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Demutualization and Privatisation

*16. How Demutualization and Emerging Electronic Markets will Impact the
Regulatory Landscape of the International Financial Services Industry,
Speech by Mr. Robert K. Wilmouth*

*Chairman of the IOSCO SRO Consultative Committee &
President and CEO of the National Futures Association of the United States of America*

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How Demutualization and Emerging Electronic Markets Will Impact the Regulatory Landscape of the International Financial Services Industry

It will be no surprise to anyone in this room when I say that the demutualization of the financial services industry is cutting an ever-wider swath around the globe. Starting right here in Stockholm in 1993, when the Stockholm Stock Exchange converted from mutual status to a for-profit entity, the trend to demutualize has accelerated rapidly during the past few years.

In the year 2000 alone, eleven exchanges from around the world converted to a for-profit corporate status. These exchanges include the Chicago Mercantile Exchange, the London Stock Exchange, the Hong Kong Stock Exchange and the Sydney Futures Exchange. Demutualization is truly an international phenomenon. And if that's not proof enough of this growing trend, a recent survey of global exchanges by BTA Consulting found that 53 percent of them plan to demutualize within the next two years and 26 percent plan to do so within the next year.

One exchange that is currently immersed in the process of demutualization is the Chicago Board of Trade. The Board of Trade is a well-established membership-driven futures exchange with long-standing traditions. Board of Trade members purchase memberships or seats on the exchange and this gives them the right to participate in the governance of the exchange and trading rights to trade on the floor of the exchange. The Board of Trade's current plan involves turning the exchange into a for-profit stock corporation with an open outcry exchange and an electronic exchange. The electronic exchange will be a wholly owned subsidiary named Electronic Chicago Board of Trade.

Why this sudden rush to demutualization? To put it quite simply: The global financial services industry is being influenced by strong new forces—forces that are causing exchanges to re-examine their business structures in order to remain competitive. Globalization of the markets,

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advances in technology, a concentration of new investment capital, competitive pricing pressure and government deregulation are all contributing to the allure of demutualization.

By demutualizing, exchanges will have a way to raise large pools of capital to finance modernization plans and new technology to compete in today's global marketplace. This can be done eventually through share offerings to non-members.

Demutualization will also change the way the exchange is governed to provide for faster decision making ability and to eliminate the control of members who view the exchange primarily as a facility through which they make their profits. Under a demutualized structure, the exchange will be owned by shareholders who will have a stake in the exchange being a profit-generating entity and will be run by an experienced management team which is driven to improve the exchange's bottom line.

Finally, demutualization will give exchange members the chance to realize the market value of their equity in the exchange while retaining their trading rights. Under the current system, the value of an exchange membership can only be realized by selling the seat, which results in the member's losing his trading privileges. By separating these two components, members will no longer have to give up their trading rights to realize the market value of their equity. If all goes as planned, members will be able to realize the equity value in a secondary market for freely tradable equity shares.

By the way, when I speak of demutualization, I am not referring only to brick-and-mortar institutions like the Chicago Board of Trade. As we all know, there are a lot of new players arriving on the scene in this industry: Electronic exchanges, Alternative Trading Systems (or ATSS) and Electronic Communication Networks (or ECNs). They are all choosing different paths to the same end—operating as cost-effectively as possible as for-profit organizations.

But is demutualization the panacea many claim it to be? Or does demutualization create more problems than it solves? And how will these new for-profit entities balance their business priorities with their self-regulatory responsibilities?

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That's what I'm here to talk to you about today—how demutualization will impact the global exchange community. And, in particular, how demutualization may change the regulatory structure of the financial services industry.

Let's begin with a look at the industry's general regulatory objectives: to ensure market integrity and to protect the investors in the marketplace. Given those general objectives, each exchange's self-regulatory responsibilities involve three basic functions. One, establishing rules to govern the conduct of those with direct access to the market and those intermediaries authorized to access the market on behalf of others. Two, monitoring compliance with those rules. And three, taking prompt enforcement actions when potential rule violations are noted.

It is unlikely that any exchange, whether it demutualizes or not, would cede the authority to write the rules that govern its market place. Similarly, the ultimate authority to interpret and apply those rules should rest with the exchange itself.

However, there are several self-regulatory practices and procedures relating to the core function of monitoring market participants that exchanges may incorporate into new business models.

Those practices and procedures include:

- Performing background checks and financial/credit checks of market participants;
- Conducting financial/operations and sales practice examinations;
- Having market surveillance and trade practice monitoring programs;
- Investigating customer complaints that may indicate a violation of an exchange's rules and regulations;
- Monitoring financial statements and other financial data of market participants; and
- Providing a dispute resolution forum.

These regulatory requirements do not change when an exchange demutualizes. But rather it is how an exchange chooses to meet their requirements that may change. So I'd like to spend the next several minutes discussing the various regulatory models that have been adopted by

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demutualized exchanges and new emerging electronic exchanges to ensure that regulatory objectives and principles are met.

One disclaimer before I continue: I am the President of National Futures Association, which has operated as an independent nationwide self-regulatory body for the US futures markets for close to 20 years. Naturally, I have very strong opinions about the role of self-regulation in this new demutualized world.

One business model an exchange may adopt when it demutualizes is to continue the status quo—performing all of its self-regulatory functions while operating a for-profit exchange. This is the business model adopted by the Chicago Mercantile Exchange when it demutualized last year.

Some people—including financial services regulators—have raised conflict of interest issues surrounding this business model. They question whether the commercial pressures of a for-profit exchange will undermine the commitment of resources and capabilities necessary to fulfill the exchange's regulatory responsibilities.

Conflict of interest issues are not new to the financial services industry. In a member-owned exchange, conflicts can arise because exchange members set rules in the public interest that may negatively affect their own commercial interests. They also monitor and enforce rules against each other. Member participants provide the industry with the knowledge and expertise necessary to develop effective, meaningful rules. Members are also more likely to follow rules that they have participated in developing.

A for-profit exchange faces a slightly different set of conflicts. For example, it may be less likely to take enforcement action against customers or users who are a direct source of income for the exchange.

Obviously, the Chicago Mercantile Exchange does not agree with that belief. On the contrary, they believe that demutualization puts a greater emphasis on ensuring that efficient regulatory controls are in place since a publicly traded exchange cannot afford to jeopardize its future

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revenue streams from trading and its brand name by concerns of market integrity from its participants. In fact, the Chicago Mercantile Exchange has reported a more vigorous enforcement of its rules since demutualization, stating that “there is a strong sensitivity to the exchange’s for-profit status and making certain that ‘the right thing is done’ to protect the exchange, its brand, its customers and shareholders.”

Another alternative for demutualized exchanges is to establish a separate corporate entity for regulatory operations. An internal corporate restructuring which segregates the market and regulatory roles of any demutualized SRO can go a long way in addressing some of the concerns about conflict of interest. This was the path taken by the National Association of Securities Dealers, the largest securities industry, self-regulatory organization in the United States. Members of the NASD voted in April 2000 to demutualize the Nasdaq Stock Market. NASD now consists of a parent holding company and two operating subsidiaries—Nasdaq and NASD Regulation, Inc., to separate its commercial exchange venture from its self-regulatory functions.

A third alternative would be for the exchange to outsource some or all of its regulatory functions to a third party, preferably an independent entity that does not operate an exchange or is affiliated with any organization that operates an exchange. Independence allows the entity to remain neutral on exchange issues. There is also other concern that is addressed by the independent outsourcing model. An exchange SRO has the ability to enforce its rules against its own participants which may also, in most cases, be direct competitors with the exchange. Market participants may be uncomfortable opening up their books and the inner workings of their operations to a direct competitor. An independent entity performing the regulatory services should eliminate this concern of market participants being audited by their competitors.

There are two possible reasons why a demutualized exchange may choose this option. The primary reason is economics. It may just be more cost effective to outsource regulatory functions to an entity whose primary mission is to provide efficient and effective regulatory services. The other reason is to avoid the perceived conflicts of interest issues I discussed earlier.

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Emerging electronic exchanges are adopting this business model which stems directly from a drive to maximize profits by finding more efficient ways to provide the services traditionally performed by exchanges. These new exchanges are essentially unbundling these services by contracting with different organizations to provide clearing, trade practice and market surveillance, rule enforcement and dispute resolution services.

We are finding this to be especially true with these new electronic exchanges, who do not have an existing self-regulatory infrastructure and are finding the costs of erecting one to be prohibitive.

I can tell you from my own experience at NFA that outsourcing is becoming a popular regulatory model. NFA currently performs some self-regulatory functions for existing open outcry exchanges. We also have signed contracts with three electronic exchanges to perform regulatory services on their behalf and are in talks with several others.

However, there are pitfalls to be avoided when outsourcing regulatory functions to a third party. As I mentioned earlier, regulatory programs and capabilities contribute significantly to an exchange's brand name and reputation. If the regulatory services provided by a third party are inadequate, the exchange may incur substantial expenses and suffer severe harm to their reputation. It is essential, then, that the statutory regulator has a strong interest in ensuring that the body performing the self-regulatory functions meets competence standards, can be held accountable, along with the exchange, for its failure to do so and agrees to provide access to information to the same extent the exchange would.

Recent legislation in the United States regarding the regulation of futures market deals with the concerns raised by this outsourcing model. The legislation specifies that exchanges may outsource their self-regulatory responsibilities to either a registered futures association, such as NFA, or to another entity registered with and regulated by the CFTC. This approach ensures that governmental oversight of the self-regulatory process will be unimpaired without inhibiting the efforts of emerging markets to find the most efficient means of fulfilling their self-regulatory obligations.

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As you can see, the issues and business choices surrounding self-regulation and demutualization are many and varied. But some things remain constant, especially the need for a flexible regulatory structure that preserves market integrity and protects investors.

At last year's IOSCO conference in Sydney, Australia, NFA's Vice-President of Strategic Planning, Karen Wuertz, presented a paper prepared by the SRO Consultative Committee. The title of the paper was "A Model for Effective Self-Regulation." The paper recommends appropriate use of SROs to assist statutory regulators in meeting their regulatory objectives of investor protection: fair, efficient and transparent markets and reduction of systemic risk. I believe the findings and recommendations in that paper are even more relevant today. Copies are available.

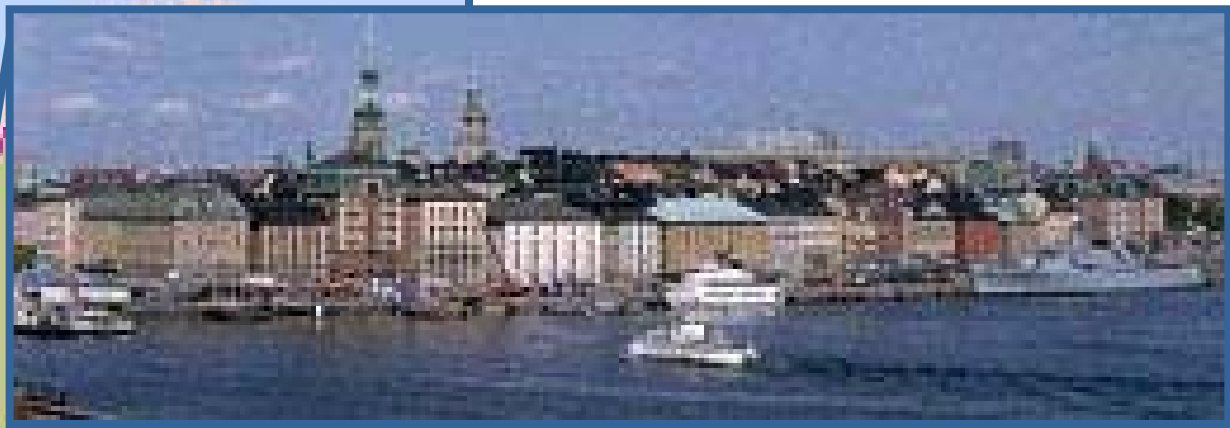
As demutualization continues to alter the landscape of the financial services industry, those of us who are regulators, whether at the governmental or self-regulatory level, face many challenges. We must remain flexible enough to permit market participants to respond to the inevitable changes that will continue to occur in this rapidly evolving industry. At the same time, we must continue to pro-actively develop innovative regulatory services that contribute to our underlying regulatory mission: market integrity and investor protection. I share with all of you an unwavering commitment to meet these challenges with energy and creativity.

Thank you.

How Demutualization Will Impact the Regulatory Landscape of the International Financial Services Industry



**Robert K. Wilmouth
President
National Futures Association**



NFA



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Why Demutualize?

- **Globalization of markets**
- **Technology advances**
- **Concentration of new investment capital**
- **Competitive pricing pressure**
- **Government deregulation**

Value of Demutualization

- **A way to raise large pools of capital to:**
 - Finance modernization plans
 - Use new technology
 - Compete in the global marketplace

Changes caused by Demutualization

- **Exchange governance**
- **Elimination of Member control**
- **Shareholder value**
- **Bottom line management**

What Will Exchange Members Gain?

- **Realize the market value of their equity**
- **Maintain their trading rights**

Who Can Demutualize?

- **Brick and mortar exchanges**
- **Alternative Trading Systems (ATSs)**
- **Electronic Communication Networks (ECNs)**

How Will Demutualization Change the Regulatory Structure of the Financial Services Industry?



General Regulatory Objectives

- **Ensure market integrity**
- **Protect marketplace investors**

Exchange Regulatory Functions

- **Establish rules to govern conduct of:**
 - those with direct access to the market
 - intermediaries authorized to access the market on behalf of others
- **Monitor compliance with those rules**
- **Take prompt enforcement actions when rules are violated**

Self-Regulatory Practices and Procedures

- **Performing background checks and financial/credit checks of market participants**
- **Conducting financial/operations and sales practice examinations**
- **Having market surveillance and trade practice monitoring programs**

Self-Regulatory Practices and Procedures

- **Investigating customer complaints that may indicate a violation of an exchange's rules and regulations**
- **Monitoring financial statements and other financial data of market participants**
- **Providing a dispute resolution forum**

How Does an Exchange Meet These Changing Requirements?

Disclaimer

Business Models

- **Status Quo**
 - Conflict of interest?
- **Separate Corporate Entity**
- **Outsource**
 - Statutory regulator must:
 - **ensure competency standards**
 - **be held accountable**
 - **provide access to information**

**“A Model for Effective
Self-Regulation”**

How Demutualization Will Impact the Regulatory Landscape of the International Financial Services Industry



**Robert K. Wilmouth
President
National Futures Association**