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Evaluating the Legal Frameworks in Determining the Role of Intermediaries in the Stock Exchange

AYESHA KHANUM¹ AND JYOTIRMOY BANERJEE²

ABSTRACT

The stock exchange is a cornerstone of the global economy. It enables capital formation, investment, and economic growth. It serves as a dynamic platform where investors and companies interact, driving financial activities worldwide. Among its key participants are intermediaries, who act as facilitators, brokers, and advisors in the trade of securities. Their roles are indispensable in ensuring the smooth functioning of markets, providing expertise, and connecting buyers with sellers. Legal frameworks governing the activities of intermediaries are critical to maintaining transparency, fairness, and efficiency in stock exchanges. These frameworks define the responsibilities and obligations of intermediaries, ensuring adherence to ethical standards and regulatory compliance. They also safeguard investor interests by promoting accountability and deterring malpractices such as insider trading or market manipulation. This article delves into the intricate legal dimensions of intermediary roles in stock exchanges, highlighting the regulatory obligations imposed on them. It examines how laws shape their conduct, focusing on requirements like licensing, disclosures, and fiduciary duties. Furthermore, it explores how these regulations vary across jurisdictions and evolve with the complexities of modern financial markets. By analysing international legal precedents, regulatory frameworks, and case studies, this study sheds light on the pivotal functions of intermediaries in fostering trust and stability in the stock market ecosystem. It emphasizes the need for robust legal oversight to adapt to emerging challenges, such as the rise of algorithmic trading and digital assets. Ultimately, this study provides a comprehensive understanding of the legal landscape surrounding intermediaries, underscoring their significance in ensuring the integrity and efficiency of stock exchanges. The evolving regulatory approaches across the globe highlight the ongoing efforts to balance market innovation with investor protection.

Keywords: Stock market, Intermediaries, Economic growth, Intermediaries, Asset.

¹ Author is a LLM Student at Amity Law School, Amity University, Bengaluru, India.

² Author is an Assistant Professor at Amity Law School, Amity University, Bengaluru, India.

I. INTRODUCTION

The stock exchange is a cornerstone of modern financial systems, serving as a vital platform for the trading of securities, including stocks, bonds, and derivatives. It facilitates capital formation, liquidity, and economic growth by connecting investors with issuers. Within this ecosystem, intermediaries such as brokers, dealers, investment advisors, and clearing agents play a critical role in ensuring the efficient and secure operation of financial markets. These intermediaries act as vital conduits, linking buyers and sellers, managing transactions, and providing advisory services, thereby fostering market stability and investor confidence.

The roles and responsibilities of intermediaries are governed by comprehensive legal frameworks designed to uphold market integrity, fairness, and transparency. These frameworks aim to mitigate risks such as fraud, insider trading, market manipulation, and conflicts of interest. Legal provisions stipulate licensing requirements, disclosure obligations, fiduciary duties, and operational safeguards, ensuring intermediaries adhere to ethical and professional standards. For instance, brokers and dealers are often required to act in the best interests of their clients, while clearing agents ensure the timely settlement of trades, reducing counterparty risk.

This article delves into the intricate legal aspects shaping the roles of intermediaries in stock exchanges. It examines key legal definitions, regulatory standards, and international frameworks, including those established by organizations such as the International Organization of Securities Commissions (IOSCO). Additionally, it analyzes jurisdiction-specific regulations, comparing approaches in major financial hubs such as the United States, the European Union, and emerging markets.³

The study also highlights challenges posed by technological advancements, such as algorithmic trading, high-frequency trading, and blockchain technology, which have redefined the scope and responsibilities of intermediaries. Moreover, globalization and cross-border trading demand harmonization of legal standards to address jurisdictional overlaps and regulatory arbitrage. By addressing these evolving dynamics, this article underscores the importance of robust legal oversight in adapting to the complexities of modern financial markets while safeguarding investor interests and maintaining market efficiency.

II. INTERMEDIARIES IN STOCK MARKET

The stock market is a complex ecosystem where intermediaries play crucial roles in ensuring

³ Tianjun Xie et al., *A Preliminary Analysis of the Role of Intermediary Institutions in Capital Markets*, 18 *Highlights in Business, Economics and Management* 56 (2023).

smooth, secure, and efficient trading activities. These intermediaries act as bridges between various participants in the market, such as investors, companies, and regulators.⁴ Their functions are critical to maintaining transparency, minimizing risks, and building trust in the financial system. Below are the key intermediaries and their roles in the stock market ecosystem:

- **Stockbrokers**

Stockbrokers are SEBI-registered entities authorized to execute trades on stock exchanges. Investors cannot directly trade on exchanges and must rely on stockbrokers to place their orders.⁵ Some of their functions includes providing trading platforms (online and offline) for investors, to execute/buy/sell orders on behalf of their clients, informing the clients about changes in trading schedules or settlement cycles, verifying the financial soundness and genuineness of clients, issuing contract notes for every transaction to ensure transparency.

The stockbrokers play a pivotal role in connecting retail investors with stock exchanges like the NSE, BSE, and others, ensuring market access and compliance.

- **Depositories and Depository Participants (DPs)**

After the Depositories Act, 1996 came into force, when the process of dematerialization started, the depositories, such as NSDL and CDSL maintains the electronic records of securities in Demat accounts. They act as intermediaries between depositories and investors. The main functions of the depositories and the DPs are holding securities in digital format, eliminating the need for physical share certificates, facilitating the dematerialization of shares for secure and convenient storage, ensuring seamless transfer of securities between accounts during trades, provides investors with real-time access to their holdings. They ensure transparency and security in managing securities while enabling investors to store and trade efficiently.

- **Banks**

Banks are essential intermediaries in the capital market for handling the monetary aspect of transactions, their functions include facilitating the transfer of funds between investors and stockbrokers, enabling seamless settlements by linking trading accounts to bank accounts, acting as custodians for funds during trading and settlement processes, and also to ensure secure fund transfers. Banks play a critical role in maintaining trust and preventing defaults in financial transactions.

⁴ Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. Pa. L. Rev. 1961 (2009).

⁵ Ibid.

- **Clearing Corporations**

Clearing corporations guarantee the settlement of trades between buyers and sellers, ensuring market integrity. They buy and sell orders to facilitate transactions, They acts as a buyer to every seller and a seller to every buyer reducing the risks, they ensure funds and securities are transferred to the rightful parties, the clearing corporations also maintain funds to guarantee trades in case of defaults. Overall, they enhance market efficiency, transparency, and reliability by ensuring that all trades are settled smoothly and within stipulated timeframes. Few of the clearing corporations working currently are NSCCL, ICCL, and MCXCCL.⁶

The main functions of these intermediaries in stock market is to create a hassle-free seamless trading experience. From executing trades, holding securities, managing funds, to guaranteeing settlements, each entity ensures a secure, efficient, and transparent financial ecosystem. They are strictly regulated by SEBI under strict guidelines, intermediaries collectively uphold the integrity and stability of the stock market, fostering trust and encouraging broader participation in capital markets.⁷

III. LEGAL FRAMEWORKS OF INTERMEDIARY ROLES

(A) International Regulatory Frameworks

Various international organizations provide guidelines for regulating intermediaries:

a. *International Organization of Securities Commissions (IOSCO)*

IOSCO's "Objectives and Principles of Securities Regulation" serve as a comprehensive framework for securities regulation worldwide. Within this framework, there are several principles and guidelines given specifically to address the regulation of market intermediaries.⁸

1. Principle 29 of the IOSCO's objectives (as mentioned supra) emphasizes that regulation should establish minimum entry standards for market intermediaries, ensuring that only qualified entities participate in the market.
2. Principle 30 of the objectives mandates that intermediaries must adhere to the initial and ongoing capital and prudential requirements commensurate with the risks they undertake. It promotes financial stability and reduces the likelihood of defaults.

⁶ Role of Intermediaries in Stock Market-1, Angel One, <https://www.angelone.in/knowledge-center/share-market/role-of-intermediaries-in-stock-market-1> (last visited Dec 29, 2024).

⁷ Himmet Koç, *INTERMEDIATION ACTIVITIES IN THE CAPITAL MARKET AND INTERMEDIATION FRAMEWORK AGREEMENTS*, 15 Lex Humana (ISSN 2175-0947) 291 (2023).

⁸ IOSCO, https://www.iosco.org/v2/about/?subsection=about_iosco (last visited Dec 30, 2024).

3. Principle 31 requires intermediaries to implement internal compliance functions that uphold standards for internal organization and operational conduct, aiming to protect client interests and assets.
4. To further its mission, IOSCO has established specialized committees, such as the Committee on Regulation of Market Intermediaries (Committee 3). This committee focuses on promoting investor protection and market efficiency by providing recommendations on issues related to market intermediaries. Its recent work includes publishing guidelines on suitability requirements for distributing complex financial products and enhancing supervision of intermediaries holding client assets.
5. By setting these international standards and facilitating collaboration among securities regulators, IOSCO ensures that market intermediaries operate under robust regulatory frameworks. This harmonization fosters global market integrity, enhances investor confidence, and contributes to the overall stability of the financial system.

b. Basel Committee on Banking Supervision (BCBS)

The BCBS sets global standards for banking regulation, which indirectly affect securities intermediaries engaged in financial markets.⁹

- *National Regulations*

Regulations governing intermediaries in the stock market vary across jurisdictions:

- *United States*

In the United States, the regulation of securities market intermediaries, such as broker-dealers, is primarily overseen by two key entities: the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA).

The Securities and Exchange Commission (SEC) is a federal agency responsible for enforcing U.S. securities laws and regulating the securities industry to protect investors and maintain fair, orderly, and efficient markets. Within the SEC, the Division of Trading and Markets oversees major securities market participants, including broker-dealers, self-regulatory organizations (SROs) like stock exchanges and FINRA, securities-based swap dealers, and transfer agents. This division establishes and maintains standards for fair, orderly, and efficient markets, ensuring that intermediaries adhere to regulatory requirements designed to prevent fraud and

⁹ IOSCO Objectives and Principles of Securities Regulation

promote transparency.¹⁰

The Financial Industry Regulatory Authority (FINRA) is a not-for-profit, non-governmental SRO that operates under SEC oversight. It is the largest independent regulator for all securities firms and brokers conducting business in the United States. FINRA's mission is to protect investors by ensuring the securities industry operates fairly and honestly. It achieves this by writing and enforcing rules and regulations for brokerage firms and brokers, conducting examinations, monitoring trading activities, and enforcing compliance with both FINRA and federal securities laws. Additionally, FINRA offers educational resources and tools to help investors make informed decisions.¹¹

- **European Union**

The Markets in Financial Instruments Directive II (MiFID II) is a comprehensive regulatory framework implemented by the European Union (EU) to enhance transparency, improve investor protection, and increase the efficiency and stability of financial markets. It significantly impacts intermediaries in the stock market by imposing stricter obligations and enhancing their accountability like transparency and reporting, Pre- and Post-Trade transparency, transaction Reporting, investor Protection, suitability and Appropriateness Tests, disclosure Requirements. Overall MiFID II imposes rigorous compliance obligations, but it also enhances market trust and stability. For intermediaries, adhering to MiFID II is essential for operating effectively within the EU's financial ecosystem.¹²

- **India**

The Securities Contracts (Regulation) Act, 1956 (SCRA) plays a foundational role in the regulation of intermediaries in the Indian stock market. It provides the legal framework for the operation of stock exchanges, the listing and trading of securities, and the roles and responsibilities of intermediaries. Under the SCRA, intermediaries such as stockbrokers, sub-brokers, and clearing corporations are required to adhere to stringent regulations to ensure fair practices, transparency, and investor protection. The Act mandates that stock exchanges enforce a code of conduct for intermediaries to maintain the integrity of the trading ecosystem.¹³ Additionally, intermediaries must comply with conditions such as registration, capital adequacy

¹⁰. Intermediation in the Modern Securities Markets: Putting Technology and Competition to Work for Investors by

¹¹ How FINRA Serves Investors and Members | FINRA.org, <https://www.finra.org/about/how-finra-serves-investors-and-members> (last visited Jan 4, 2025).

¹². MiFID II | European Securities and Markets Authority. <https://www.esma.europa.eu/publications-and-data/interactive-single-rulebook/mifid-ii>.

¹³ Kamal A. El Wassal, *The Development of Stock Markets: In Search of a Theory*, 3 IJEFI 606 (2013).

norms, and record-keeping as specified by the regulatory authority. The SCRA works in conjunction with the Securities and Exchange Board of India (SEBI) to establish comprehensive oversight over intermediaries, promoting market stability and efficiency. By providing a legal basis for penalizing misconduct and ensuring compliance, the SCRA contributes significantly to maintaining the trust and confidence of investors in the stock market.

The Securities and Exchange Board of India (SEBI) plays a pivotal role in regulating intermediaries in the stock market to ensure a secure, transparent, and efficient securities market. SEBI mandates that intermediaries such as stockbrokers, sub-brokers, depositories, merchant bankers, and portfolio managers obtain a certificate of registration before conducting business, ensuring they meet prescribed standards of organizational setup, financial soundness, and operational capacity. Through a comprehensive regulatory framework, SEBI sets specific regulations for each category of intermediary, addressing capital adequacy, business conduct, record-keeping, and reporting to standardize practices, minimize risks, and promote fair trading. It supervises and audits intermediaries for compliance, with penalties for non-adherence, while also enforcing ethical practices and transparency to safeguard investor interests. SEBI has the authority to issue directions addressing concerns like fraud prevention and systemic risks, ensuring the orderly conduct of market operations. Additionally, SEBI monitors trading activities to prevent malpractice, facilitates dispute resolution between intermediaries and investors, and promotes capacity building through education and certification standards. This robust regulatory framework, in line with the SEBI Intermediaries Regulations, upholds market integrity, fosters investor confidence, and maintains a fair and efficient securities marketplace.¹⁴

IV. CHALLENGES IN REGULATING INTERMEDIARIES

Regulating intermediaries in stock markets is fraught with challenges due to their pivotal role in maintaining market integrity, liquidity, and investor confidence. These entities, including brokers, dealers, investment banks, and clearing houses, perform diverse and evolving functions, such as executing trades, underwriting securities, and providing market analytics. Technological advancements, like algorithmic and high-frequency trading (HFT), complicate regulation by introducing risks of market manipulation and volatility, while digital trading platforms operating across jurisdictions raise cross-border regulatory issues.¹⁵ Intermediaries often face conflicts of interest, such as advising clients while profiting from proprietary trading

¹⁴ Nicholas Mbaya Odhiambo & Sheilla Nyasha, *Financial Intermediaries, Stock Market Development and Economic Growth in African Countries*, in Finance for Sustainable Development in Africa (2023).

¹⁵ Anastasia Sotiropoulou & Stéphanie Ligot, *Legal Challenges of Cryptocurrencies: Isn't It Time to Regulate the Intermediaries?*, 16 European Company and Financial Law Review 652 (2019).

or prioritizing firm interests over clients, making transparency and fair treatment a regulatory hurdle. Globalization exacerbates these challenges, as intermediaries operating in multiple jurisdictions can exploit regulatory differences, leading to arbitrage. Cybersecurity and data privacy risks further compound the problem, as intermediaries handle vast amounts of sensitive data vulnerable to breaches.¹⁶

Additionally, unethical practices like front-running, insider trading, and price manipulation require sophisticated surveillance systems to detect and penalize misconduct. Stringent regulations often increase compliance costs, leading to resistance or disproportionately impacting smaller firms, thereby reducing market diversity. Regulatory frameworks frequently lag behind market innovations, creating oversight gaps as intermediaries adapt rapidly to new trends.¹⁷ Systemic risks posed by large intermediaries, as evidenced during the 2008 financial crisis, highlight the potential for cascading failures, although excessive regulation risks stifling innovation and liquidity. Finally, ensuring intermediaries provide accurate and transparent information remains critical to maintaining investor trust and market integrity.¹⁸

V. CASE STUDIES IN SECURITIES MARKET

- ***Robinhood and GameStop Saga***

The Robinhood and GameStop saga of early 2021 highlighted significant challenges in regulating stock market intermediaries, especially trading platforms, clearing houses, and market makers. In this case, retail investors, largely coordinated through the Reddit forum r/WallStreetBets, drove up the price of GameStop shares in a short squeeze against institutional investors. Robinhood, a popular trading platform, found itself at the centre of the controversy when it restricted purchases of GameStop, citing liquidity issues and clearinghouse collateral requirements. This raised concerns about Robinhood's conflicts of interest, as the platform generates revenue through payment for order flow (PFOF) from market makers, leading to accusations that it prioritized institutional partners over retail investors. The saga exposed vulnerabilities in the financial system, where extreme volatility strained clearinghouses and created systemic risks.

Additionally, the sudden restrictions by Robinhood underscored the importance of transparency and effective communication in maintaining investor trust. The event also highlighted the

¹⁶ R. V. Vaidyanatha Ayyar, *New Intermediaries and Their Regulation*, in *The WIPO Internet Treaties at 25: A Retrospective* 213 (R. V. Vaidyanatha Ayyar ed., 2023), https://doi.org/10.1007/978-981-19-8390-0_11 (last visited Jan 4, 2025).

¹⁷ Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. Pa. L. Rev. 1961 (2009).

¹⁸ *Challenges in regulating intermediaries in stock markets*.

challenges of regulating market manipulation in the age of social media and the fast-paced growth of retail trading platforms. It became clear that existing regulatory frameworks were insufficient to address the complexities of these new market dynamics, emphasizing the need for adaptive regulations that balance innovation, fairness, and systemic risk management. The saga also pointed to the necessity of global regulatory coordination to prevent regulatory arbitrage, ensuring that intermediaries operate with accountability and protect market integrity¹⁹.

- ***Bernie Madoff Scandal***

The Bernie Madoff scandal, one of the largest Ponzi schemes in history, highlights the critical role and responsibilities of intermediaries in the financial market. Madoff's firm, Bernard L. Madoff Investment Securities LLC, operated as both broker and dealer, allowing him to control trades and fabricate investment activity, which went unchecked for decades. The firm lacked independent custodians and fund administrators, meaning investors' money was controlled entirely within Madoff's operations, eliminating crucial third-party oversight.²⁰ Additionally, the auditing firm, Frierling & Horowitz, failed to detect the fraud due to a lack of thorough due diligence, and the SEC, despite receiving multiple warnings, failed to investigate effectively, allowing Madoff to continue his scheme. The scandal exposed significant gaps in regulatory oversight, such as the absence of independent verification of trades, insufficient auditing, and the concentration of power within one firm, all of which contributed to the scheme's longevity. It underscored the need for stricter regulations requiring independent custodians, better due diligence, and stronger enforcement by regulators to protect investors and maintain market integrity.²¹

- ***SCAM 1992***

The 1992 Harshad Mehta scam, one of the largest financial frauds in Indian history, exposed significant weaknesses in the regulation of intermediaries in the stock market. Harshad Mehta, a stockbroker, manipulated the Bombay Stock Exchange (BSE) by exploiting loopholes in the banking system and stock market operations to artificially inflate stock prices. He used forged bank receipts to secure funds from banks, which were then used to drive up stock prices, creating a bubble that eventually collapsed, leading to massive losses for investors. The scandal revealed the role of intermediaries such as brokers, banks, and regulatory bodies in enabling the

¹⁹ *The Robinhood and GameStop saga: Challenges in regulating intermediaries in stock markets.*

²⁰ J. R. Kearl, *Rules, Rule Intermediaries and the Complexity and Stability of Regulation*, 22 *Journal of Public Economics* 215 (1983).

²¹ *Bernie Madoff scandal: A case study in the role of intermediaries in stock markets*

fraud. Mehta, as both a stockbroker and a market manipulator, took advantage of the lack of transparency and insufficient oversight. In response, significant regulatory changes were introduced, including the strengthening of SEBI's powers, the introduction of electronic trading and dematerialization of shares, stricter regulations on banking and financial intermediaries, and better monitoring of brokers. These reforms were aimed at improving market transparency, preventing market manipulation, and protecting investors, marking a pivotal moment in the evolution of India's financial markets.²²

VI. RECOMMENDATIONS FOR EFFECTIVE REGULATION

- Globalized financial markets require harmonized regulations to address risks like regulatory arbitrage, where firms exploit lenient jurisdictions, leading to potential financial instability and market manipulation.²³
- Organizations such as IOSCO and the Financial Stability Board can develop shared regulatory frameworks to mitigate systemic risks, promote consistent standards, and improve cross-border information sharing to detect and prevent fraudulent activities.
- Emerging technologies, including high-frequency trading, blockchain, and AI, have transformed financial markets but introduced risks like data breaches, market manipulation, and systemic crashes, necessitating updated regulatory frameworks.
- Regulators must collaborate with technology experts to develop guidelines ensuring transparency, security, and fairness in adopting innovations while addressing risks associated with algorithms and digital trading platforms.
- Investor education initiatives, such as financial literacy campaigns, workshops, and resources, empower retail investors with knowledge about market mechanisms, financial products, and legal protections, fostering a more informed and stable market.
- Strengthening cybersecurity measures is critical to protecting sensitive financial data, ensuring market stability, and preventing systemic risks caused by cyberattacks on intermediaries and trading platforms.²⁴
- Mandating robust cybersecurity practices, including encryption, secure authentication, and compliance with data protection laws like GDPR, enhances trust in financial

²² Harshad Mehta scam: A case study in stock market intermediaries and regulatory changes.

²³ Arno Kourula et al., *Intermediary Roles in Regulatory Programs: Toward a Role-based Framework*, 13 *Regulation & Governance* 141 (2019).

²⁴ Tanja Jorgensen, *Peer-to-Peer Lending - A New Digital Intermediary, New Legal Challenges*, 2018 *NJCL* 231 (2018).

systems and minimizes cascading effects from cyber threats.

VII. CONCLUSION

Intermediaries are the backbone of stock exchanges, serving as essential facilitators in the trading ecosystem. They enable seamless transactions, uphold regulatory compliance, and contribute to maintaining market stability, all of which are crucial for fostering investor confidence. However, as financial markets continue to evolve with unprecedented speed, driven by technological innovation, globalization, and complex regulatory environments, the legal frameworks governing intermediaries must keep pace.

To achieve this, there is a pressing need to strike a delicate balance between embracing innovation and safeguarding investor interests. Emerging technologies, such as blockchain and artificial intelligence, present opportunities to enhance efficiency and transparency but also pose significant challenges, including cybersecurity risks and ethical considerations. The interconnected nature of global financial markets further necessitates a cohesive regulatory approach that transcends national boundaries, ensuring uniformity in standards and practices.

The regulators, policymakers, and market participants must work collaboratively to address these multifaceted challenges. This involves continuous dialogue, the proactive updating of legal norms, and the creation of adaptive policies that respond to shifting market dynamics. At the core of this effort lies the imperative to build and sustain trust in the financial system, as well as to ensure resilience against systemic risks. The evolving legal landscape underscores the importance of fostering a culture of integrity, accountability, and innovation among intermediaries. By doing so, they can continue to play their pivotal role in promoting efficient, transparent, and equitable markets. Ultimately, the collective efforts of all stakeholders will determine the future of global financial systems, ensuring that they remain robust, inclusive, and capable of navigating the complexities of the modern economic environment.
