VIII. CARVING A COMPETITIVE LANDSCAPE IN THE TRADING SPACE: ASSESSING THE PROPOSED OWNERSHIP STRUCTURE FOR STOCK EXCHANGES IN INDIA

- Rashmi Birmole*

ABSTRACT

Given the dynamic nature of financial markets, the need to introduce inter-exchange competition assumes paramount importance for an investor to exercise choice, and for the market to adapt to evolving challenges at large. At present, the competitive landscape in the Indian trading space pales in comparison to global developments. Market infrastructure in India has been in a state of duopoly for the last two decades, raising concerns about excessive concentration of market share and its unintended stagnating consequences on innovation. To address these concerns, the Securities and Exchange Board of India recently released a Discussion Paper on Review of Ownership and Governance Norms for facilitating new entrants to set up Stock Exchange/Depository for public consultation. The framework proposed in the paper aims to introduce competition in the trading space and facilitate the setting up of new stock exchanges by lowering a crucial entry barrier, i.e., the default precondition of dispersed shareholding, as is imposed by the extant ownership framework. Through this paper, the author attempts to analyse the possible repercussions of the proposed framework on inter-exchange competition and puts forward recommendations and issues that ought to be considered prior to implementation. In the course of doing so, the author also discusses factors that have contributed to the emergence of duopoly in stock exchanges, while briefly commenting on the shortcomings of the dominance and the dispersed ownership model.

* The author is a fourth-year student of B.A. LL.B. at ILS Law College, Pune. Views stated in this paper are personal.

I. INTRODUCTION

The end of what could perhaps be termed as the most unprecedented year in human history, witnessed the launch of three new stock exchanges in the United States of America ("**US**"), bringing the count to a total of 16 stock exchanges presently operating in the country.[1] The launch was expected to increase competition against heavyweights like the New York Stock Exchange (**"NYSE"**) and NASDAQ, and potentially lower the trading costs in the financial markets. The author's intention of beginning with a contemporary illustration is to emphasize the dramatic changes that stock markets are presently undergoing on a global front. With globalization taking a hold over capital markets around the world, investors are becoming increasingly wary

[1] John McCrank, *Competition to heat up among U.S Stock Exchanges with new entrants,* REUTERS (Mar 21, 2021), https://www.reuters.com/article/us-usa-exchanges-idUSKBN25H23K.

of better trading facilities and market efficiency.[2] The rapid strides made by the global FinTech industry has made innovation become an absolute imperative to drive future growth and address industry challenges in the financial markets.

Taking a leaf out of the book of other jurisdictions, the Securities and Exchange Board of India ("**SEBI**") released a Discussion Paper on Review of Ownership and Governance Norms for facilitating new entrants to set up Stock Exchange/Depository ("**Paper**") on January 06, 2021, proposing changes to the extant framework under the Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2018 ("**SECC Regulations**"). The proposed changes address the sine qua non of introducing competition in the Market Infrastructure Institutions ("**MII**") space, i.e., low entry barriers, the absence of which has inhibited new players from setting up or acquiring existing stock exchanges on account of the default pre-condition of dispersed shareholding at the initial stage itself. At the outset, the recommendations outlined in the Paper seem radical and pathbreaking, coming second only to the corporatisation and demutualization of stock exchanges which was undertaken in 2005 to separate exchange ownership and management in India.

II. EMERGENCE OF DOMINANCE IN THE TRADING SPACE

The National Stock Exchange of India Ltd. ("**NSE**") first commenced operations in 1994 with the launch of the wholesale debt market.[3] At the time,

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[2] All Answers Ltd., *Competition and Integration of Stock Exchanges*, UKDISS.COM (Mar 25, 2021), https://ukdiss.com/examples/competition-stock-exchange.php?vref=1.

[3] *History and Milestones*, NATIONAL STOCK EXCHANGE OF INDIA LTD., (Mar 21, 2021), https://www.nseindia.com/national-stock-exchange/history-milestones.

the Bombay Stock Exchange ("**BSE**") occupied the position of the dominant stock exchange in a market with nineteen others operating across India but remained plagued with outdated trading and settlement procedures. BSE's Sensex, a value weighted equity index, is regarded as a barometer to this day and is presumed to reflect the economic development and health of the country. Soon after its launch, NSE dramatically improved the quality of trading services offered, and soon surpassed BSE and the other stock exchanges to become the exchange of choice,[4] with the use of superior technology, professional management and foreign investor preference driving its growth.[5]

Presently, NSE and BSE command dominance in the Indian trading space out of the nine exchanges operating in India (inclusive of the affiliates of NSE and BSE), both in terms of trading volumes and market shares. In the year 2019-20 itself, NSE amassed profits to the tune of INR 1560 crores,[6] and a majority share in the equity derivatives and cash segments of the capital markets.[7] In addition to their extensive reach and technological efficiency, the journey of the two stock exchanges into dominant market players was also catalysed by the decline of regional stock exchanges in the Indian financial

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[4] Chandrasekhar Krishnamurthy, John. M. Sequeira, Fangjian FU, *Stock Exchange Governance and Market Quality*, 27 JOURNAL OF BANKING AND FINANCE 1859, 1861-1862 (2003).

[5] *NSE may overtake BSE in market cap for the first time*, LIVE MINT, Aug 09, 2009, https://www.livemint.com/Money/umDdFDlhn3bfHf1BkDvrZP/NSE-may-overtake-BSE-in-marketcap-for-the-first-time.html.

[6] *NSE Annual Report 2019-20*, NATIONAL STOCK EXCHANGE OF INDIA LTD., (Mar 25, 2021), https://www1.nseindia.com/global/content/about_us/NSE_Annual_Report_2020.pdf.

[7] Chiranjivi Chakraborty, *SEBI prepares ground to end NSE's dominance with liberal ownership norms for MIIs*, THE ECONOMIC TIMES, Jan 06, 2021, https://economictimes.indiatimes.com/markets/stocks/news/sebi-prepares-ground-to-end-nses-dominance-with-liberal-ownership-norms-for-miis/articleshow/80137053.cms?from=mdr.

markets. Moreover, the high entry barriers in terms of minimum net worth and dispersed shareholding requirements in the existing regulatory framework played a crucial role in strengthening the dominant position of NSE and BSE in the Indian trading space.

A. Decline of Regional Stock Exchanges

The advent of electronic trading in the year 2000 and the extension of the nationwide reach of the trading terminals, brought with it a simultaneous decline in the trading volumes of all regional stock exchanges ("**RSEs**") in India.[8] RSEs, which were primarily established to cater to the needs of regional allocation of capital and investors, lost their relevance. The prior requirement of compulsory listing by companies on RSEs located in the areas where the main works or fixed assets were situated, proved to be a compliance burden. Consequently, SEBI took steps towards the withdrawal of the requirement and issued the SEBI (Delisting of Securities) Guidelines, 2003, permitting listed entities to voluntarily delist from RSEs provided that they remain listed on an exchange with nationwide terminals.[9] This step, in turn led to a further decline in the operations of the RSEs, which soon after turned defunct. In 2008, SEBI issued an exit policy for RSEs whose recognition had been withdrawn, renewal had been refused or those that wished to voluntarily surrender their recognition.[10] The policy was subsequently reviewed and

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[8] Sujit Kumar Acharya et al., *Relevance of Regional Stock Exchanges in India*, 1 SEARCH – A JOURNAL OF ARTS, HUMANITIES AND MANAGEMENT 43, 46 (2012).

[9] Securities and Exchange Board of India, SEBI (Delisting of Securities) Guidelines, 2003, SMD/Policy/Cir-7,2003 (Issued on Feb 17, 2003), SEBI, https://www.sebi.gov.in/legal/circulars/feb-2003/circular-no-7-dated-february-17-2003_15827.html.

[10] Securities and Exchange Board of India, Guidelines in respect of exit option to Regional Stock Exchanges, MRD/DoP/SE/Cir- 36 /2008 (Issued on Dec 29, 2008) SEBI,

reissued in 2012,[11] requiring non-operational RSEs to compulsorily delist on failure to meet the stated turnover and net worth requirements within the specified time. These developments were the primary factors driving the decline of RSEs in India, all the while stimulating the growth of NSE and BSE as the leading exchanges in the trading space.

B. Shortcomings – Technical and Competition Concerns

Concerns surrounding the excessive concentration of market share in the hands of NSE and BSE and the possibility of anti-competitive conduct and institutional tardiness in responding to the changing dynamics of the financial market are outlined as few of the reasons necessitating a review of the present framework. Disruption in trading activities caused on account of technical glitches faced by investors and market participants is not an uncommon phenomenon.[12] In a recent occurrence, trading on the terminals of NSE went through a four-hour long suspension following technical snags faced in the risk management system.[13] Traders in the derivative segment complained of

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https://www.sebi.gov.in/legal/circulars/dec-2008/guidelines-in-respect-of-exit-option-to-regional-stock-exchanges_6994.html.

[11] Securities and Exchange Board of India, Exit Policy for De-recognized/Non-operational Stock Exchanges, CIR/MRD/DSA/14/2012 (Issued on May 30, 2012), SEBI, https://www.sebi.gov.in/legal/circulars/may-2012/exit-policy-for-de-recognized-non-operational-stock-exchanges_22825.html.

[12]See *Technical glitch hits trading in Bank Nifty*, THE HINDU (Jun 04, 2020), https://www.thehindu.com/business/technical-glitch-hits-trading-in-bank-nifty/article31751271.ece;

Palak Shah, *Brokers shoot off letter to NSE over technical glitch*, THE HINDU BUSINESS LINE (Nov 19, 2019), https://www.thehindubusinessline.com/markets/stock-markets/nse-trading-disruption-brokers-shoot-off-> complaint-letter/article30018153.ece;

National Stock exchange impacted by technical glitch intra day trading affected, THE FIRST POST (Jun 04, 2020), https://www.firstpost.com/tech/news-analysis/national-stock-exchange-impacted-by-technical-glitch-intra-day-trading-affected-3835947.html.

[13] Palak Shah, *Tech-glitch brings trading to a halt at NSE for four hours*, THE HINDU BUSINESS LINE (Feb 24, 2021), https://www.thehindubusinessline.com/markets/stock-markets/tech-glitch-brings-trading-to-a-halt-at-nse-for-four-hours/article33926628.ece.

losses and NSE's failure to migrate to the disaster recovery site came under heavy criticism. Claims surrounding technical malfunction in the BSE tendering page were also made in respect of the recent delisting offer made by Vedanta Limited,[14] which fell through for lack of the minimum participation required for the process to be deemed a success under the erstwhile SEBI (Delisting of Equity Shares) Regulations, 2009.[15]

The frequent technical snags faced by investors on trading terminals become more problematic when viewed from the perspective of institutional difficulty and lack of judicial precedent in imposing financial liability on exchanges for losses suffered by investors on account of such technical malfunctions or suspensions.[16] As per SEBI's mandate, stock-brokers are required to follow prescribed uniform documentation to simplify the trading account opening process with their clients.[17] An integral part of the standard documentation that is executed with clients is the document outlining the 'Rights and Obligations of stock-broker, sub-broker, and client for trading on exchanges',[18] which contains clauses that categorically amount to a relinquishment of any claim against the exchange on account of any

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[14] Hormaz Fatakia, *Vedanta Delisting Offer Fails*, BLOOMBERG QUINT (Oct 10, 2020), https://www.bloombergquint.com/markets/vedanta-delisting-offer-fails.

[15] Regulation 17, Securities and Exchange Board of India (Delisting of Equity Shares) Regulations, 2009, PART III SEC. (IV), THE GAZETTE OF INDIA, https://www.sebi.gov.in/sebi_data/commondocs/delisting2009_p.pdf.

[16] Sachin Mampatta, *Seeking compensation for tech glitches could be a tough task for investors*, THE BUSINESS STANDARD (Mar 04, 2021), https://www.business-standard.com/article/markets/seeking-compensation-for-tech-glitches-could-be-a-tough-task-for-investors-121030300139_1.html.

[17] Securities and Exchange Board of India, Simplification and Rationalization of Trading Account Opening Process, CIR/MIRSD/16/2011 (Issued Aug 22, 2011), https://www.sebi.gov.in/sebi_data/attachdocs/1314013806825.pdf#page=1&zoom=page-width,-16,300.

[18] *Id.* at Annexure 4.

"suspension, interruption, non-availability, or non-functioning of the exchange's service or systems". These documents also indicate the client's acknowledgement of the uncertainty of trading over the internet and the absence of any representations and warranties made by the exchange with reference to the same. By and large, the aforementioned processes, coupled with the unavailability of alternative exchanges and terminals, limit an investor's ability to recover losses faced on account of such technical snags and disruption in trading, and place investors in an inherently disadvantageous position. The proposals outlined in the Paper, in addition to the recent introduction of 'Financial Disincentives' that stock exchanges are mandated to pay in the event of technical glitches and disruption,[19] can be viewed as a part of SEBI's ongoing efforts to tackle these issues. Firstly, doing away with dispersed ownership requirements and effectively introducing competition in the MII space may lead to a potential reduction in instances of technical snags and business disruption as stock exchanges will be compelled to adopt efficient practises in order to stay relevant and profitable. Secondly, the setting up of new stock exchanges will permit investors to exercise choice, an element that the present state of market infrastructure fails to offer.

NSE's dominant position and its possible abuse was recently assessed by the Competition Commission of India ("**CCI**") in *Manoj K Sheth v. National Stock Exchange of India Ltd.*,[20] in the context of its co-location

[19] Securities and Exchange Board of India, Standard Operating Procedure for handling of technical glitches by Market Infrastructure Institutions (MIIs) and payment of 'Financial Disincentives' thereof, SEBI/HO/MRD1/DTCS/CIR/P/202 (Issued Jul 05, 2021), https://www.sebi.gov.in/legal/circulars/jul-2021/standard-operating-procedure-for-handling-of-technical-glitches-by-market-infrastructure-institutions-miis-and-payment-of-financial-disincentives-thereof_50903.html.
[20] Manoj K Sheth v. National Stock Exchange of India Ltd., 2021 SCC OnLine CCI 38.

facility, and largely pertained to the preferential access granted to high frequency traders and market participants by way of the co-location servers located within the premises. In the matter, the informant alleged that NSE had created artificial information asymmetry and manipulated the market by granting access to its servers in a preferential manner. While CCI delineated the relevant market as the "market for providing co-location services for algo-trading in securities to the trading members in the territory of India", it noted that NSE would still remain dominant if the scope of the relevant market was extended to traditional non-algorithmic trading. However, there was no *prima facie* case of anti-competitive conduct made out against NSE. The actions and policies of NSE in relation to its co-location facility have also previously come under CCI's scrutiny in *Advocate Jitesh Maheshwari v. National Stock Exchange of India Ltd*.[21] At the time, CCI decided against delving into the allegations for want of sufficient information and data to form a *prima facie* view about NSE's role in providing discriminatory co-location services. While accepting that the grant of preferential access led to the denial of market access to others, CCI's decision to drop the matter was primarily motivated by SEBI's ongoing investigation into the same.

In the past, a finding of abuse of dominance by NSE was arrived at in *MCX Stock Exchange Ltd. v. National Stock Exchange of India Ltd*.,[22] where CCI imposed a penalty to the tune of INR 55.5 crores on NSE for abuse of dominant position under the Competition Act, 2002,[23] for, *inter alia*, having

[21] Advocate Jitesh Maheshwari v. National Stock Exchange of India Ltd., 2019 SCC OnLine CCI 13.
[22] MCX Stock Exchange Ltd. v. National Stock Exchange of India Ltd., 2011 SCC OnLine CCI 52.
[23] Competition Act, 2002, Act No. 12, Acts of Parliament, 2003, § 4(2).

waived transaction fees in respect of currency futures trades executed on its platform and adopting a predatory pricing policy. On an appeal preferred by NSE to the Competition Appellate Tribunal, the order of the CCI was upheld.[24] The Supreme Court, on appeal, stayed the order imposing penalty on NSE and the matter is presently sub-judice. From the foregoing discussion, it can be observed that CCI has consistently found NSE to occupy a dominant position in the trading space. While occupying a dominant position is not a violation in itself, it has significant repercussions on the smooth functioning of a market as dynamic as the financial market, where the slightest possibility of abuse carries with it the risk of considerable monetary losses for investors and general loss of confidence in the market. Thus, the proposals outlined in the Paper can be viewed as an attempt to counter this risk and eliminate this long-held dominance by introducing efficiency and competition in the financial market.

III. OWNERSHIP NORMS IN STOCK EXCHANGES – REGULATORY OVERVIEW

A. Existing Limits on Shareholding

Limits on shareholding and ownership in stock exchanges were introduced post-de-mutualization through the Securities Contracts (Regulation) (Manner of Increasing and Maintaining Public Shareholding in Recognized Stock Exchanges) Regulations, 2006,[25] which also mandated stock exchanges to maintain a minimum public shareholding of 51%. In 2012, the said regulations

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[24] National Stock Exchange of India Ltd. v. Competition Commission of India, 2014 SCC OnLine Comp AT 37.

[25] Securities Contracts (Regulation) (Manner of Increasing and Maintaining Public Shareholding in Recognized Stock Exchanges) Regulations, 2006, PART II SEC. (III) (2), THE GAZETTE OF INDIA, https://www.sebi.gov.in/acts/screguupdate.pdf.

were repealed with the issuance of the Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2012,[26] which imposed similar limits on shareholding and voting rights under Chapter IV of the regulations. These regulations were subsequently replaced with the Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2018 ("**Regulations**"),[27] which govern ownership in stock exchanges at present. Under the Regulations, the maximum shareholding in a stock exchange is capped at 5% for persons, acting individually or with persons acting in concert, and at 15% for specific classes of institutions, including banks, insurance companies and depositories, respectively.[28] With respect to foreign ownership, persons acting individually or with persons acting in concert, are permitted to hold up to 5% shareholding, and institutions up to 15% of the total shareholding,[29] with an additional cap of 49% on the combined holding of all persons' resident outside India.[30] The requirement on maintaining 51% public shareholding has also been retained in the extant Regulations.[31]

B. Prior Attempts at Review

The scope of setting up new stock exchanges in India and introducing fair competition was first explored by the Committee on the Review of

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[26] Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2012, PART III SEC. (IV), THE GAZETTE OF INDIA, https://www.sebi.gov.in/sebi_data/attachdocs/1340272091708.pdf.

[27] Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2018, PART III SEC. (IV), THE GAZETTE OF INDIA, https://www.sebi.gov.in/legal/regulations/oct-2018/securities-contracts-regulation-stock-exchanges-and-clearing-corporations-regulations-2018_40630.html.

[28] *Id.* at Regulation 17(2).

[29] *Id.* at Regulation 17(3).

[30] *Id.* at Regulation 17(4).

[31] *Id.* at Regulation 17(1).

Ownership and Governance of Market Infrastructure Institutions, also known as the Bimal Jalan Committee, in 2010. The Committee, in its report,[32] recognized the negative consequences of dispersed shareholding on an investor willing to further the operational interests of the firm. However, it went on to justify the existing framework as a way to exercise sufficient control on a stock exchange which is also entrusted with regulatory functions. Taking note of the committee's suggestion to review the norms after a period of five years, a committee was constituted under the Chairmanship of Shri R. Gandhi to review the existing framework governing MIIs in 2017,[33] which proposed stricter governance requirements and proposed classifying intermediaries like registrar and transfer agents as MIIs.

IV. PROPOSED CHANGES TO THE EXTANT FRAMEWORK

A. Ownership Norms

I. Setting up an MII – domestic promoters

The Paper proposes to liberalize the existing ownership framework and permit promoters to hold up to 100% of the shareholding in an MII, subject to gradual dilution to 51% or 26 % over 10 years.

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[32] Securities and Exchange Board of India, *Report of the Committee on 'Review of Ownership and Governance of Market Infrastructure Institutions'* (2010), GOVERNMENT OF INDIA, https://www.sebi.gov.in/sebi_data/commondocs/marketinfraAnnexA_p.pdf.

[33] *See* Press Release, Securities and Exchange Board of India, SEBI seeks public comments on Report submitted by Committee on Review of Regulations and Relevant Circulars pertaining to Market Infrastructure Institutions (MIIs) (May 04, 2018), https://www.sebi.gov.in/media/press-releases/may-2018/sebi-seeks-public-comments-on-reports-submitted-by-committee-on-review-of-regulations-and-relevant-circulars-pertaining-to-market-infrastructure-institutions-miis-_38855.html.

II. Setting up an MII - foreign promoters

Further, foreign promoter individuals or entities belonging to Financial Action Task Force ("**FATF**") compliant countries are allowed to hold up to 49% of the shareholding in an MII, subject to similar gradual dilution requirements. The period of 10 years is reduced to 5 years for foreign promoter individuals and entities belonging to jurisdictions that are no longer members of the FATF. The Paper seeks to retain the existing restriction on the combined holding of persons resident outside India of 49 % of the shareholding in an MII.

III. Domestic acquisition in an existing MII

The Paper permits domestic individuals and entities to acquire and hold up to 100% of the shareholding of an MII, provided that acquisitions beyond 25% shall be subject to SEBI's approval. Acquisitions of a stake beyond 25% shall also be gradually diluted to 51% or 26% over 10 years from the date of closure of the open offer.

IV. Foreign acquisition in an existing MII

The paper proposes a set of conditions similar to the ones applicable to foreign promoters seeking to set up an MII in India for foreign individual or entities looking to acquire a shareholding in an existing MII. Foreign individuals and entities belonging to FATF member jurisdictions are permitted to acquire and hold up to 49% of the shareholding of an MII, provided that acquisitions beyond 25% shall be subject to SEBI's approval. Acquisitions of a stake beyond 25% shall also be gradually diluted to 51% or 26% over 10 years from the date of closure of the open offer.

V. DISPERSED SHAREHOLDING MODEL – A PRIMER

The proposals outlined in the Paper have been premised on the understanding that a dispersed shareholding model inhibits competition between stock exchanges by depriving a promoter of exercising sufficient control, thereby limiting upside gains arising out of entrepreneurial capital. Understanding the repercussions of the proposals on inter-exchange competition necessitates a closer look at the dispersed shareholding model and its various drawbacks.

Entities with widely dispersed shareholding fall within the 'outsider' system of corporate governance, which places a higher emphasis on the protection of minority shareholder rights and informational transparency.[34] However, the inherent fragmentation of ownership makes it difficult for shareholders to take collective decisions and acts as a barrier in exercising control. It can be reasonably understood that shareholders in such entities have little economic incentive to actively engage in corporate governance and monitor the management,[35] rendering the management largely unaccountable for their actions. This creates a clear demarcation between the domains of ownership and management, introducing agency problems that are typically associated with such shareholding models. The separation of ownership and professional management in entities with dispersed shareholding models are known to result in the divergence of shareholders' and managers' interests, which may have some significant implications on performance and

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[34] ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT [OECD], CORPORATE GOVERNANCE: EFFECTS ON FIRM PERFORMANCE AND ECONOMIC GROWTH, at 47, (1999), https://www.oecd.org/sti/ind/2090569.pdf.

[35] Jonathan Mukwiri, Mathias Siems, *The Financial Crisis: A Reason to Improve Shareholder Protection in the EU?*, 41 JOURNAL OF LAW AND SOCIETY 51, 61 (2014).

innovation. For instance, since a manager's position, personal wealth and prestige is tied to an entity's performance, he may prefer low-risk projects which yield short-term returns over projects which are aimed at the long- term profitability and performance.[36] This is because managers usually do not have a financial interest in ensuring the optimal performance of an entity,[37] but are exposed to employment risk, which unlike financial risk, cannot be managed by diversification. However, a dispersed shareholding model can have a favourable effect when innovative activity and entrepreneurial gain rely on external funding from market participants, which is attracted by the presence of minority shareholder protection and transparency, which such models are known to guarantee. Conversely, shareholders of entities with concentrated ownership patterns have a strong incentive to monitor and exercise better control over the actions of the management, which comes at the cost of a host of difficulties in terms of innovation and performance. The presence of shareholders with consolidated shareholdings may influence the independence of the management in a self-serving way and impede their ability to take independent and rational decisions. While the concentrated shareholding model may not be the ultimate answer to all agency problems, the Paper's reliance on the model to encourage the setting up of new stock exchanges is reasonably well placed.

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[36] Barry D. Baysinger et al., *Effects of Board and Ownership Structure on Corporate R&D Strategy*, 34 THE ACADEMY OF MANAGEMENT JOURNAL 205, 205 (1991).
[37] Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VIRGINIA LAW REVIEW 789, 790 (2007).

VI. INTER-EXCHANGE COMPETITION IN THE US AND EUROPEAN UNION

A. The United States

The equity markets of the US are inarguably one of the most developed and sophisticated financial markets in the world. The Securities Exchange Commission's ("**SEC**") vision with respect to inter-exchange competition is focused on encouraging a structure in which exchanges compete for trading volume in individual stock instead of listing.[38] Resultantly, competition among exchanges is based on incentives for attracting order flow. The Securities Exchange Act, 1934, the principal enactment governing securities exchanges in the US, initially barred brokers from transacting in any security unless it was registered and listed on that specific exchange.[39] This effectively gave the exchange on which the stock was listed monopoly over trading in that stock. Consequently, the requirement was amended in 1994 through the Unlisted Trading Privileges Act to permit stocks to trade on all exchanges, independent of where the stock was technically listed.[40] In a bid to further encourage competition among stock exchanges, the SEC urged the creation of a central market linking the various venues where stock is traded. SEC's report led to the creation of a National Market System (**"NMS"**) through the Securities Acts Amendments of 1975, aimed at promoting competition

[38] Paul G. Mahoney et al., *The Regulation of Trading Markets: A Survey and Evaluation*, *in* SECURITIES MARKET ISSUES FOR THE 21ST CENTURY 222, 223 (Merritt Fox, Lawrence Glosten, Edward Green, Menesh Patel ed., 2018).

[39] The Securities Exchange Act, 15 U.S.C § 12(a) (1934).

[40] Eric Budish Robin S. Lee John J. Shim, *A Theory of Stock Exchange Competition and Innovation: Will the Market Fix the Market?* (National Bureau of Economic Research, Working Paper No. 25855, 2019), https://www.nber.org/system/files/working_papers/w25855/w25855.pdf.

between trading venues.[41] Among other changes, the amendment inserted Section 11A in the Securities Exchange Act, 1934, the rules created under which were subsequently recast and introduced through a massive set of rules known as Regulation NMS which took effect in 2007.[42] Regulation NMS ushered in a new era of competition and allowed brokers to view quotations in every market that the stock is trading in, and route the customer's order to the exchange offering the best price. Rule 611 of the regulation, also known as the 'Order Protection Rule' prohibits an exchange from executing a trade at a price that is inferior to that of a 'protected quote' on another exchange. The rule is primarily aimed at preventing what are known as 'trade-throughs' or execution of trades at a price inferior to that available in another exchange. Overall, these developments have led to market wide connectivity, acceleration in trading volumes and reduction in cost.[43] These measures have also enabled retail investors in the US to trade with greater convenience and lower commissions.

C. European Union

Prior to 2007, stock exchanges in the European Union ("**EU**") were regulated by the Investment Services Directive ("**ISD**"),[44] which primarily sought to facilitate a single European market for all financial services and products. The "single passport" regime created under the directive permitted

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[41] Pierre-Cyrille Hautcoeur, Amir Rezaee, Angelo Riva, *Competition among Securities Markets: Stock Exchange Industry Regulation in the Paris Financial Center at the Turn of the Twentieth Century* (INCAS Project Discussion Paper No. 8 (2018), https://halshs.archives-ouvertes.fr/halshs-01863942/document.

[42] Regulation NMS, 17 C.F.R. § 200, 201, 230, 240, 242, 249, 270 (2005).

[43] Phil Mackintosh, *Regulation NMS for Dummies*, (Mar 25, 2021), https://www.nasdaq.com/articles/reg-nms-dummies-2019-05-09?.

[44] Council Directive 93/22/EEC of the European Parliament and Council of 11th June 1993 on Investment Services in the securities field, O.J. (L 141) [Hereinafter *Investment Services Directive*].

investment firms to offer services in all member states, based on host state authorization and supervision, without being subjected to additional licensing procedures. Full and fair access to stock exchanges classified as 'regulated markets' by host states to investment firms was another ISD mandate. ISD's reliance on mutual recognition proved insufficient in ensuring the operability of investment firms across the EU,[45] and was replaced by the European Commission in an ongoing effort to increase competition among exchanges. The Directive on Markets in Financial Instruments ("**MiFID**") subsequently came into force in 2007 through the 'Lamfalussy' process in stages,[46] with an overarching objective of creating an integrated financial market. Widely regarded as the cornerstone of the EU's regulation of financial markets,[47] the MiFID abolished the "concentration" rule which was found to have a stifling effect on competition and strengthened the segregation of financial markets along national boundaries.[48] As it earlier stood, the rule vested in member states the right to require investment firms to carry out transactions solely on regulated markets where the security in question was listed and the right to exempt resident investors from the rule, contingent on obtaining express member state authorization.[49] This invariably exposed existing exchanges to

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[45] *Commission Proposes New Directive on Investment Services*, INTERNATIONAL LAW OFFICES, (Mar 27, 2021), https://www.internationallawoffice.com/Newsletters/Banking-Financial-Services/European-Union/Oppenheimer-Wolff-Donnelly/Commission-Proposes-New-Directive-on-Investment-Services.

[46] Council Directive 2004/39/EC of the European Parliament and Council of 21st April 2004 on Markets in Financial Instruments, O.J. (L 145).

[47] *Investment services and regulated markets – Markets in Financial Instruments Directive (MiFID*), The EUROPEAN COMMISSION, (Mar 28, 2021), https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-markets/securities-markets/investment-services-and-regulated-markets-markets-financial-instruments-directive-mifid_en.

[48] Stavros Gkantinis, *Regulation and Innovation: Comparing U.S and European Equity Trading Markets* (Harvard Law School Student Scholarship Series Paper No. 13 (2006), https://core.ac.uk/download/pdf/5080561.pdf.

[49] Investment Services Directive, art.14.

competition from multilateral trading facilities which were subjected to pre and post trade transparency requirements to ensure a level playing field between exchanges and new competitors.[50] In addition to eliminating barriers to cost border trading, the MiFID also introduced improved requirements inter-alia transaction reporting, transparency, risk management and best execution practises,[51] which enabled investors to source quality services at competitive prices, which in turn was instrumental in building investor confidence. On identification of certain shortcomings faced during the global financial crisis, an updated version of the MiFID supported with a corresponding regulation,[52] was adopted in 2014 and took effect in 2018,[53] and seeks to enhance trading on both regulated and multilateral trading platforms and remains applicable to this date.

VII. COMPETITIVE POSITIONING IN THE TRADING SPACE – PROSPECTS

At its core, the Paper recognizes the intersection between technology and financial markets and the need to lead with innovation. Given SEBI's highly prescriptive approach, the proposed changes directed towards easing ownership norms in the stock exchange seem entirely antithetical to the recommendations of the Bimal Jalan Committee but aligned in the right direction. With exchanges around the world competing amongst each other,

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[50] Press Corner, *Markets in Financial Instruments Directive (MiFID): Frequently Asked Questions*, THE EUROPEAN COMMISSION, (Mar 25, 2021), https://ec.europa.eu/commission/presscorner/detail/en/MEMO_07_439.
[51] *Id.* at FAQ no. 6.
[52] Commission Regulation No. 600/2014 of the European Parliament and Council of 15th May 2014 on Markets in Financial Instruments, O.J. (L 173).
[53] Council Directive 2014/65/EU of the European Parliament and Council of 15th May 2014 on Markets in Financial Instruments, O.J. (L 173).

other quasi-exchanges and automated trading systems,[54] it is high time that SEBI jumps on the bandwagon. To that extent, it can be reasonably concluded that the recommendations in the Paper have come at an opportune time.

The underlying idea is to compel existing exchanges to adapt to financial technology and other investor initiatives to remain efficient in an ever-evolving competitive market while facilitating the entry of new exchanges in the market. Easing the existing stringent ownership limits in stock exchanges in the initial stages is likely to spur investment by deep pocketed promoters, both domestic and foreign, truly invested in advancing the capabilities of the stock exchange. A regulatory framework that allows promoters and acquirers to have 'skin in the game' by way of concentrated shareholding in a stock exchange seems like a step forward in the direction of operational and competitive efficiency.

Another crucial factor that warrants consideration is a stock exchange's regulatory and surveillance functions and its role as a public fiduciary. As a matter of fact, a dispersed ownership structure was primarily justified on the basis of a stock exchange's systemic importance in the financial market, and its status as a public utility.[55] In addition to acting as a trading facility for a wide range of asset classes, stock exchanges are also entrusted with functions including inter-alia risk containment through margin requirements, capital adequacy of members, etc., market surveillance, governance of trading members, and investigation and resolution of investor complaints filed against

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[54] Mahmood Bagheri, Chizu Nakajima, *Competition and Integration among Stock Exchanges: The Dilemma of Conflicting Regulatory Objectives and Strategies*, 24 OXFORD JOURNAL OF LEGAL STUDIES 69, 72-75 (2004).
[55] Securities and Exchange Board of India, Board Meeting Memorandum dated Jun 21, 2018, https://www.sebi.gov.in/sebi_data/meetingfiles/jul-2018/1531116664373_1.pdf.

trading members and listed companies. In light of the same, ensuring that an exchange's identity as a 'first-level regulator' remains uncompromised in the face of its commercial endeavours should be prioritized before any decision on the proposed ownership structure is made. It is advisable to divest stock exchanges of their regulatory functions and bring the latter under SEBI's purview, in a centralized manner.[56] On that note, determinations surrounding the eligibility of promoters or acquirers of a stock exchange will need to involve an objective assessment of any possible conflict of interest that exists or may arise.

The proposals, if implemented, may also give rise to several strategic partnerships which will contribute specialised knowledge and ensure long-term development.[57] The acquisition of Refinitiv US Holdings Inc. ("**Refinitiv**"), a financial market data and infrastructure provider, by the London Stock Exchange Group ("**LSEG**") is an accurate representation of competitive positioning in the financial market in recent times. Structured as an all-share transaction, the transaction was aimed at combining two complementary capabilities to create a leading financial market infrastructure provider and broaden the latter's global footprint in terms of coverage in emerging markets. As a result of the transaction, ordinary shares representing 37% economic interest and 29% voting rights were acquired by the sellers of Refinitiv in the LSEG, the parent company or the 'exchange operator' which owns the London Stock Exchange. Acquisitions of such nature, i.e.,

[56] *Stock Exchanges – the more, the merrier?,* INSTITUTIONAL INVESTOR ADVISORY SERVICES, (Apr 5, 2021), https://www.iiasadvisory.com/institutional-eye/stock-exchanges-the-more-the-merrier.
[57] L.C. Gupta, *Demutualization of Exchanges*, THE ECONOMIC TIMES, November 20, 2006, https://economictimes.indiatimes.com/demutualisation-of-exchanges/articleshow/482140.cms.

acquisitions that rely on the holding company model, are not feasible under the existing ownership framework. That is set to change with the proposed permissibility of 100% promoter and acquirer shareholding, however, the gradual dilution process will largely determine the practicalities of an 'exchange operator' model in the Indian financial market. In the face of growing competition, exchange operators also view ancillary services as crucial strategic partners that can add a new dimension to their existing operations. Stock markets around the world have witnessed this trend in the form of strategic alliances,[58] such as the acquisition of Mergent, an indexing business, by the Nasdaq OMX Group to offer a fuller range of services beyond listings and trading.[59]

The glaring difference between NSE's trading volumes and the number of listed companies, in comparison to its counterpart,[60] paints a rather 'lopsided' picture of the duopoly that exists in the MII space. As a natural consequence, new stock exchanges may face an inherent disadvantage in competing with bourses like NSE, which are known to have established terminals and trading volumes. To that end, certain transitory incentives and relaxations may need to be deliberated upon. Devising a framework that allows stocks to trade on exchanges other than the home exchange on which they are listed is also a preliminary suggestion to tackle the initial hurdles of attracting sufficient order flow. This will also ensure that a suspension in trading as a result of technical malfunction on the home exchange does not

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[58] *Stock Exchange Alliances and a Mechanism for Cooperation among the OIC Member States in the Area of Financial Markets*, 26 JOURNAL OF ECONOMIC COOPERATION 35, 36 (2005).
[59] Chris Flood, *Strategic alliances change face of industry*, FINANCIAL TIMES, Nov 12, 2012, https://www.ft.com/content/ae8891d6-2cf0-11e2-9211-00144feabdc0.
[60] Rakesh Sharma, *BSE vs NSE*, THE BUSINESS STANDARD, Jan 27, 2013, https://www.business-standard.com/article/specials/bse-vs-nse-198012601047_1.html.

necessarily suspend trading across the entire market.[61] However, parallel trading of the same security on different exchanges may contribute to fragmentation of the financial market, a plausible risk that the regulations must be prepared to counter. Drawing from the experience of the NYSE,[62] introducing competition in the MII ecosystem is likely to reduce transaction costs and high commissions charged on trades. In the past, NSE has lowered transaction fees in certain segments following changes announced by the BSE in its fee structure.[63] This supports the proposition that the consequences of growing competition will be strongly felt in terms of revised transaction fees charges by exchanges.

VIII. RECOMMENDATIONS AND SUGGESTIONS

A. Minimum Public Shareholding ("MPS") Norms

Presently, Regulation 17(1) of the SECC Regulations require recognized stock exchanges to maintain a minimum of 51% public shareholding. Under Regulation 19A, the stock exchange is required to institute a monitoring mechanism to ensure compliance with the shareholding limits specified under the regulations. The said limit is also subject to monitoring by the depositories on a daily basis with regard to listed stock

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[61] Ameya Karve, Santanu Chakraborty, *Dual-listed stocks insurance for Indian markets' glitches*, LIVE MINT, Jul 17, 2017, https://www.livemint.com/Money/CS43HvKEIxi0GNBZaK8JbL/Duallisted-stocks-an-accidental-insurance-for-Indian-market.html.

[62] Chris Bummer, *Disruptive Technology and Securities Regulation*, 84 FORDHAM LAW REVIEW 977, 1029 (2015).

[63] *NSE cuts fees on options, currency derivatives to deepen market*, THE HINDU BUSINESS LINE, Jan 15, 2018, https://www.thehindubusinessline.com/markets/stock-markets/nse-cuts-fee-on-options-currency-derivatives-to-deepen-market/article9625316.ece.

exchanges.[64] While the Paper purports to review key ownership norms, it fails to address whether the provisions relating to MPS norms will remain applicable. There is a need to provide sufficient clarity with respect to:

a. Whether the MPS limit is eliminated in the proposed framework.
b. If yes, the threshold on MPS applicable to stock exchanges that are listed or proposed to be listed.
c. If no, the stage at which the retained MPS limit shall become applicable, provided a decision with respect to the gradual dilution process is arrived at.

MPS norms were primarily implemented with the objective of ensuring higher participation from non-promoter shareholders in public listed entities. This rationale was further stressed in a Press Release published on July 4, 2010 by the Ministry of Finance, which stated that "A dispersed ownership structure is essential for the sustenance of a continuous market for listed securities to provide liquidity to the investors and to discover fair prices. Further, the larger the number of shareholders, the less is the scope for price manipulation."

Hence, a proposal seeking to effect a change of this magnitude in the existing ownership structures governing stock exchanges needs to address the applicability of MPS norms, more so in the case of listed exchanges.

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[64] Securities and Exchange Board of India, Procedures for ensuring compliance with Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2012 (SECC Regulations) by Listed Stock Exchanges, CIR/MRD/DSA/01/2016 (Issued on Jan 01, 2016), https://www.sebi.gov.in/sebi_data/attachdocs/1451651951883.pdf.

D. Harmonizing Thresholds Triggering SEBI Approval

Presently, Regulation 19 and 20 of the SECC Regulations requires stock exchanges to ensure that all its shareholders, directors and key management personnel are fit and proper persons. Additionally, persons intending on acquiring shares of both unlisted and listed stock exchanges are required to:[65]

a. Seek post acquisition approval from SEBI for acquiring shares amounting to 2% to 5% of the total shareholding.
b. Seek pre-acquisition approval from SEBI if the acquisition amounts to more than 5% of the total shareholding.

In the Paper, approval from SEBI is to be sought by both foreign and domestic acquirers from acquisitions exceeding 10% and 25%. Moreover, Clause 4.1.2. contains a blanket statement proposing prior approval for all mergers and acquisitions in a stock exchange. It is relevant to highlight that while the role of a stock exchange as a 'first level regulator' is bound to invite heightened scrutiny from SEBI, having to seek approval at practically every stage of acquisition might prove to be cumbersome for potential acquirers.

In this regard, the thresholds of percentage shareholding necessitating SEBI approval should be harmonized to avoid confusion among potential acquirers and investors and the approval procedure remains expedient. The author is also of the opinion that SEBI should refrain from adopting a tight-fisted approach in approving acquisitions to truly encourage innovation and competition, in letter and spirit.

[65] *Id.* at 2(III).

E. Minimum Benchmark for Transaction Costs

Besides charging a regulatory fee on the value of transactions executed on the terminals and the levy of securities transaction tax, SEBI does not presently regulate the rates at which fees are charged by stock exchanges for the execution of trades. In the past, SEBI had merely issued guidelines to be followed while charging said transaction fees after NSE's pricing policy which was deemed "predatory" by the CCI came to light.[66] It is advisable to put in place a minimum cost benchmark for transaction fees, in consultation with CCI, that can be charged by exchanges in various segments in the near future. In a dissent order released by certain members of CCI in *MCX Stock Exchange Ltd. v. National Stock Exchange of India Ltd*.,[67] the possibility of passing a direction to NSE to indicate a floor price was considered. During the proceedings against NSE, its method of calculating cost on the basis of "average variable cost" to defend allegations of predatory pricing was categorically rejected by the CCI. In light of the above, it is worthwhile to mention that determining variable costs is dependent on industry characteristics and is highly challenging in cases of multi product firms like NSE, as any other stock exchange.[68] This further underscores the need to safeguard against the possibility of pricing policies being found predatory or exclusionary in the face of increased competition and reduce enforcement

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[66] Securities and Exchange Board of India, Revision of transaction charges by stock exchanges, MRD/DoP/SE/Cir-14/2009 (Issued on Oct 14, 2009), https://www.sebi.gov.in/legal/circulars/oct-2009/revision-of-transaction-charges-by-the-stock-exchanges_3479.html.

[67] MCX Stock Exchange Ltd. v. National Stock Exchange of India Ltd., 2011 SCC OnLine CCI 41.

[68] Sunil Barthwal, *NSE vs MCX-SX : Predatory Pricing?*, THE ECONOMIC TIMES (Apr 15, 2010), https://economictimes.indiatimes.com/nse-vs-mcx-sx-predatory-pricing/articleshow/5807329.cms?from=mdr.

actions. However, it must be ensured that the setting of a minimum benchmark does not impede the liberty of the management to determine a viable pricing structure to compete efficiently in the market.

F. Applicability of SEBI (Substantial Acquisition and Takeovers) Regulations, 2011 ("SAST Regulations")

The proposed ownership framework in the Paper mandates compliance with the provisions of the SAST Regulations, in the event of domestic or foreign acquisitions exceeding 25% shareholding in both listed and unlisted stock exchanges. There is no clarity over the specific provisions that will have to comply with or any rationale offered for the said proposal. The mandatory requirement of making an open offer to the existing shareholders of a stock exchange on an acquisition exceeding 25% of the total shareholding may deter financial or private equity investors looking to acquire a strategic stake in a stock exchange, with no intention of gaining control over the day-to-day management of the exchange or being classified as a 'promoter'. In all likelihood, having to comply with mandatory open offer requirements may dilute the essence of the liberalized ownership framework the Paper envisions. Hence, it is recommended that compliance with the provisions of the SAST Regulations be limited to listed stock exchanges and omitted with respect to unlisted stock exchanges.

IX. CONCLUDING REMARKS

The nature of the stock markets is one that calls for constant re-evaluation and re-conceptualization. Stock exchanges, in particular, form the core infrastructure of stock markets and must keep up with the pace at which these markets evolve. Growth and innovation in stock market infrastructure cannot sustain without a regulatory framework which aims at encouraging inter-exchange competition as a means of achieving efficiency. To that end, the proposals asserted in the Paper seem well-intentioned as a preliminary step. However, for the intended consequences to materialize, a closer and more comprehensive look is warranted in light of the foregoing considerations.