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**Plenary 5**

**Demutualization and Privatisation**

*16. Market Demutualization and Privatisation,  
Speech by Olof Stenhammar*

*Founder and Chairman of OM, Sweden*

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*Panel Five*  
*Mr. Olof Stenhammar*

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## **MARKET DEMUTUALIZATION AND PRIVATISATION**

**IOSCO Conference, Stockholm – 2001**

*Olof Stenhammar*

*Founder and Chairman of OM AB*

I would like to take us back somewhat longer than just the last 5 – 6 years when this concept has been a hot topic among financial market operators and regulators on the global arena. As a market operator and worldwide supplier of transaction technology for 17 years OM has gained a wide experience of different regulatory structures.

When introducing the plan to start OM in 1984 as a for profit, privately owned and electronic stock options market with integrated clearing I had never even heard about the word “demutualization”. I believe nobody else in our business had either. Working on this presentation on my Microsoft 2000 Word program I found that the word was not even a part of the Microsoft wordbook. (Little red waves)

Now it is a household word in our business. Fascinating!

When we opened the OM stock options market in 1985 after one year of planning I had heard all the No-No’s and the Don’ts you can imagine here in Sweden.

“An exchange can not be privately owned.”

“It should not be for profit.”

“It should be open outcry, not electronic.”

Well, I can disclose that there was no sophisticated grand master plan or advanced strategic thinking behind my choice of organizational structure.

Any historical ties or knowledge, or experience on organization of Exchanges did luckily enough not burden my mind. I just wanted to do business making investors use and trade standardized stock options.

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At that time hardly anybody knew anything about derivatives in Sweden. It was not only a matter of finding technological solutions for trading and clearing.

We had to write a completely new rulebook, non-existent, for the Swedish market. And a major part of our effort had to be to educate the market including the regulators.

Derivatives clearing was a totally unknown concept in Sweden, so the integrated clearing set up that we invented here turned out to be a rather unique and extremely cost efficient way of clearing stock options.

Introducing a completely new instrument to the market together with a totally new way of trading was of course a challenging combination.

At the start the big question was; how do we persuade the regulators to accept our plan to open a privately owned market place? We needed a good regulatory set up designed by our selves since the Swedish law did not really offer any solution.

In the fall of 1983 I ordered all Rules and Regulations available from the CBOE in Chicago, the American Stock Exchange in New York and the SEC in Washington. I can assure you; that was a substantial pile of paper work, which took me about 3 months to go through and about an extra 3 months to understand maybe half of.

But it was a very good school. If there is anything US regulators are good at it is writing extensive regulations.

The Swedish financial markets had never before seen such a comprehensive set up of rules and regulations as we suggested for the new options market at the start 1985. The law governing the Stockholm Stock Exchange had maybe 10 – 12 pages in the law book. I believe we more than doubled that already in our first print out.

To be able to stand any chance of success we needed to build confidence with the regulators and with the market place. I wanted them to understand from the first day that we were serious and that we wanted the same thing as they, to do things right in a regulatory perspective.

But also that we at the same time wanted to make it fit into a commercial framework. Nobody should ever doubt that this was first of all a commercial effort.

The lack of knowledge by the regulators was later somewhat of a problem for us. After the crash of 87 when there was a few substantial losses made, especially in the futures market, the derivatives market came under criticism and we felt a need to strengthen the supervisory effort and knowledge that was not then sufficiently present at the Bank Inspection Board. (The predecessor to today's host the Swedish Financial Supervisory Authority)

We therefore took the initiative to start Clearing Control an independent supervisory body operating at arm length distance from OM with regulatory questions within derivatives trading that we thought were missing.

We also in 1986 started our own school – the OM Institute – to educate the market not only in how to use options as an investor but also courses regarding rules, clearing and settlement matters etc.

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OM took several other initiatives to strengthen supervisory efforts in the Swedish market.

I am giving you this background as a clear example of that there actually is no real contradiction between privately owned for profit exchanges and a good regulatory framework.

During these early years we also had to fight a competing options exchange, SOFE, started 1986 by some influential members of the Stock Exchange critical to the way we had set up our operations. SOFE should do “all the right things” having a mutual set up, being a not for profit floor exchange etc. SOFE closed their business in 1989.

When in 1992 the new *Securities Exchange and Operations Act* was passed by the Swedish parliament ending the monopoly granted to the Stockholm Stock Exchange and leading to its demutualization it came as a surprise. To us and certainly to the Stock Exchange, that during our first 7 years of operation had expressed criticism of our organizational set up.

When the Stock Exchange in 1993 finally became a privately owned for profit corporation the management of the Exchange very quickly grasped the advantages and transformed the company into a very well run and competitive operation. I know that the management of the Exchange at that time can witness what a fantastic kick the demutualization meant to their ability to run the company effectively. Since 1998 the Exchange is a part of the OM Group now merged with our stock options market to one single Exchange for stock related products.

I dare say that the decision by the legislators to pass this revolutionary Exchange Act would never have been taken if OM had not been leading the way.

Proving that a privately owned exchange can take full responsibility in building and enforcing a good regulatory framework.

We were at some occasions accused of overdoing our regulatory efforts.

I am glad we did it especially looking back at the different market crisis we manage to go through unhurt.

But maybe most important was that we did not do it because we wanted to be nice guys. We did it mainly for commercial reasons.

Since we all agree on that you cannot operate a market without the confidence of the market players this was therefore a commercial prerequisite for the whole operation to be accepted. To protect and build our brand and continuous value to our customers and to our shareholders a good regulatory framework is an integral part for any market place.

We have heard today and we are all very much aware of the importance to ensure market integrity and to protect the investor’s interest in that market place.

I have many times argued that confidence is not something you can buy or command people to have in you. It is something you earn by the way you act and behave.

This was valid in 1985 and still is and may serve as a comfort for critics of privately operated market places. And this is valid whether you run a mutually or demutualized exchange.

Privately operated and owned market places do thus **not stand** in any opposition to high regulatory and supervisory standards required by the market and the authorities.

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It is not just a question of high moral. To me it is a question of being a good businessman.

We can then of course always argue about the level of regulation and who should be responsible for what within the regulatory structures. The conflict of interest built into a for profit exchange supervising its own operations, which we have heard about today, can be solved in different ways. Separating the two functions or outsourcing the supervisory part might be one way. But it can also be done within the Exchange itself.

We will see different solutions, which I think is an advantage as long as markets are not using regulatory savings as a competitive tool.

We have to remember that a true competition between markets today is a fact. The investor can make a choice. Do I want to trade this instrument on LSE, DB, Jiway or maybe some other market?

I dare say that this choice is not done based on regulatory reasons or to save on regulatory costs. (I am not talking about differences in tax laws etc. governing investors trading behavior and the like). The regulatory cost is not a major part and there is and should not be any room for regulatory arbitrage between markets.

Liquidity or maybe rather lack of liquidity and fragmented and expensive clearing and settlement solutions are the major cost drivers in securities transactions today. This is especially true if you choose to make a crossborder trade not using straight through processing offered by for example Jiway and other new markets.

We find a different situation in Europe than in most other areas at the moment.

Driven by new technologies and deregulation the European map for securities markets is changing drastically. The structures of national exchanges with monopoly status in their respective countries are disappearing

We expect mergers and takeovers between exchanges and clearing organizations. Exchanges will even disappear. We are all looking for a consolidation among European market places.

But instead today we see a fragmentation on the European scene never experienced before. New types of markets (ECN's, ATS's, etc) offer in parallel to the traditional exchanges alternative trading possibilities for the same securities.

The fragmentation phase is a natural result leaving an overregulated situation behind us. This happens when regulations are lifted. The fragmentation phase will however be short, I believe. I am sure that in less than two years we will see a completely different situation in Europe.

A consolidation and integration of order flows and thereby liquidity is a must to offer investors all the benefits of cost reduction inherent in the full implementation of new trading and clearing technologies.

Self-regulation **must** continue to have a major part of the regulatory structure in Europe also in the future. I believe that the last couple of year's turmoil has been handled rather well from a regulatory standpoint by the different markets.

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A trend to cry for more detailed centralized supervision is unfortunate and an example of an underestimation of the different market segments capability to adjust to a new and continuously changing situation.

The over all regulatory structure consists of **two** major parts separated from each other in responsibilities but interfacing and interdependent.

We have a centralized supervisory part on national or transnational levels and we have the decentralized part handled by the different market players.

The important thing for the regulatory efforts in Europe must be to find a suitable borderline between centralized supervision on pan European level and selfregulated market segments.

We don't need more regulation. We need better regulation adjusted to the new European situation.

I support the effort by for example the "Committee of Wise Men" to work for a **conformity of regulatory structures** on a pan European level. We need to **set over all standards valid in the whole union**. The first step may be a convergence of national regulatory structures and increased transparency and openness. I know the work has already started.

We also need to define the borderline between centralized supervision and selfregulation.

The aim must be to find an over all regulatory framework for the different market segments and the different market players to work within.

Within this over all framework the market places must have the authority to write their own rules and also, within that framework, have the authority to apply and interpret these rules.

This have to be the guiding principles for providing an effective supervisory structure for Europe not imposing unnecessary regulatory costs and new levels of bureaucracy into a basically well functioning self regulatory system today.