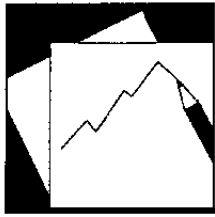


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IMF Working Paper

Demutualization of Securities Exchanges: A Regulatory Perspective

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IMF Working Paper

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Abstract

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“Demutualization” is a term used to describe the transition of a securities exchange from a mutual association of exchange members operating on a not-for-profit basis to a limited liability, for-profit company accountable to shareholders. Demutualization in its many forms has become a widespread phenomenon—one with increasing appeal in emerging market countries. Demutualization challenges the traditional approach to supervision of securities exchanges and raises issues regarding their role in the regulation and supervision of capital markets.

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I. INTRODUCTION

Demutualization of securities exchanges² has captured media headlines in recent years—it seems that everyone is doing it. An informal survey by the World Federation of Stock Exchanges (the FIBV) in 2000 showed that 100 percent of its member respondents were either demutualized, in the process of demutualizing, or actively considering demutualization.³ It is an impressive statistic—especially considering that the first stock exchange to demutualize (the Stockholm Stock Exchange) did so only in 1993. Since then, demutualizations have included the Amsterdam Stock Exchange, the Australian Stock Exchange, the London Stock Exchange, the Deutsche Bourse, the Paris Bourse, the Chicago Board of Trade, the Toronto Stock Exchange, and the Hong Kong Stock Exchange. Most recently, Nasdaq⁴ announced its own full demutualization.

This paper will explore the nature of demutualization, what drives it, and what the implications are for securities regulation—particularly, how demutualizations can affect the regulatory structure and the reliance on an exchange to carry out self-regulatory or regulatory functions.⁵ The paper focuses on the experience of demutualizing stock exchanges, and their regulators, in advanced economies but also considers the growing interest in demutualization of exchanges in emerging market countries where the motivation and experience are very different. The description of a typical traditional exchange is based on the model in advanced economies and differs from the experiences in emerging market countries, where exchanges may have originated as development projects and as government-owned or operated entities.

² “Exchange”, for the purposes of this paper, means an equity, options or futures exchange that comes under the supervision of the securities regulatory authority.

³ 45 percent of respondents were demutualized, 16 percent had gained member approval to demutualize and 39 percent had formulated proposals being considered by the membership. Note that most of these exchanges would not be considered fully-demutualized under the definition given by this paper and that this statistic better reflects the intentions of exchanges than the current reality (Steil, 2002).

⁴ Under American securities law, Nasdaq is a quotation and reporting system rather than an exchange. For the purposes of this discussion, there is no need to distinguish between the two. Nasdaq has an application for exchange status pending at the U.S. Securities Exchange Commission.

⁵ In many countries, exchanges are not considered self-regulatory organizations—which are thought of as stand-alone organizations like the National Association of Securities Dealers in the United States. Despite this, most, if not all, exchanges carry out some regulatory functions including market surveillance, regulation of trading conduct (preventing abusive market practices), regulation of sales and business conduct (dealing with the relationship between broker and client) and risk management and capital adequacy regulation. In addition, many exchanges take a role in regulation of listed companies through enforcement of listing standards and listing agreements.

II. BACKGROUND

A. What is Demutualization?

Demutualization is the term used to describe the transition from a mutual association of exchange members operating on a not-for-profit basis to a limited liability, for-profit company, accountable to shareholders. Essentially, demutualization separates ownership (and voting rights) from the right of access to trading.

In most advanced economies, exchanges historically predated securities regulation. Exchanges began as private clubs, or curbside meetings, that eventually adopted a formal structure. Eventually rules were developed setting time and place of trading, priority of trades, and price-setting mechanisms. Exchanges formalized their ownership structure by granting “seats” to members—a seat entitled the owner to trade on the floor of the exchange (or “sit” on the exchange) and each seat holder had an equal vote on the exchange’s affairs.⁶ Only those with seats were entitled to trade. The mutuality of this structure was generally reinforced by a prohibition on members trading elsewhere—that is, for the purpose of the securities traded on the exchanges, members pledged to trade only with each other and only through the exchange. Nonmembers could not trade on the exchange or with members.⁷ This arrangement made sense in a closed economy—the monopoly exchange was the most efficient means of pooling sufficient liquidity to support the capital-raising process.

Exchanges began taking on a regulatory function as a credit screening mechanism aimed at assuring other participants that the other side of the trade would settle. Restrictions on membership grew into a full range of regulation governing members. Many exchanges were granted special charter status under law—often governed by a special act of the legislature—and all were not-for-profit entities. Finally, exchanges began to be seen as institutions which served a public function, as well as, private clubs. Securities regulators, once established, and were granted authority to regulate exchanges.

Demutualization alters the governance structure of the exchange although its operations and services may remain the same. The exchange may still be regarded as serving a public function and may act as a regulator. Access to trading becomes a matter of contract with the exchange—dealers simply sign up as users or participants. Shareholders, a separate group, are entitled to the profits obtained from market operations. And whereas the exchange previously operated on a not-for-profit basis, with demutualization, it becomes a for-profit company, offering service to market intermediaries and listed companies. The corporate *raison d’etre* of the exchange alters

⁶ This was the case for traditional floor-based exchanges. Exchanges that did not begin as floor-based (such as Nasdaq) do not have seats but have had a mutual organization where membership entitles the owner to access trading on the market and to vote.

⁷ Membership thus conferred a considerable advantage where the exchange traded desirable securities—a non-member could not trade in the securities directly and needed to rely on a member to purchase or sell the exchange’s securities.

completely—it is now organized around profit rather than as an extension of the business costs its members incurred as market intermediaries.

Demutualizations have generally occurred in stages, as illustrated by the examples provided later in the paper. The initial stage is an exchange of membership (or seats) for shares in the new corporation—usually current members receive shares equal in proportion to the voting rights they previously held as members (i.e., if a member owned 3 seats of a hundred, that member now holds 3 percent of voting shares). The exchange becomes a for-profit private corporation but ownership remains in the same hands. Some exchanges have created a private corporation through a private placement transaction that involves a wider group of shareholders—usually listed companies and institutional investors. A “full” demutualization requires a further step—a public offering of shares that are publicly tradable and widely held. Few exchanges have reached this stage.

Box 1. The Functions of an Exchange

Trading System: The main function of a securities exchange is the provision of a trading system—the means whereby buying and selling of securities takes place. The system might be floor-based, with traders required to be physically present on the floor of the exchange, or electronic with traders situated at electronic terminals outside of the exchange building. Trading systems apply different technology and system architecture and trading rules to create a unique system of trade execution (matching of buyer and seller). In operating a trading system, the exchange pools liquidity by bringing together buyers and sellers and offering them a way to execute a contract to trades.^{1/} A trading system disseminates data (both pre and post trade), routes orders and executes trades. The trading system may include sophisticated order-routing facilities—to the exchange from the market participant, from the exchange to the clearing and settlement system, a mechanism for the allocation of trades—which trades receive priority, how much of a trade will be filled—and setting trade allocation rules.

Other operational functions: Supplementary to its role as a trading system provider, the exchange may provide additional services—trading terminals that access the system might be designed and operated by the exchange, data services building on trading data are often a large part of an exchange's business and an exchange might also provide for the clearing and settlement of trades. Exchanges may utilize their data services to produce an index of representative securities to serve as the market's benchmark and may also offer investment products based on the index.

Regulatory functions: As mentioned, the genesis of regulation on exchanges was credit. Sometimes called the “credit ring”—this aspect of regulation ensures that parties to a trade can meet their obligations. Efficient trading would, of course, be impossible unless each party to the trade believes the other party can deliver the cash or securities promised. In order to ensure the continuity of the credit ring, the exchange sets access and operational standards (capital, proficiency, adequate risk management), monitors compliance with these standards and enforces against non-compliance. Standards have developed into sophisticated credit controls, capital adequacy formulas, segregation and custody standards and books and records requirements applied to members. The counterparty to a trade may be the exchange member on the other side of the trade—necessitating these controls for all members.^{2/} Some exchanges have handled settlement risk by creating a central counterparty that will act as a counterparty to each trade—this means the exchange or the clearing house (essentially the aggregate of the members) will assume the risk of the individual trade. In these cases, appropriate controls must also be in place so that the central counterparty's exposure to the individual member is minimized.

Although under the traditional member-owned structure, regulation of members is self-regulatory in nature, the exchange's regulatory functions are carried out by a full-time professional staff with operational independence from members. Of course, these employees ultimately report to a board of directors consisting of member-elected representatives but there still remains a distance between the members and those regulating them. Typically, an exchange has a separate regulatory department consisting of market conduct regulation, financial and business conduct regulation, listed company regulation and investigations and enforcement with a full-time head of department responsible to the board for the regulatory functions. Most exchanges recruit expert staff from the industry and involve their member dealers in policymaking, through member committees, and in disciplinary decisions, with enforcement proceedings often heard before a panel of members (peers).

Box 1 (concluded). The Functions of an Exchange

In addition to the regulatory requirements necessitated by settlement risk, exchanges develop and enforce market conduct rules—these rules encourage a fair and transparent market, which in turn attracts market participation and enhances liquidity. Market conduct rules include prohibitions on market manipulation, front running of clients and insider trading as well as the accurate marking of trades to honor the allocation method used on the exchange (for example, customer priority over broker orders or requirements to expose customer orders to the market). An exchange may also develop and enforce business and sales conduct rules, which govern the relationship between the client and the dealer.

Market surveillance and on-site inspections are the tools for monitoring compliance with market conduct rules as its on-site inspections. Inspections and off-site reporting are used to monitor compliance with financial regulation and business conduct rules. Market surveillance involves real-time monitoring of trading on the exchange by exchange employees. Market surveillance personnel on floor-based exchanges would be physically present on the trading floor monitoring trading, resolving disputes and enforcing trading rules. In an electronic environment, market surveillance is assisted by electronic alerts systems that detect unusual trading, and connect trading data with other events (for example, a sudden drop in price might be connected to a poor earnings announcement from the company).

As exchanges developed, it became common to require that new listings of securities be sponsored by one of the members of the exchange—a form of guarantee to other participants that the exchange member had done some due diligence to assure that the company met a standard agreed to by the members. Sponsorship still forms part of the listing process on many modern member-owned exchanges but regulation of listed companies has developed into full-blown original and continuous listing requirements and corporate disclosure rules. The exchange may have rules governing dividends, share splits, mergers and other transactions. The exchange will have policies and procedures governing halting and suspension of trading and delisting of stock. Some securities regulatory systems rely exclusively on exchanges for regulation of issuers by requiring that all public companies be listed on an exchange, thus using the resources of the exchange to supplement the resources of the regulator.

Investigations and enforcement functions support the areas of regulation. Traditionally exchanges have had in-house investigators and carried out enforcement proceedings against members or listed companies through internal processes. Disciplinary hearings against members were generally held before a panel of peers although the trend has been, in recent years, to professionalize these panels and use retired members of the judiciary, for example, or other third party experts to act as decision makers rather than members. Penalties against traders or dealers can include suspension of trading rights, financial penalties or expulsion from membership. Enforcement proceedings against listed companies generally take the form of a delisting or suspension hearings—exchanges have few remedies against listed companies other than the threat of delisting.^{3/} Enforcement against listed companies is complicated by the pressures of competition among exchanges for listings—as discussed later, this pressure is growing.

Listing: The development and enforcement of listing requirements is a regulatory function but also serves a separate function whereby the exchange reviews the issuer on a merit basis. In setting and maintaining this listing standard the exchange offers investors an assurance that the securities are of a certain quality.

Membership: What began as control on settlement risk developed into a full range of membership requirements in addition to compliance with the regulations described above. Membership in the exchange is a control on access to the exchange and to trading in the exchange's listed securities. Many exchanges impose particular qualifications on officers and directors of the member and on traders. New member applicants generally require approval from the membership or the board of directors for admittance, are required to pay an initial fee and make other commitments to the exchange—such as participation in exchange committees or as market makers.

Fees and revenues: Under the traditional model, exchanges earned revenues through membership fees, trading fees charged to members on each transaction, initial and annual listing fees charged to listed companies, and sale of data and other information to members and to the public.

1/ Lee, 1998

2/ The FIBV market principles states that an exchange's regulations must address terms and conditions of access, professional conduct and qualifications, capital requirements, credit safeguards, management of conflicts between market participants and enforcement and compliance procedures, FIBV 1998 Market Principles, Principle 3.

3/ Typically, investigations regarding listed companies will be passed to securities regulatory authorities, which have greater authority over public company matters. For example, in an insider trading case, the exchange cannot compel evidence from or prosecute third party investors (or even officers of the company) if they are not members of the exchange and the exchange cannot impose fines or bar an insider from trading as a securities regulator can.

III. EVOLUTION OF THE EXCHANGES' REGULATORY ROLE

Over time, the regulatory function of exchanges was formalized and as government authorities strengthened their role in securities regulation, the exchanges become subject to increased supervision by regulatory authorities. Many exchanges are now subject to formal licensing or accreditation under securities legislation with attendant terms and conditions. In most countries, regulators have authority to inspect exchanges, review and approve rules and make orders binding on the exchange. Increasingly, exchanges are being subject to onsite examinations. In some cases, regulators have even brought enforcement actions against SROs or exchanges (such as that brought by the U.S. Securities Exchange Commission (U.S. SEC) against the National Association of Securities Dealers as operator of the Nasdaq market in 1995).

Under the traditional model, regulators have grappled with the challenges of the exchange's self-regulatory role and the conflict of interest inherent in self-regulation—which has led in some cases to poor execution of regulatory responsibilities. For example, in the case of the Nasdaq market, the NASD failed to discipline market makers colluding on price (creating artificially wide spreads). These same market makers controlled the NASD board of governors and key NASD committees that should have addressed the issues. Other exchanges have poorly funded their regulatory functions and focused on other operations at the expense of regulation. The Bombay Stock Exchange, the largest in India, is another example—its failure to maintain adequate regulatory standards (a direct result of member self-interest) and under funding of its regulatory functions has led to a lack of regulation culminating in a number of market manipulation scandals which have caused market volatility and serious losses to investors, and which have undermined the Indian capital markets as a whole. Although regulation of listed companies is not a self-regulatory but rather a regulatory function, similar challenges apply to it—there is risk of under funding and the tension between attracting listings from public companies and enforcing listing standards against those same companies.

The approach to these difficulties of exchange-delivered regulation has differed among countries—in most European countries, for example, exchanges are relied on for market conduct regulation and market surveillance but do not carry out financial or business conduct regulation of member dealers. In the U.S. and Canada, exchanges and other self-regulatory organizations have been traditionally relied on for very extensive regulation of their members and regulators have preferred to address conflicts of interest with increased supervision.

The forces that have generated pressure on exchanges to demutualize have also created new conflicts of interest and forced regulators and exchanges to reconsider what and how regulatory functions are delivered by the exchanges. In some cases, this has a significant effect on the regulatory structure. Most exchanges at one time enjoyed a monopoly on trading in listed securities—this has gradually been eroded because electronic trading technology has allowed both traders and listed companies to access a broader range of markets allowing for the listing of securities on more than one market (“interlisting”)—thereby creating competition among exchanges for listings. New exchanges and alternative trading systems, using new inexpensive trading system technology, have become another source of competition.

Without a monopoly on listings, exchanges have to compete for liquidity—the result has been reduced trading fees, streamlining of operations and a rethinking of the exchange business structure. New conflicts of interest and a deepening of some existing conflicts of interest have emerged—the competition for listing may have an adverse affect on listing regulation standards,⁸ the pressure to reduce trading fees to compete with other markets may result in under funding of regulation and the exchange’s traditional focus has shifted from a monopoly standard setter to a competitor for liquidity.

In reaction to some of these changes, exchanges have begun to re-organize their regulatory functions. Many exchanges that previously carried out licensing, proficiency, prudential and business conduct regulation have shifted that form of regulation to another SRO, relying on the SRO to ensure management of settlement risk and to regulate conduct with clients. The Toronto Stock Exchange, for example, passed these regulatory functions to the Canadian SRO, the Investment Dealers Association, retaining market conduct and listings regulation. The NASD, as a result of the U.S. SEC enforcement action, split the Nasdaq market (and market conduct regulation and listing requirements) from the regulator, NASDR. The Australian Stock Exchange similarly gave up many of its regulatory functions to the regulatory authority (also retaining listings and market conduct regulation) although this was done in the context of demutualization.

IV. FORCES FOR DEMUTUALIZATION

The roots of demutualization can be traced directly to the enormous **technological changes** that have affected the securities industry in the past fifteen years. Technology has been the impetus for demutualization—services once offered exclusively by the local exchanges are now available elsewhere, creating competition for order flow and listings. Exchanges are now markets competing with other markets and companies and investors now comparison shop for liquidity in this “market for markets”.⁹ The traditional exchange governed by its members is seen to be unable to adequately respond to competitive pressures—a governance structure that relies on member decision making is slow and encumbered by the many, and often conflicting, interests of the individual members.

A. The Market for Markets

Competition for liquidity comes from two sources: interlisting/cross border listing and the development of new exchanges and alternative trading systems. Both have been made possible by the appearance of electronic trading and the wide real-time dissemination of trading data which has broken down borders and allowed investors to access markets anywhere in the world.

⁸ Listings have taken on a different meaning in a competitive environment—listed companies once aspired to reach an exchange’s listing standard and relied on it to create value, now exchanges must attract the listed company—now an exchange needs a listed company more than the company needs the exchange (Macey and O’Hara, 1999).

⁹ Karmel, 2000.

Interlisting occurs when a single security is listed and traded on more than one exchange. Interlisting has become the norm for very large ‘blue chip’ companies—often the shares of companies are traded on their own national exchanges as well as the NYSE or Nasdaq (for example, Nokia and Nortel). This is a relatively new (and growing) phenomenon that relies on electronic trading, the real time dissemination of trading data to a wide area which enables the system to bring together investors from a very broad area (indeed, now the globe).

Exchanges, of course, mostly began as regional marketplaces, listing regional securities and providing investments to local people.¹⁰ In a closed economy, the exchange acted as the central liquidity pool for equity investors in that economy. Many exchanges now feel the pressure of competition for order flow since investors now have a wide range of choice and are most likely to direct order flow to the exchange that provides the deepest liquidity (and therefore cheapest and fastest execution of the trade).

Cross border listing is an extension of interlisting—now companies can interlist on their own national exchanges as well as on a larger foreign exchange. Most major exchanges (with the notable exception of the New York Stock Exchange and the Hong Kong Exchange) are now fully electronic and participation is no longer tied to location, which means that exchanges do not have a natural territory. Cross border listing allows liquidity to move across borders which has caused some exchanges to lose liquidity. This was true of the Stockholm Stock Exchange, for example, which before its demutualization in 1993 was consistently losing order flow to the London Stock Exchange—a turnover tax in Sweden made it cheaper to trade interlisted securities in London.

The emergence of new marketplaces has been made possible by cheap technology (lower barriers to entry) and by the huge increases in volume of trading which has rendered the operation of markets profitable, causing competitors to enter the market and compete head on with exchanges. These new marketplaces are both new exchanges and alternative trading systems (ATSs). An ATS can be described as an automated system other than an exchange that brings together buyers and sellers of securities in a way that results in an irrevocable contract of trade.¹¹ ATS do not regulate users (except to create trading rules specific to their systems) and do not carry out a listing function.

¹⁰ A study of the early years of stock exchange development in the U.S. showed that originally exchanges served only the local area. Even large companies such as AT&T were almost exclusively owned by shareholders in the surrounding region until competition (driven by technology) caused consolidation among markets with the NYSE emerging as the dominant marketplace (Arnold, 1999).

¹¹ This definition is an amalgam of the definitions used by the Forum of European Securities Commissions (FESCO, now the Committee of European Securities Regulators or CESR), the U.S. Securities Exchange Commission (SEC) and the Ontario Securities Commission.

Alternative trading systems have threatened the traditional role of exchanges as providers of liquidity¹² by offering cheaper trade execution. In response to competing exchanges and ATS, some exchanges have been forced to reduce their trading costs in order to maintain competitiveness for order flow. In some cases, ATS also provide alternative and faster execution methods, which have caused the exchanges to alter their traditional methods—for example, by providing extended trading hours, or alternative price discovery mechanisms.

The extent of the ATS competitive threat to exchanges is not yet clear. Most ATS currently operating rely on exchanges as the major market in a security while providing adjunct services and rather than presenting themselves as a wholly alternative market. The exception to this might be ATS that specialize in bond trading. In any event, ATS do present a different business model (limited liability companies without a regulatory function) and have been the first serious competition to exchanges and much of the debate over demutualization at exchanges has centered on the threat posed by ATS.

B. Increasing Divergence of Member Interests

Historically, members of stock exchanges were dealers with a similar model of business. The brokers were either trading specialists (proprietary traders or speculators) or full-service brokers with a combination of trading, underwriting, retail and institutional businesses. These firms offered more or less the same client services, with more or less similar profit margins. In fact, in many countries, commission levels were determined by regulation and there was little competition. The homogeneity of members lent itself to the mutual association structure.

The securities industry has, of course, changed enormously in the past 30 years. The automation of trading and the proliferation of electronic information have had a massive impact on the brokerage business. Trading volumes have soared, cash has flooded into the market and investors have an enormous amount of information available to them. Businesses have unbundled and rebundled services partially in response to unfixing of commissions—when commissions were unfixing in North America, for example, competition between firms began in earnest. Trading commissions may no longer subsidize advisory or research activities, for

¹² Under the traditional model, exchanges had a monopoly in trading in the securities of a listed company—members were prohibited from trading those securities anywhere else. As noted, this was first eroded by interlisting, under which members are usually only required to trade on the exchange that will give the client the best price (the best execution rule). ATS have had a limited but growing success in challenging this monopoly—most ATS offer trading in unlisted securities (often corporate or government debt instruments). ATS that have successfully offered trading in listed securities are usually members of the exchange (for example, market makers on Nasdaq) and the liquidity offered on the ATS interacts with that on the host exchange. The exchanges have responded to the threat ATS's pose to their monopoly with attempts to tighten up execution rules so that liquidity is directed to the exchanges. ATS can also compete by attracting its own listings—essentially acting as an exchange—for example, virt-X in the UK and Europe originated as an ATS (Tradepoint) and has now become a full-fledged exchange.

example, and dealers have had to market such services separately. New technology—most notably, client on-line access to trading and information—has also forced a re-examination of the business model. Some dealers have specialized in retail clients who don't want advice, others in institutional clients only. New intermediaries, including banks, have also entered the market, increasing competition and forcing innovation.

As a result of these changes, the members of an exchange are increasingly less homogeneous. Further, consolidation and the emergence of huge financial conglomerates has fragmented members of some exchanges along the lines of size and global reach. Recurring conflicts between large and small members of exchanges has surrounded the future business direction the exchange should take—small firms may want more common technology where big firms don't need it, big firms may want global alliances whereas small firms may see their business threatened by allowing cross border trading. Large global financial institutions have less stake in the mutual structure since the traditional structure often favours local intermediaries that have more stake in market making and specialist activity.¹³

The appearance of ATS has sharpened the divergence of member interests. Many, if not most, ATS are owned by financial conglomerates or by a consortium of brokerage firms (for example, EuroMTS, Archipelago and Tradepoint). Members may have different abilities to compete or fill niches not threatened by ATS. In any event, it is clear the members of the exchange “benefit or suffer from ATS competition differently”¹⁴ making the mutual association's task of facing ATS competition quite difficult. Without demutualization, an exchange continues to be an extension of the interests of its broker owners. When those interests are not common, innovation and competition are impeded.

C. New Focus for Exchange Operations

The logic of the traditional member-run exchange has, therefore, been eroded and the business aims of the exchange have changed—exchanges have become technology providers, requiring expertise and skill that may be much different from that of running a brokerage business. Professional management is now required to an extent it has not been before and the expertise on a governing board consisting of brokerage firm members is not matched with the needs of the exchange. In order to remain competitive in the world of electronic market places, exchanges have struggled with this mismatch of expertise and the fragmentation of member interests. A greater role for professional management, without the need to gain consensus of the brokerage firm members or meet the needs of individual members, may improve the exchange's ability to face competition with innovation or by entering into alliances with other exchanges or ATS.

¹³ Steil, 2002.

¹⁴ Karmel, 2000.

D. Alliances and Mergers

One response to increased competition—particularly cross-border competition from large exchanges that draw listings and trading globally—has been the formation of alliances and mergers between exchanges and marketplaces. A small exchange threatened by larger exchanges or marketplaces may see an advantage in forming a partnership with others—the alliance or merger can pool listings and allow members of one exchange access to a larger variety of instruments. The most successful example of this has been Euronext, the alliance of the Paris, Amsterdam and Brussels exchanges. Each of these exchanges faced stiff competition from the larger London Stock Exchange and Deutsche Bourse. The alliance has created a Europe-wide exchange which now effectively competes with the larger exchanges—Euronext, which came to be in 2000, now claims 25 percent of trading volumes in Europe.

Alliances and mergers are made possible by demutualization which creates a more streamlined, operations-oriented approach to the business of running a market and which can move beyond its members. It is unlikely that a traditional mutual organization could move quickly enough to capture merger or alliance opportunities even if the interests of members could be satisfied.

E. Capital

Demutualization, when it proceeds to the public offering stage, releases the exchange's ownership value and raises capital for the exchange. It is notable that in advanced economy countries, capital raising has *not* been the main force in support of demutualization. This appears to be the case also in emerging markets where, as discussed below, demutualizations appear to be regarded both as a mechanism through which to rid the market of corrupt self-regulation and a spur to innovation in the exchange.

F. Regulatory Pressure

Demutualizations in advanced economies appear to have been driven by business considerations rather than by regulatory concerns—although in cases such as the NASD/Nasdaq, increased scrutiny by regulators has resulted in a re-engineering of governance structure that is compatible with the changes necessary to engineer a demutualization. However, in emerging market countries, regulatory concerns may be the impetus for demutualizations which seem, more often than not, to be driven by the authorities in an attempt to wrest control of a institution that serves a public role and as a regulator from a self-interested group of brokers—the traditional model fails to deliver an appropriate level of regulation or fails to sufficiently develop the capital markets because the exchange is controlled by the interests of the members which may not be the same interests as those of the capital market as a whole. Examples of emerging market demutualizations are discussed in detail below.

V. BENEFITS OF DEMUTUALIZATION

The shift from not-for-profit mutual organization to for-profit organization with ownership separated from access to trading may allow the exchange to respond more effectively to competitive pressure and to act separately from the interests of individual members thereby creating a more streamlined and market-oriented exchange.

A. Streamlining Operations

Demutualization requires an exchange to focus its business differently—accountability to shareholders who are not all members and the for-profit nature of the exchange mean that operations will have to be tailored to meet market needs and therefore generate profits. No longer constrained by individual member expectations, the exchange can choose to streamline its operations or add new innovative services. For example, an exchange might sell off its money-losing derivatives operations and specialize in equity products—despite the objections of some members whose revenues depended on the derivatives operations. An exchange might offer direct access to institutional clients—a service that has growing appeal but which is in direct competition with the business of the members.

B. Streamlined Decision Making

Similarly, the demutualized exchange, because it is further separated from its members' control, may have more professional management and may be more efficient in its decision making—allowing the exchange to respond quickly to change and to remain innovative and competitive. One of the drawbacks of the mutual organization has been the (real or perceived) cumbersome decision making process inherent in a mutual governance structure, which often involves discussion and consensus in member committees and at the board and through which, ultimately, a minority of members might successfully block decisions not in their individual interest.

C. Capital

A demutualization can provide an influx of capital that the exchange can use to improve technology, seek innovation in technology and services or acquire other markets. A year following its demutualization, the Toronto Exchange purchased the only other equity-trading exchange in Canada (the Canadian Venture Exchange) thus consolidating the Canadian market and eliminating a source of domestic competition. OM Gruppen, the holding company of the Stockholm Stock Exchange, has used its capital to expand both its trading technology business and its trading system business. It has purchased the Jiway trading system in London—after famously making an unsuccessful bid for the London Stock Exchange. An examination of demutualizations reveals, however, that raising capital has not been a driving force for demutualization.¹⁵

¹⁵ Steil, 2002.

Box 2. Why Not Demutualization? The Case of the New York Stock Exchange

While exchanges everywhere are demutualizing, the NYSE remains a long-standing mutual organization. Although its President, Richard Grasso, told the press in mid-1999 that it would be “demutualized by Christmas”, the NYSE has yet to get member support for a demutualization plan. Why not? One can speculate: First, the NYSE is a well-capitalized exchange that does not need a new influx of capital so there may be no financial incentive to go to the market. Second, the economic interests of the members act as a disincentive—the exchange is largely floor-based and although it has electronic order-routing, all orders are routed through the specialist for the stock—the specialist makes its profit from the franchise over the stock. Third, the NYSE enjoys a virtual monopoly on trading in NYSE listed stocks by virtue of its own and U.S. SEC regulations. This monopoly preserves the NYSE’s liquidity pool. Demutualization might mean changes to the structure of the exchange—possibly phasing out of floor trading and allowing in ATS—neither of these measures would be in the interests of the specialist firms who are a major voting interest on the exchange. In addition, the NYSE enjoys a considerable premium as a result of its regulatory reputation—the listing quality and high standards for member firms attract liquidity. Demutualization may cause doubt as to the future of the NYSE’s self-regulatory and listing functions—the current dialogue on the issue suggests that the U.S. SEC would force the NYSE to divest itself of most of its regulatory functions prior to demutualization. Finally, the NYSE has successfully attracted and retained liquidity and does not appear to be losing substantial ground—the exchange continues to be a very strong global competitor. If the NYSE continues to maintain this position, it may remain the outlier in the strong trend to demutualization among its competition.

VI. A REGULATORY PERSPECTIVE

A. What Do Regulators Care About?

Regulators are mainly concerned about three things: (1) that the exchange remain a viable institution and that if it does not, there is an orderly winding up of the exchange; (2) that the exchange treat listed companies and market intermediaries fairly; and (3) to the extent that the exchange continues to carry out regulatory functions, those functions be well and fairly executed. Or as an Australian parliamentarian put it, during the debate over demutualization of ASX, the issue is:

whether the commercial pressure [or governance structure] of a for-profit entity will undermine the commitment of resources and capabilities of the exchange to effectively fulfill its regulatory and public interest responsibilities to an appropriate standard.¹⁶

¹⁶ Hansard, 1997.

Two elements weave through these concerns: first, how does the regulator go about supervising a demutualized exchange and how is that different than its supervision of a traditional exchange; and second, to what extent can the exchange maintain its role in regulation of the capital markets and, if it can no longer carry out regulatory functions, where will those functions be housed?

B. The Regulator's Role in Demutualization

Regulators, by in large, have the authority to approve or disallow a demutualization transaction. Regulators may be granted the power to license or “recognize” an exchange under securities legislation or may be appointed supervisor of an exchange in another way.¹⁷ The Swedish Financial Services Authority, for example, has licensing authority over the exchange—the proposed merger of the securities exchange and the derivatives exchange that created Stockholm Stock Exchange was a material change to the terms of the license of both exchanges which therefore required regulatory approval. Regulators may have established criteria for recognition as part of their oversight of the exchange. Often regulators have the ability to delegate regulatory functions to the exchange and through this retain a certain authority over the exchange's transactions and operations.

Demutualization has coincided with a trend among regulators to pay greater attention to the role of SROs and exchanges. It has been a global trend to grant securities regulators greater power (often in the form of self-funding and greater independence from government) and more powerful regulators have turned their attention to the regulation of market participants. Historically, securities regulation in advanced economy countries has tended to focus more on the regulation of public companies (disclosure) rather than on the market conduct of participants or marketplaces. This seems to have been due to the origin of exchanges, their special status under legislation and a general lack of innovation or change.

The situation has changed enormously in recent years as SROs and exchanges have become a very great focus of securities regulators. One of the watershed events in this respect in North America was the SEC's enforcement action brought against the NASD. It is notable that the enforcement action did not begin as a result of the SEC's own oversight program but as a result of a study by academic economists whose study of bid-ask spreads on the Nasdaq market concluded that they were artificially wide. For their part, the U.K. authorities undertook an examination of the state of financial services regulation in the 1990s and concluded that SROs are unworkable and stripped the SROs and exchanges of most of their regulatory responsibilities and handed those responsibilities to the Financial Services Authority. Since these events, oversight or supervision programs for the exchanges and SROs has been a hot topic among

¹⁷ The IOSCO Objectives and Principles of Securities Regulation (1998) require regulators to have licensing and supervisory authority over the exchange in most cases. Although some jurisdictions the regulator does not have licensing authority, the regulator may have a role in approving the demutualization through its role as supervisor.

securities regulators. Many regulators have recently instituted oversight programs where none had existed before.

The history of regulator-exchange relations suggests that while many of the issues that have arisen in the context of demutualization did not arise with traditional exchanges, this may have been more a lack of focus on the part of regulators than the issues related to demutualization specifically. There are, however, unique regulatory issues that do arise and these are discussed below.

C. Regulatory Role of Exchanges

Self-regulation, of course, carries with it an inherent conflict of interest—those responsible for regulation are those being regulated. The management of the conflict requires active supervision by the government regulatory authority and appropriate mechanisms for oversight such as review and approval of rules by the regulator, onsite examination and access to books and records by the regulator, appropriate administrative procedures for hearings and other decisions and transparency and disclosure requirements.

The introduction of a demutualized or for-profit structure brings with it another set of conflicts—the conflict of shareholder interests and the interests of appropriate regulation. The first potential conflict of interest is that shareholders, who are interested in profit, may underfund the exchange’s regulatory function. While in theory, the exchange should only benefit from an adequate regulatory standards, exchanges may succumb to competitive pressure—especially those competing against ATS that have no such regulatory role or costs. The regulator must ensure that the regulatory function is properly funded. The regulator must also prevent cross-subsidization of the exchange’s functions.¹⁸ For example, if the exchange competes against other trading systems but is the sole self-regulator (and therefore has a monopoly on regulatory services) the exchanges should not be allowed to use its regulatory revenues to fund the trading system operation.

The second conflict of interest is the disincentive to regulate market participants (who represent order flow and are a direct source of revenue for the exchange) and listed companies (who provide the listing and pay listing fees, another source of revenue) when both of these groups could withdraw liquidity from the market. The increase in available marketplaces allows market participants and listed issuers to take their business elsewhere—creating a disincentive for the exchange to regulate these entities. Competition for listings is fierce and many exchanges have begun to argue that the listing function is not a regulatory function but rather a “branding” function. Regulators who rely on exchanges for all regulation of issuers should be especially

¹⁸ (IOSCO, 2001).

concerned.¹⁹ Neither the standards for participants or issuers nor the enforcement of those standards should be permitted to erode as a result of demutualization.

The last conflict of interest is the regulation of competitors. An ATS can be participants on the exchange and therefore be regulated by the exchange. A brokerage firm owner of an ATS might also be directly regulated by the exchange. Intense competition might be an incentive for the exchange to impose rules and regulations that are anti-competitive or to enforce rules against the competitor differently. The ASX, for example, recently bid for the Sydney Futures Exchange at the same time a rival bid was made by a technology company listed on the ASX. The potential for conflict was obvious—as the regulator of the listed company the ASX would have access to confidential information and the right to make decisions binding on the company that could affect the bid. The Australian Securities and Investment Commission (ASIC) had to step in to directly supervise the handling of the technology company's listing matters for the duration of the bid.²⁰

This conflict of regulator competitors may be the most pressing of the conflicts of interest. It may be an issue that regulatory oversight cannot resolve and may result in exchanges giving up regulatory power.

D. The Public Role of an Exchange

Exchanges play a key role in the functioning of the financial sector and can have an important impact on the functioning of the overall economy. Should an exchange cease to open for trading as a result of financial insolvency, the economic impact might be great indeed—investors rely on the exchange to establish liquidity for their investments; companies need the exchange to value their shares and provide a forum for investment.

The viability of an exchange was not a topic much discussed in advanced economy countries prior to the advent of new trading technology and ATS. Most exchanges were the sole trading platform for the local/national brokerage industry; most investors relied on the national or local exchange for a location to trade. Little thought was given to the possibility that they might fail. If, for some reason, there was a threat of insolvency, contributions could be expected from members who were liable for the exchange.

Once an exchange becomes a limited liability company facing competition and, therefore, is more threatened financially, the viability of the exchange might be an issue for the authorities. Questions of regional or national interests may arise as cross-border operations threaten local exchanges—many countries will be reluctant to allow an exchange to wind-up.

¹⁹ Many regulators do rely exclusively on exchanges to carry out regulation of public companies—all public companies are required to list and the exchanges are required to review and approve disclosure documents and compliance with disclosure requirements.

²⁰ Seagal, 2001.

E. Approving a Demutualization: Specific Issues

Corporate governance: The public interest responsibilities of the exchange—its regulatory role and its place as a part of the financial structure—create special corporate governance needs. Particularly, the composition of the board and key committees (for example the audit and regulation committees) should be carefully considered. In North America, the strong trend has been to move toward exchanges (and SROs) with 50–50 boards—that is, to have equal numbers of shareholder or industry representatives and independent non-industry representatives. This governance structure has been installed at the NYSE, NASD and the Canadian exchanges. Even though not all of these bodies are demutualized strong concern over self-regulation has led to these requirements. Regulators have also required audit committees to have 50 percent independent representation. The board of governors of the new SRO for market regulation created after the demutualization of the Toronto Stock Exchange is also required to have 50 percent independent representation. The demutualization of the Singapore Exchange (SGX) was approved on the condition that the appointment of the Chair and CEO of SGX must be approved by the Monetary Authority of Singapore and a nominating committee, whose members are approved by the Monetary Authority, must be constituted to recommend all board appointments.

In addition to board and committee composition, regulators have considered reporting and financial filing requirements for the exchanges—including annual financial filings, annual reporting or self-assessments made to the regulator and additional disclosure to shareholders regarding regulatory activities. Regulators have also begun to include corporate governance issues in on-site examinations.

Financial viability: The concern that an exchange remain financially viable is perhaps a concern generated more by the advent of competition rather than by demutualization itself. However, as mentioned, the viability of an exchange as a key institution in the financial sector has become an issue in demutualizations. In many countries, the winding-up of an exchange is likely to be intolerable to authorities, particularly if the exchange is regarded as the national exchange although it should be noted that where an exchange is not independently viable, a range of options including international alliances could be considered. In the event, it will fall to the regulator to monitor the exchange's financial condition—not only to inform the policy discussion on the future of the exchange but also to prevent market disruption in the event of a failure.

There is no clear answer as to how the financial viability of an exchange should be monitored—or how the insolvency of an exchange should be handled. The regulator's options can involve a number of alternatives and combinations. For example, most regulators require filing of annual financial statements. These financial filings give some insight into the exchange's financial condition. Separate targeted financial reporting can also be developed to assist in the monitoring. Most securities regulators will have general powers to order an exchange to take an action and this could be relied on in the event of an impending insolvency. The Australian authorities opted for the establishment of a reserve fund, a capital cushion for the exchange. There were, however, no restrictions on the use of the reserve fund once the demutualized exchange was in operation.

The Canadian authorities required the Toronto Stock Exchange to enter into an early warning-style reporting system. The exchange developed some financial ratios for the measurement of the exchange's financial condition. The exchange then has an obligation to report when the ratios are exceeded. The securities regulator then has broad authority to take action or request that the exchange do so. This would allow the securities regulator to prevent new capital expenditures or force the exchange to increase fees or something like this. If necessary, the securities regulator could force the wind-up of the exchange.

Ownership restrictions²¹: Because of the exchange's unique position (in its role in the functioning of the markets and as a regulator), most demutualized exchanges have considered ownership restrictions. Control over the exchange has been an issue.

(a) *Restrictions by size*: One concern is that a particular interest group not have a stranglehold on the exchange. This for example is the argument of small brokerage firms who do not want to be at the mercy of large financial conglomerates. By restricting the size of the ownership stake, no one group can control the exchange. At some exchanges, such a restriction has been the condition of member agreement to demutualize. Of course, there is usually a means of waiving the restriction. For example, Swedish law says that any one person can own only 10 percent of an exchange unless an exemption is granted by the regulator (which was the case for the OM purchase of the Stockholm Stock Exchange). Similarly, under U.K. law ownership in the LSE is limited to 10 percent but this did not prevent a bid for control by the OM group or merger discussions with the Deutsche Bourse.

Restrictions on ownership are one way of controlling the exchange. However, given that demutualization is aimed at allowing the exchange to operate as an entity in its own right—rather than as an extension of its members/users business—continuing to restrict ownership to such small amounts as 10 percent or 5 percent (as in the case of the Toronto Stock Exchange) may defeat the purpose of demutualization. Indeed in the case of London and Toronto, those exchanges, although demutualized, have been unable to shake the conflicts between members who have different interests. For example, the LSE member-shareholders have not been able to realize a merger with the Deutsche Bourse, a business move that was supported by the larger brokers. If the future competitiveness of the LSE depends on its ability to make global alliances then the current ownership structure is a problem.

(b) *Restrictions by type*: Some exchanges or their regulators have to consider the nature of ownership. If the exchange, for example, is seen as a national public institution, the regulatory authorities might prohibit foreign ownership. Or in a more positive sense, ownership of an exchange could be limited to those with some expertise in its operation.

²¹ Securities regulators will also carry out fit and proper assessments of owners, directors and officers of the exchange as they would for any market participant.

Access: There are three ways in which the exchange, as a central part of the financial structure and the main source of liquidity, supplies access—to trading, to listing and to data.

(a) *Access to trading:* From a regulatory perspective, access to trading on the exchange must be both fair (without anticompetitiveness) and responsible (an adequate level of protection to the system). Since exchanges are now in competition with ATS—which are often members of the exchange or owned by members of the exchange—they cannot be allowed to exploit their position either as the main pool of liquidity or as regulators to shut out competitors. Exchanges therefore must have a transparent process for entry to trading, transparent standards of membership and the decision denying access should be appealable to a regulator and/or a court.

On the other hand, as the exchange competes for liquidity, it cannot open its doors to just anyone. This is particularly the concern where the exchange is the primary regulator of dealers. Dealers should meet a certain standard before access is allowed. The standard should include a prudential standard, so that the clearing and settlement of trades is not disrupted, and a business conduct standard (to ensure appropriate skill and ability to comply with trading rules).

(b) *Access to listing:* Competition for listings is the main source of competitive pressure for exchanges. Quality listings and liquidity are partners and liquidity is the lifeblood. However, this competition for listings cannot be allowed to reduce the regulatory quality of the exchange. While exchanges normally have a vested interest in the quality of an original listing (the branding of an exchange often depends on its quality) there can be a tendency to ignore violations of rules by listed companies since they are so important to the exchange. There is, in fact, a debate amongst regulators and exchanges as to whether listings are in fact a branding issue or a regulatory issue. One school of thought suggests that exchanges are not in fact the regulators of listed companies and should not perform that function—their incentive to attract quality listings is the incentive for original listing requirements, and for continuous requirements to ensure the quality is still there. Beyond that, it is argued, the job of regulating listed companies falls to the regulatory authority that regulates all issuers. However, in most countries, the securities regulatory authority relies heavily, if not exclusively, on the exchanges to regulate listed companies and may itself only regulate nonlisted issuers. This being the case, regulators will have a stake in the access to listings.

(c) *Access to data:* While exchanges may operate with varying degrees of transparency (that is, more or less pre and post-trade information), in order to create an effective price discovery mechanism, all market participants of a similar class must have equal access to the data. The exchange cannot permit some participants to have more or less information or to receive information at different times.

Fee setting: Some regulatory authorities already become quite involved in the fee-setting at exchanges. It may not be the appropriate role of the regulator to participate in fee setting or to limit fee-setting practices. However, as with access, fee setting can be a source of anti-

competitive behavior and should therefore be monitored. This is particularly true vis-à-vis ATS. Fee setting policies, in general, should be reviewed by the regulator and the recognition criteria or recognition order should include an undertaking to ensure fee setting is fair.

The other aspect of fee setting is to ensure that the exchange does not cut fees so that it cannot support sufficient resources to operate the exchange. This may be an issue where competitive pressure for cheap trading is intense. Nor should the fees for trading be subsidized by regulatory fees—in situations where the exchange is the monopoly regulation services provider but competes for order flow, there may be a temptation to use the regulatory fees to subsidize the trading business.

Technology: Exchanges are quickly becoming technology businesses and this is a new source of challenge for regulators who generally lack expertise in systems technology. The reliance on technology to maintain a functioning market means that the state of technology at the exchange takes on a regulatory focus. Regulators have an obligation to ensure that the exchange is handling its technology properly. There could be a requirement that the exchange be subject to periodic audits, report outages etc.

F. Regulatory Structure

What functions should remain with the exchange?

Exchanges and regulators have attacked this issue differently. All exchanges have retained some regulatory function—at a minimum, most exchanges carry out real-time market surveillance and supervision of market conduct. It would be impossible to delink the market from market surveillance from an operational point of view and to separate the two would be lose significant expertise and access to data.

The role of some exchanges has been limited to this minimum. The U.K. Financial Services Authority (U.K.FSA), for example, has concluded that exchanges should not carry out any further regulatory functions—the exchanges retain only the authority to regulate market conduct and that is limited to real-time surveillance. The U.K. Listing Authority (now part of the U.K. FSA) rather than the exchanges is responsible for establishing original and continuous listing requirements and for enforcing these standards (with suspension ability). The Bolsa Mexicano de Valores has a similarly limited regulatory role—the exchange reviews new listings and carries on real-time surveillance. All other regulation of market intermediaries and listed companies is carried out by the government regulator.

Other exchanges retain authority over listed companies. The Nasdaq has both responsibility for market conduct regulation and for regulation of quoted companies. The remaining regulatory functions are undertaken by the NASD. Many demutualized exchanges have accepted this allocation of regulatory function. There are no fully demutualized exchanges that still carry out prudential or business conduct regulation of members. Fully demutualized exchanges do not create market conduct rules and regulations or perform onsite examinations of members.

Self-listing has only been an issue on those exchanges that have fully demutualized (made a public offering). The ASX and OM, for example, both have listed their own shares. There is an obvious conflict in monitoring one's own compliance with listing requirements. To avoid conflicts of interest, the listing of ASX shares was supervised by the Australian Securities and Investments Commission (ASIC) and the ASIC continues to be responsible for ensuring that ASX complies with continuous listing requirements. The Monetary Authority of Singapore has the right to administer rules regarding listing as they apply to SGX's own listing. SGX is also required to have an internal conflicts of interest committee to deal with issues of self-listing.

Another variation on division of regulation is in place in Canada. Following demutualization of the Toronto Stock Exchange, a separate division of regulation was created within the exchange, reporting to an independent committee of the board of governors. This division carried out all market regulation functions (prudential and business conduct regulation of brokers is carried on at a separate SRO) including listings and market surveillance. Two years following demutualization a separate SRO, called Market Regulation Services Inc. was established, taking on all market regulation functions for the Toronto Stock Exchange and any ATS operating in Canada. The new SRO, which is 50 percent owned by the exchange and 50 percent by the Canadian dealer SRO, has a 50–50 board of directors and is directly supervised by the securities regulator.

While in practice, there appears to be consensus that a fully demutualized publicly traded exchange should not have a policy making or rule setting role with respect to market participants other than strictly for conduct on its own market, there is no similar consensus for the treatment of the listing function. Many exchanges are reluctant to give up control over the products available on the exchange, arguing that quality of listings is the chief competitive feature of an exchange. Regulators may, however, see the listing function as a purely regulatory one—and may conclude that a demutualized exchange cannot adequately carry out the function. This issue will be of serious concern to regulators that rely on exchanges exclusively for issuer regulation.

Box 3. Conflicts of Interest, As Was: Traditional Model

Nature of the conflict

Self-regulation= self-interest

Underfunding of regulation

Anti-competitiveness, unfair barriers to access

Membership a club, disincentive to enforce compliance against members

Competition for listing, disincentive to enforce against companies

Supervisory response

Licensing requirements (e.g. Toronto)

Curtailing regulatory functions (e.g. Nasdaq, London)

Off-site report including financials, enforcement activity (e.g. NYSE)

On-site inspections (e.g. NYSE, Nasdaq, Toronto)

Rule review

Appeal rights

Enforcement actions (c.g. Nasdaq)

Box 4. Conflicts of Interest, As Will Be: Demutualized Model

Conflicts

profit=self-interest

Underfunding

Competition for volume/liquidity, disincentive to enforce against “customers”

Competition for listings, disincentive to enforce against companies

Self-listing

Regulation of competitor ATS

Supervisory response

Licensing requirements (e.g., Toronto)

Curtailing regulatory functions (e.g., London, Mexico)

Increased direct oversight, onsite inspections, rule review, appeal rights (e.g., Euronext, virt-X)

G. How Should the Regulatory Area Be Structured?

In addition to considering which regulatory functions must remain with the exchange, the arrangement for regulation should be considered. Several different structures have emerged. The regulatory function might remain part of the exchange as it has in the traditional exchange model. This is the structure that is currently used by the London Stock Exchange. Because the LSE’s regulatory functions are minimal, less separation is appropriate.

In Nasdaq’s case, while it retains some functions itself, the bulk of regulation is undertaken by the NASDR. Prior to the full demutualization of Nasdaq (which has not yet been completed), both NASDR and Nasdaq reported to separate boards. These boards, however, reported to the same parent board. Separation will be greater but not complete under demutualization. A last option would be to rely on another SRO or exchange for regulation. In the case of the Toronto Stock Exchange, all regulation has been moved to a SRO although the exchange remains involved in ownership and governance of that SRO.

In 2000, the U.S. SEC recognized the International Stock Exchange—a purely electronic for-profit options exchange. The ISE does not perform any regulatory functions having subcontracted those functions to the NASD.

Should regulators decide that some regulatory functions should remain with the exchange, additional supervisory structures might be required. For example, the ASIC is currently considering a separate review board, accountable to ASIC and consisting of a majority of independent representatives and a minority of exchange member representatives. This review board would act as an internal audit of the ASX’s regulatory functions, reporting to ASIC on a regular basis.

Box 5. The Structure of Demutualizations: Some Examples

“Demutualization” is a standard term that has been used to describe a number of structures with the common element of separation of decision making (governance) from access to trading. Most exchanges that would describe themselves as demutualized are not, in fact, very far down the path of separating ownership and access because they remain closely held companies owned by members. Some exchanges have chosen to demutualize by way of allotment of shares to members only and others have widened the pool of shareholders to include listed companies or institutional investors. Some exchanges, including the Stockholm Stock Exchange (SSE) and the Australian Stock Exchange (ASX), are listed public companies either owned by larger companies (as is the case with OM) or widely held (ASX).

The various structures that might be considered by demutualized exchanges are best illustrated by way of example. This note discusses three structures: the Stockholm Stock Exchange which is fully demutualized, the Toronto Stock Exchange (TSE) which is not yet fully demutualized, and Nasdaq which has just announced plans to fully demutualize.

SSE: In 1992, the Swedish government rescinded the SSE’s monopoly and allowed competing marketplaces to enter the Swedish market. In 1993, the exchange made the decision to demutualize, partly motivated by the specter of new competition and also by intense competition from the London Stock Exchange, which then provided cheaper and more efficient trade execution. The exchange became a limited liability for-profit company and abandoned its special legal status. One half of the shares were allotted to members—each granted shares in proportion to the annual fees paid—the other half to listed issuers in recognition of the contribution to the exchange made by each group. The shares were not immediately freely tradable. At this stage, the SSE could be considered only partially demutualized since it was not yet a public company and its interests were still closely tied to brokerage member firms. However, the shares did become freely tradable and between 1994 and 1998 OM, a brokerage firm-cum-competing exchange, acquired the majority share in the SSE and the two exchanges were merged. The fully demutualized exchange, called the Stockholm Stock Exchange, is now a wholly-owned subsidiary of OM. OM currently operates a number of exchanges including the Jiway market in London and also has a large business in selling trading systems.

TSE: In 2000, the TSE demutualized by becoming a for-profit, limited liability company and rescinding its status as a charter company under a special statute. The exchange was also motivated by increased competition—in this case, from Nasdaq and the NYSE, the securities regulator’s stated intention to allow ATS to enter the Canadian market and by the increasing difficulty in achieving consensus among a fractured membership. Members were granted shares in proportion to the seats they had held on the exchange. These shares are not freely tradable and shareholders can only transfer the shares to another shareholder or to the TSE treasury. While this is not full demutualization, the concepts of ownership and access have been separated. New market participants seeking access do not have ownership in the exchange. The TSE also operates on a for-profit basis.

Nasdaq: In 2000, the National Association of Securities Dealers, a member-owned not-for-profit organization as the sole owner of the Nasdaq,¹ voted to offer 10 percent of Nasdaq to non-members in a private placement transaction. In addition, warrants convertible to voting shares, were also issued. Warrants and shares were parceled out to “stakeholders” including large quoted companies, institutional investors and market makers. Unlike the other exchanges mentioned, the primary motivator for this transaction seems to be to raise capital. In April 2001, Nasdaq completed the second phase of its private placement issuing another large parcel of shares and warrants. When the warrants are exercised over the next five years, Nasdaq will be 60 percent owned by non-members with no one shareholder owning more than 5 percent. Nasdaq appears to have been motivated by the desire to unlock value and also to further separate the market from the self-regulatory organization. In addition, while the NASD has over 5,000 members (previously all owners of the Nasdaq because of NASD’s 100 percent ownership), only about 3,000 of those trade on Nasdaq—creating a mismatch of interests. The separation of Nasdaq and the NASD is seen as way of allowing each organization to better focus on its tasks.

Box 5 (concluded). The Structure of Demutualization: Some Examples

SGX: The Singapore Exchange (SGX) was formed as a demutualized exchange in 1999 as the result of the merger of the Stock Exchange of Singapore and the Singapore International Monetary Exchange. SGX issued an IPO in December 2000, becoming a publicly traded, listed and widely held company. SGX owns a number of subsidiaries including clearing systems for equities and derivatives trading and the securities depository. SGX's business plan is focused on creating a strong regional presence and remaining competitive against large cross-border exchanges and ATS. SGX has recently entered into alliances with ASX in Australia and the American Stock Exchange.

Bolsa Mexicano de Valores: The Bolsa has been a demutualized exchange since its creation by statute. Shares are held by members only on a one-member, one-vote basis and the Bolsa operates for profit. The Bolsa has very limited trading—largely government securities—and realizes greater profit on its technology and trading system business than on the traditional operation of the market. The Bolsa operates a joint-venture debt trading/order-matching system.

1/ Under American securities law, Nasdaq is a quotation and reporting system rather than an exchange. For the purposes of this discussion, there is no need to distinguish between the two. Nasdaq has an application for exchange status pending at the U.S. Securities Exchange Commission.

Box 6. Regulating Exchanges Versus Alternative Trading Systems

To the extent that regulatory authorities have allowed the introduction of ATS into their jurisdictions, they have treated ATS differently than exchanges. This has been a contentious topic—exchanges have often complained that they are at a competitive disadvantage to ATS. In brief, ATS are regulated differently because an exchange plays a more central role in the markets (based on size of pool of liquidity) and performs a regulatory function. ATS are treated like a brokerage firm under some regulatory regimes or are treated like a brokerage firm with some added requirements (for example, data dissemination or additional reporting requirements). To the extent that an ATS begins to become a key institution in the financial sector—when order flow and liquidity become big enough—an ATS may be regulated like an exchange.

VII. EMERGING MARKETS: THE DEMUTUALIZATION CURE?

Demutualizations have swept the advanced economies. And now a variety of emerging market countries appear to be considering demutualization of local exchanges. The motivation appears to be completely different, however, from that of advanced economies. In many emerging market countries, regulators are even more involved in the day-to-day life of the exchange—regulators often pre-exist the exchange and exchanges have been established by the regulators in an effort to further develop capital markets. Regulators directly appoint board members and continue to be involved in the business decisions as well as the regulatory affairs of the exchange. In most emerging market countries, no official SRO exists outside of the exchanges.

In these countries, demutualizations seem to be driven by the regulator rather than the exchange—with very different bases. For the purposes of this discussion, the cases of Thailand and India illustrate the difference in approach taken by authorities in emerging market countries.

A. Thailand

The Stock Exchange of Thailand (SET) is a mutual organization. Although it operates as a SRO, 5 of its 11 board members are chosen by the regulator (SEC). SET has a monopoly, as no other exchange can set up in Thailand and all trading in listed securities must be on SET. The government supports SET by granting various tax incentives to the exchange and to investors in listed companies. The SEC is currently considering demutualization.²² The monopoly and nonprofit status of the exchange has resulted in inefficient use of resources and a resistance to change—with no incentive to modernize the exchange. As a result, there is a lack of quality of listing and the Thai equity market has been marginalized and with growing international competition this would only get worse. The SEC believes that changes to the governance structure (demutualization) will encourage innovation—and while it will not cure the ills of the exchange, it sets a necessary foundation for change. In the SEC's view, demutualization would improve SET's flexibility in operations and allow it to respond to more diverse stakeholders. There is a development perspective. A proposed plan of demutualization will grant 45 percent of shares to members, 10 percent to listed companies and 55 percent to the public at large (with a 5 percent cap on any one individual's holdings). The SEC believes that this demutualization will put the SET in a position to join an international alliance, which will boost its competitiveness and benefit the Thai market. At present, a SET committee is still reviewing the demutualization proposal.

B. India

India has a very large number of exchanges. One of its largest, the National Stock Exchange (NSE) formed in 1992 is a demutualized exchange—it is owned by shareholders rather than market participants, is run for profit and is not tax sheltered. These shareholders are largely the state-owned banks. The other large exchanges, notably the Bombay Stock Exchange (BSE) and the Calcutta Stock Exchange (CSE) have, until recently, been mutual organizations. Under political pressure to respond to the latest in a series of stock market and financial sector scandals—this one causing severe market value drops and runs on banks—the Ministry of Finance imposed a form of demutualization on the remaining exchanges, all of whom are carrying out direct regulation of brokerage firms. This “demutualization” took the form of a Ministry of Finance decree that no broker would be allowed to sit on the board of an exchange. The brokerage representatives on the boards of the BSE and CSE resigned leaving behind representatives of SEBI and a few independent board members to govern the exchanges. The authorities have plans to continue the demutualizations but it is unclear how they will proceed.

²² Thavaramara, 2000.

As in Thailand, demutualization is approached in India partially as a cure for crippling self-interest. The authorities believe that if the mutual organization structure continues, the exchanges will continue to under-perform operationally or with respect to its regulatory obligations or both. While in the case of the SET there is minimal regulation being carried out by the exchange, in India the exchanges are relied on for almost all direct regulation of market participants. Because the Indian capital market is so large, it may be impossible for a government regulator to take direct responsibility for all its participants.

What then becomes of self-regulation under enforced demutualization? The benefits of self-regulation should be considered very carefully before a demutualization is finalized. The most obvious benefit of self-regulation, of course, is that regulatory costs are borne directly by the industry. It is unclear, for example, whether the Indian authorities can or will devote additional resources to regulation—in such an enormous market, it is difficult to foresee a regulator ever having sufficient resources to carry out all regulation of market participants. Another benefit of self-regulation is that it provides the industry with a connection to the regulator, allows for industry participation in rule making and in enforcement. This should lead to greater credibility with the industry. However, the Indian brokerage community has displayed a weak commitment to regulation—as witnessed by a string of scandals over the past ten years including a market disruption in spring 2001 that was the result of the exposure of wide-spread non-compliance with the law, and therefore the involvement of these brokerage firms in regulation is questionable. Solutions being considered by the Indian authorities include increasing the independence of the exchanges and allowing them to continue a role in regulation and/or strengthening the central government regulator.

C. Malaysia

Not all emerging market countries view demutualization primarily as a means of improving the regulatory functioning of exchanges. The Malaysian Securities Commission recently released its “Capital Markets Masterplan”—which makes a large number of recommendations aimed at strategically positioning the Malaysian capital markets in a globally competitive market. The recommendations include steps to improve the quality of market intermediaries and issues and to strengthen the regulatory framework. The masterplan also includes recommendations to “enhance the competitive position and efficiency of market institutions.” This would mean consolidating and demutualizing Malaysia’s exchanges. The Malaysian exchanges, like many in southeast Asia, face serious competition for order-flow and listings from the more developed Singapore and Hong Kong exchanges and are struggling to find a niche for themselves. The masterplan takes the view that demutualization would “facilitate broader representation of [the exchanges’] constituents’ interests in its management and decision-making process” as well as provide necessary capital for expansion and improvement of the marketplaces. The key to the masterplan’s competitive strategy appears to be the ability of demutualized exchanges to then enter into strategic alliances with global trading networks—a way to match the resources and ability of its competitors in Singapore and Hong Kong SAR.

VIII. CONCLUSION

Demutualization—now a widespread global phenomenon—has been looked to as a means of meeting developmental and competitive challenges and even to address failure to carry out credible operations. Although the state of demutualization of stock exchanges appears to be in transition—with few exchanges fully demutualized—it seems clear that the trend will not be reversed. As Steil (2002) has observed, the extent of movement toward a demutualized structure is related to the competitive threat—hence the early demutualization of the Nordic exchanges that faced intense competition—but the incentives to innovate, and benefit from demutualization, will only occur when ownership actually changes hands and nonmembers become owners.²³ Whether regulators play a role in determining the structure or not, understanding the incentives at work will be important to understanding and assessing the continuing regulatory role exchanges play in the securities market. From the regulatory perspective, authorities must carefully consider the impact of the demutualization on the viability of the exchange as a key institution and the impact on the regulatory structure. As exchanges move forward toward full demutualization, the regulatory role of the exchange becomes more difficult and yet the advantages of self-regulation are not easily discarded. New issues will arise as a result of demutualization including direct investor access to exchanges, global alliances, and cross-border ownership. These issues will challenge authorities to balance the public interest role of the exchange with its commercial goals—and further challenges for the authorities to include their supervision of the exchange and their reliance on the exchange as a regulator.

²³ Steil, 2002.

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