Corporatization & demutualization of stock exchanges in India

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EXISTING STRUCTURE OF THE STOCK EXCHANGE IN INDIA

A Stock Exchange is an organized market for purchase and sale of listed Industrial and financial securities. Securities traded on Stock Exchanges include shares and debentures of Public Limited Companies, Government Securities, etc.

According to the Securities Contracts (Regulation) Act, 1956, Stock Exchange is an association, organization or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business in buying, selling and dealing securities[1].

Section 2 (f) of the above said Act defines recognized stock exchange as a Stock Exchange, which is for the time being recognized by the Central Government under Section 4. SEBI is empowered under Section 4 to grant recognition to Stock Exchanges.
In terms of the legal structure, the stock exchanges which are recognized under the Securities Contracts (Regulation) Act in India, can be segregated into two broad groups – 20 stock exchanges which were set up as companies, either limited by guarantees or by shares, and the 3 stock exchanges which are functioning as associations of persons (AOP) viz. BSE, ASE and Indore Stock Exchange. The 20 stock exchanges which are companies are: the stock exchanges of Bangalore, Bhubaneswar, Calcutta, Cochin, Coimbatore, Delhi, Gauhati, Hyderabad, Interconnected SE, Jaipur, Ludhiana, Madras, Magadh, Mangalore, NSE, Pune, OTCEI, Saurashtra-Kutch, Uttar Pradesh, and Vadodara. Of these, the stock exchanges of Ahmadabad, Bangalore, BSE, Calcutta, Delhi, Hyderabad, Madhya Pradesh, Madras and Gauhati were given permanent recognition by the Central Government at the time of setting up of these stock exchanges. Apart from NSE, all stock exchanges whether established as corporate bodies or Association of Persons (AOPs), are non-profit making organizations. 7 stock exchanges are set up as companies limited by shares and the remaining 13 are set up as companies limited by guarantee[1].

It is thus clear that BSE, ASE and Indore Stock Exchange will have to be both corporatized and demutualised, while of the balance 20 stock exchanges, 18 stock exchanges that are already corporate entities, will only have to be demutualised. Two stock exchanges, NSE and OTCEI, are not only corporatized but also demutualised with segregation of ownership and trading rights of members. Further, NSEIL is a for-profit company and the Board of NSEIL comprises of representatives of shareholders, (some of whom have 100% stock broking subsidiaries) and outside non-shareholder directors. But even these two stock exchanges may if necessary, have to undergo changes in organizational structure consequential to the recommendations of the Group so that a common structural model is adopted by all the stock exchanges.

**TRADITIONAL STRUCTURES OF STOCK EXCHANGES**

Internationally (as well as nationally), stock exchanges have been the product of circumstance, or of design. These differences in the origins of stock exchanges have tended to lead to differences in perceptions of the role of stock exchanges, and in views about what
their relationship with the legal system should be. Stock exchanges have also been subject to limited competition from other firms.

Historically, stock exchanges all over the world were mutual organizations owned by and run for the common benefit of their members, with no member taking profits. They were more like "clubs" where the dealers transacted business through the open outcry system.[2]

**DEMUTUALIZATION**

Demutualization refers to the conversion of an existing non-profit organization into a profits-oriented company. In other words, an association that is mutually owned by members converts itself into an organization that is owned by shareholders. The company can take different shapes and forms, that is, it could be either a listed or unlisted company which may be closely held or publicly held.

This process involves the segregation of members' right into distinct segments, viz. ownership rights and trading rights. It changes the relationship between members and the stock exchange. Members while retaining their trading rights acquire ownership rights in the stock exchange, which have a market value, and they also acquire the benefits of limited liability[1]. The shareholders in a corporatized stock exchange may be a diverse group, as members may decide to retain their shares or to sell them. Demutualization however, does not insulate them from competition. A stock exchange whose management does not effectively work to maintain its position in the market may soon become a take-over target.

This term is not restricted only to corporatization of stock exchanges. Any organization that is a non-profit body (which is not the same as loss-making), and is not distributing its profits to owner-members but retains the same to develop infrastructure of the organization, can demutualise.

For instance, Australia's life insurer and funds manager AMP recently demutualised, as did Sun Life Assurance, the Canadian insurance firm. Recently, several stock exchanges like the London Stock Exchange and two US stock exchanges, New York Stock Exchange and Nasdaq, have announced that they will demutualise.[1]
Thus recapitulating once again Demutualization refers to the transition process of an exchange from a "mutually-owned" association to a company "owned by shareholders". In other words, transforming the legal structure of an exchange from a mutual form to a business corporation form is referred to as demutualization. The above, in effect means that after demutualization, the ownership, the management and the trading rights at the exchange are segregated from one another.

A demutualised exchange is way different from a mutual exchange; the three functions of ownership, management and trading are intervened into a single Group in a mutual exchange. The broker members of the exchange over here are both the owners and the traders on the exchange and they further manage the exchange as well. A demutualised exchange has all these three functions clearly segregated.

SEBI had formed a Group on Corporatisation and Demutualization of Stock Exchanges under the Chairmanship of Justice M H Kania, former Chief Justice of India, for advising SEBI on corporatization and demutualization of exchanges and to recommend the steps that need to be taken to implement the same. The Group submitted its Report to SEBI on August 28, 2002. SEBI has taken up with Central Government to amend the SC(R) A to affect Corporatisation and Demutualization.

THE PROCESS OF DEMUTUALIZATION TAKES PLACE IN THE FOLLOWING MANNER:

The exchange values all its assets including the value of seats and arrives at a total value. This is then divided into different shares and offered to the public. Later, the shares are listed on the stock exchange itself, and the funds got by selling the shares will be distributed among the members of the exchange as payment for their seats. If the company is not being listed, the shares may be offered to the members, not for transfer.[1]

CORPORATISATION

On the other hand Corporatisation of Stock Exchanges is the process of converting the organizational structure of the stock exchange from a non-corporate structure to a corporate structure. Traditionally, some of the stock exchanges in India were established as
"Association of persons", like BSE, ASE and MPSE. Corporatisation of these exchanges is the process of converting them into incorporated Companies.[2]

FORCES BEHIND THE DEMUTUALIZATION

Demutualization as a concept is neither a very new concept nor very sophisticated. The essence lies with the separation of ownership and management. Thus it is well driven by the good intentions of proper governance, which has taken a new turn after the collapse of many large corporations in the year 2002. Although there is no exclusive definition of mutual or demutual organization, a ‘mutual’ organization is an enterprise owned by its members, providing a variety of service to the members for their benefit.[1] This also implies that mutual are not for profit organizations; are restricted in their capacity to raise equity, and are characterized by diffused decision-making power. The expression demutualization means the transition from a mutual company, in which there are no shares, and every member has one vote, to a company limited by shares and one vote per share. But it is also used to describe the process by which a company limited by shares in which every member is required to have the same number of shares, converts to a more usual economic model; or simply one where the link between membership in the exchange company or ownership of a share in it, is broken. Thus the central idea with demutualization does not only rests on the basic status of the organization i.e., whether it is “for profit” or “not for profit”. It is found that there are many “for profit” organizations even stock exchanges, which are not demutualized. The crux of the problem thus lies with the ownership of the exchange. Separation of ownership and membership is the fundamental ingredient of the demutualization as well as the essence of effective governance. The issues addressed here are essentially those arising from permitting non-brokers to own stake in the exchange, and brokers not to have an ownership interest of any kind or to have ownership to a limited extent.
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