stock can be traded in any stock exchanges like BSE and NSE of India. Though the meaning of stock exchange is explained but it is pertinent to know the history of stock exchanges. 4

In this Article, the birth of stock exchange will be focused. Indian stock market is marked to be one of the oldest stock market in Asia. It dates back to the close of 18th century when East India Company used to transact loan securities. In 1830s trading of corporate stocks and shares took place in Bank and cotton press first in Bombay. An informal group of 22 stock brokers started trading stocks under a banyan tree opposite Town Hall of Bombay each investing princely amount of Rupee 1. In 1860 the exchange flourished with 60 brokers. The share mania in India started when the American war broke and the cotton supply from U.S to Europe stopped. Further brokers increased to 250. The informal group of stockbrokers organised themselves as the Native Share and stock brokers association which in 1875 formally organised as the Bombay Stock Exchange.

The primary function of an exchange is to help provide liquidity; in other words, to give sellers a place to liquidate their share holdings. Stocks first become available on an exchange after a company conducts its initial public offering (IPO). In an IPO, a company sells shares to an initial set of public shareholders (the primary market). After the IPO “floats” shares into the hands of public shareholders, these shares can be sold and purchased on an exchange.

The exchange tracks the flow of orders for each stock, and this flow of supply and demand sets the stock price. Depending on the type of brokerage account you have, you may be able to view this flow of price action. For example, if you see that the “bid price” on a stock is $40, this means somebody is telling the exchange that he or she is willing to buy the stock for $40.

At the same time you might see that the “ask price” is $41, which means somebody else is willing to sell the stock for $41. The difference between the

two is the bid-ask spread. 5

Most stocks are traded on exchanges, which are places where buyers and sellers meet and decide on a price. Some exchanges are physical locations where transactions are carried out on a trading floor. The other type of exchange is virtual, composed of a network of computers where trades are made electronically. The purpose of a stock market is to facilitate the exchange of securities between buyers and sellers, reducing the risks of investing. Just imagine how difficult it would be to sell shares if you had to call around the neighbourhood trying to find a buyer. Really, a stock market is nothing more than a super-sophisticated farmers’ market linking buyers and sellers. Before explaining further it is need to understand the difference between primary market and secondary market.

**Characteristics of Stock Exchanges**

- It is a place where securities are purchased and sold.
- The trading in an exchange is strictly regulated and rules and regulations prescribed for various transactions.
- Both genuine investors and speculators buy and sell shares.
- The securities of corporations, trust, governments, municipal corporations, etc. are allowed to be dealt at stock exchanges.
- Stock exchanges are usually established at joint stock companies.
- The transactions take place between the members or their authorised agents.
- The securities are listed at stock exchange in a systematic manner and only these are traded.
- The stock exchanges are managed by the board of directors elected by shareholders.
- The exchanges are run as per certain rules and bye-laws decided earlier.

**Chapter II**

**Role of Stock Exchange in Corporate Governance**

Corporate Governance is a term that refers broadly to the rules, process or laws by which business are operated, regulated and controlled. The term can refer to internal factors defined by the officers, stockholders or constitution of a corporation as well as to external forces such as consumer groups, clients and government regulations. Historically the main direct contribution of exchanges has established themselves as promoters of corporate Governance recommendations for listed companies. Demutualisation and the Corporatization have changed the role of stock exchanges in Corporate Governance. SEBI committee defined the objective of corporate governance as the maximisation of shareholders™ wealth keeping in mind the interests of the

---

Traditional Role of Stock Exchanges

The regulating functions of stock exchanges were in the past mostly limited to issuing rule and clarifying aspects of existing frameworks. The standard-setting role of stock exchanges was essentially exercised through the issuance of listing, ongoing disclosure, maintenance and de-listing requirements. On the enforcement side stock exchanges have shared their regulatory function with the capital market supervisory agencies. Stock exchanges were also assigned the role of monitoring the compliance with the legislation and subsidiary regulation.

- Stock exchanges provide new market for securities. The securities can be listed and then traded at the exchanges. It provides an opportunity to companies to raise funds for capital issues.
- It increases goodwill to the company. The securities are listed only after the scrutiny of financial positions of a company.
- Stock exchanges provide ready market for the purchase and rate of securities. Besides new companies the existing companies also need to issue shares at the time of expansion.
- Those who invest in shares are confident of getting a ready market for their securities. The exchange provides liquidity to securities. When investors are not sure of getting ready market for their shares then they will hesitate to invest.
- The corporate sector can get information regarding trends of investment, investors, choice and priorities etc., from stock exchanges on regular basis. On the basis of this information, companies can plan their future issues.

Stock exchanges act as medium for capital formation in the country. It helps in creating the habit of savings among people. People can invest their savings in corporate and government securities. Small savings of large number of people help in capital formation in the country. Companies can sell their shares through stock exchanges. Stock exchanges provide a platform to the companies for raising additional funds. An exchange allows the trading of listed securities only. While getting the shares listed on an exchange, a company is required to follow certain guidelines for protecting the interests of shareholders. While following the guidelines of the exchange, the management of the company is also regulated.

---

6 Secondary Market Department, *Corporatization and Demutualization of stock Exchange*, (30 January 2003), www.sebi.gov.in

Chapter III
Impact of Demutualisation and Corporatization of Stock Exchanges in Corporate Governance

Historically, stock exchanges were owned, controlled and managed by a set of brokers. They set the rules and regulations which they were expected to follow. This led to a conflict of interest. In case of disputes, integrity of the stock exchanges suffered. NSE, however, was set up with a pure demutualised governance structure i.e., ownership, management and trading rights were distributed between three different set of entities. NSE™s ownership vested in the hands of banks, insurance companies, financial institutions, its management was drawn from the professionals and brokers were offered trading rights on the exchange. This separation of ownership, management and trading rights eliminated conflict of interest and provided transparency in operations. Currently all the stock exchanges in India have a demutualised set up.

Demutualisation

Demutualisation means restructuring the stock exchange and changing it from a nonprofit organisation mutually owned organisation by its members into a profitable company owned by various entities including the public. The shares of the exchange can then be distributed among members, financial institutions and the public. Done properly, a change in the status of the exchange could provide the needed capital to build the marketplace, lower costs to members and better serve investors.

Now the members of it are its shareholders. It has become a publicly traded company. When stock exchanges go for public it is demutualisation.8

Corporatization

Corporatization means stock exchange should be organised as a company. The idea is to separate ownership, management and trading rights from each other. [21]

It is not necessary that any stock exchange which is corporatised is also demutualised. There are still some stock exchanges like Calcutta Stock exchange, Bhubaneswar stock exchange, Bangalore Stock exchange etc., out of 20, 18 stock exchanges are corporate entities and need to be demutualised that it must be converted into profit-making organization.[22]

Corporatization and Demutualisation of Stock exchanges

According to section 2 (aa) of the Securities Contract and regulation Act, 1956 Corporatization means corporatization means the succession of a recognised stock exchange, being a body of individuals or a society registered under the

---

8 Section 7, Securities Contract and Regulation Act 1956.
Societies Registration Act, 1860 (21 of 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;

According Sections 2 (ab) of the SCRA, 1956 demutualization means the segregation of ownership and management from the trading rights of the members of a recognised stock exchange in accordance with a scheme approved by the Securities and Exchange Board of India.

According to section 4A of the SCRA, 1956 on and from the appointed date all recognised stock exchanges who are not corporatised and demutualised before the appointed date shall be corporatised and demutualised as per the provisions contained in section 4B. Appointed date shall be fixed by the SEBI by issuing a notification in official Gazette and SEBI can fix different appointed date for different recognised stock exchanges.9

6. Conclusion

Thus from the above discussions an inference can be drawn that Stock exchanges play a very important role in the corporate governance but recently the role of it has changed. Corporatization of Stock Exchange has no adverse effect on Corporate Governance as separation of ownership, management will cause efficiency. But profit motive of stock exchange after being demutualised may somehow affect the performance of the stock exchange in corporate governance as now it itself has become a company. There are different opinions on the performance of stock exchanges after it is demutualised. Some says that intense competition may increase the skill of the performance of stock exchange. Some other’s view is that because of profit motive it may however have adverse effect on the stock exchange. This project has commented on the main issues that present themselves when exchanges consider what is to be the exchanges most appropriate structure post-demutualization, including:

1. Corporate governance issues, such as what should be the composition of the board, whether the board should establish committees, and what share-dealing rules and policies should be introduced for the exchange’s own directors and managers.
2. Competition has increased among the stock exchanges.
3. Stock exchanges now face competition from Alternative Trading System. Investors are getting Traditional functions of the stock exchange became available from other sources and made investors seek the means that can provide liquidity more efficiently.

The discussion highlights a variety of issues that need to be addressed in order to maximise the benefits to be gained from demutualization. It is unlikely that

one set of solutions will suit all Exchanges. Each exchange will need to consider these and other issues in the light of its own particular environment.\textsuperscript{10}

7. Suggestion

However, some laws are implemented like SCRA, SEBI ACT 1992, which shall protect the interest of the investors as well as other corporate sectors which are listed in the stock exchanges for selling of its shares. SEBI plays a very important role to regulate the securities market. SEBI regulates the securities market and gives guidelines to the stock exchanges and thus protect the interest of the investors.

Some issues that should be taken into consideration are as follows:

The management of the stock exchange must be made strong.

Corporatisation and demutualisation of stock exchanges are complex subjects and involve a number of legal, accounting, Companies Act and tax issues. These issues would need careful examination, before a clear roadmap could be prepared to take this process forward. SEBI felt that it would be desirable to appoint a Group comprising of eminent personalities, in fields of law, accountancy, finance, company law affairs and taxation to advise SEBI on this matter and to recommend the steps that need to be taken to implement the announcement of the Finance Minister.

References

\begin{itemize}
  \item [2] David Harper, Getting to know the stock exchange, investopedia(22 September 2013)\texttt{http://www.investopedia.com}
  \item [3] Investopedia Staff, Stock basics how stocks trade?, Investopedia.\texttt{www.investopedia.com}
\end{itemize}

\textsuperscript{10} Shamshad Akhtar, \textit{Demutualization of stock exchanges, Problems, Solutions and case studies}, Director, Governance, Finance and Trade, East and Central Asia Department, Asian Development Bank, At 83,(2002)\texttt{http://www.set.org.com}


