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Plenary 4

Mergers, Demutualization and Governance of Securities Exchanges

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Panel 4: Mergers, Demutualization and Governance of Securities Exchanges

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THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS
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Panel 4: ***Mergers, Demutualization and Governance of Securities Exchanges***

The ownership and organizational structures of securities exchanges have been evolving for a number of years in many jurisdictions around the world. More and more exchanges are abandoning their traditional mutualized ownership structure, in which the exchange is owned by the brokers which execute trades on the exchange, and are converting to a corporate form of ownership, in which shares in the exchange may be owned by non-broker third parties. Additionally, many exchanges and related settlement systems are merging, consolidating within a single company group, or forming alliances with other exchanges and settlement systems. These changes in ownership and organizational structure have raised issues relating to the ability of a for-profit exchange properly to exercise regulatory responsibilities vis à vis brokers that execute trades on the exchange and to conduct proper surveillance on the market. These changes also raise issues relating to the adequacy of the corporate governance processes and mechanisms of exchanges, specifically relating to the ability of for-profit exchanges adequately to take into account the conflicting interests of owners, participating brokers, end-users, and the public in making decisions relating to the operation and management of the exchange. Panelists will discuss these trends and their implications for exchange regulation and governance.

Time: Thursday, 20 May, 2004, 2:00 p.m. to 3:30 p.m.
Place: Ballroom, Grand Hyatt Hotel, Amman

Andrew Sheng, Chairman, Securities & Futures Comm. of Hong Kong *(Panel Chairman)*
Mr. Jeffrey Lucy, Chairman of the Australia Securities and Investments Commission
Karen K. Wuertz, Senior Vice-President, Strategic Planning & Communications,
Ranjit Ajit Singh, Director, Strategy and Risk Mgmt Division, Malaysia Securities Commission

<u>Opening Remarks</u>

Good Afternoon. I would like to add my thanks to our hosts, the Jordan Securities Commission and Dr. Bassam Saket. Over the years, I have had the opportunity to visit different countries all over the world for the IOSCO annual meeting. I always return from these trips with stories to tell friends, family and colleagues about the old friends that I have seen, the new friends that I have made, the sights that I have seen and the experiences that I have had. Amman will be the same; I will have wonderful memories to share with others back home. Jordan is a wonderful place, and I look forward to seeing more. I would also like to recognize the hard work that is done by the IOSCO Secretariat office throughout the year and especially for their efforts in presenting this annual conference year after year. It is certainly an honor to be invited to speak here today, and on such a timely and important topic.

Many of you know me but for those who do not, I would like to tell you a bit about my background so you will understand the focus of my remarks. I have been associated with National Futures Association for close to twenty years. Aside from a brief stint at the Chicago Stock Exchange, my entire career has been primarily with a futures self-regulatory organization in the United States. My knowledge and experience lend themselves to talking about regulatory developments in the U.S. futures market but I will also do my bit to give you an overview of exchange developments and trends.

For those of you who are not familiar with the National Futures Association, we are a self-regulatory organization that oversees futures industry intermediaries in the United States. It is sometimes easier to explain what NFA does by stating what we do not do; NFA does not operate a market, we are not a trade organization and we are not a statutory regulator. We are purely and simply a self-regulatory body devoted to customer protection. We work very closely with the Commodity Futures Trading Commission; we are in fact very proud of the close working relationship that has developed between our two agencies over the past two decades.

<u>Trends and Developments</u>

Three years ago, in Stockholm, NFA's founder and former CEO Bob Wilmouth delivered a speech entitled "How Demutualization and Emerging Electronic Markets will Impact the Regulatory Landscape of the International Financial Services Industry." He noted that eleven exchanges from around the world had converted to a for-profit corporate status in 2000 alone and 53% planned to demutualize within the next two years. He noted that the global financial services industry was being influenced by strong new forces – forces that were causing exchanges to re-examine their business structures in order to remain competitive. Globalization of the markets, advances in technology, a concentration of new investment capital, competitive pricing pressure were all contributing to the allure of demutualization. Three years later those forces have not changed, and in fact, those forces have strengthened. I think it would be interesting to look at a number of significant developments and trends over the past few years in light of the questions that were posed three years ago: Is demutualization the panacea many claim it to be? 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?

- The Chicago Mercantile Exchange had its initial public offering in 2001, its shares traded at about $35; today, they are close to $120. They raised their capital base from $70 million to $500 million. Volume increased 15% in 2003 and is up 19% thus far this year.

- The Chicago Board of Trade, which is still in the process of demutualizing, had volume in April of 53.6 million contracts, up 75% from April 2003.

- Domestic futures volume has almost doubled over the last few years.

- The CME-CBOT common clearing link was fully implemented in January of this year. This clearing link is intended to deliver capital efficiencies and cost savings.

- Since the passage of the Commodity Futures Modernization Act ("CFMA"), the CFTC has approved 8 new exchanges and accepted registrations of 7 designated clearing organizations. The CFTC also has received notices from 13 ventures of their intent to operate exempt markets.

- While open outcry continues to operate successfully in some futures exchanges, we are seeing some exchanges close their trading floors in favor of an electronic platform, and new exchanges operating solely as electronic markets.

- At the New York Stock Exchange, despite its recent troubles, first quarter trading volume is up almost eight and half percent over the first quarter of 2003. NASDAQ, the largest electronic trading platform in the U.S. is also enjoying large volume increases this year.

- In the equity options industry, there are now 6 U.S. options exchanges.

- Many alliances are being formed between exchanges, across borders and among self-regulatory agencies. NFA has memoranda of understanding with KOFEX and the China Futures Association. We provide these organizations with regulatory information, training programs and work together on other mutually-beneficial projects. Our regulatory training has also become more and more popular as markets that are looking to grow and expand are strengthening their regulatory knowledge and expertise.

As a regulator that has never operated a market, I am watching with interest as exchange ownership structures evolve. Currently, successful exchanges have a variety of business models – mutualized, demutualized, floor based, electronic, floor and electronic operating side-by-side, for profit and not-for-profit. This leads one to conclude that at this point in time there is not a single market model and ownership structure that fits all exchanges.

Demutualization wasn't the only subject Bob Wilmouth talked about three years ago; he also noted that electronic exchanges would be established to compete with the traditional open-outcry exchanges and that these exchanges may adapt a less traditional approach to their self-regulatory responsibilities. That prediction has come true. As I mentioned earlier, several new electronic exchanges have been designated by the CFTC and they have all adopted a less traditional approach to their self-regulatory responsibilities. Rather than build their own SRO infrastructure, they have all outsourced those functions, most of them to NFA. We have entered into agreements with six exchanges, and are negotiating with several others. Of course, not all of these exchanges have been or will be a great success. However, it will be interesting to see what the landscape looks like three years from now.

This new world of for-profit, competitive, electronic exchanges, co-existing with the traditional brick and mortar, mutual, open-outcry markets, may provide a new level of complexity to the regulator. Even though exchanges are evolving, NFA's mission as a self-regulatory body – to ensure market integrity and to protect investors in the marketplace – has not changed and will not change.

As the marketplace changes, the conflicts of interest inherent in the self-regulatory process change as well and government regulators may need to find new ways to manage those conflicts. Conflicts of interest have always been present in any self-regulatory regime; it is how these conflicts are mitigated and managed that changes. However, as Andrew said last year in Seoul, we cannot change everything at once, we need to prioritize and balance vested interests, conflicting interests and the public interest. Any reforms need to be managed, and managed well.

Impact on Regulatory Process

Unfortunately along with changing market structures and more competitive landscapes, the financial services industry has been rocked by scandals eroding investor confidence. The scandals have prompted rulemaking, such as Sarbanes Oxley and 95 new rules filed by the NASD in the past three years. The scandals are also driving an examination of the regulatory structure itself, particularly the role of self-regulatory organizations. Of particular note is the recent reorganization undertaken by the NYSE. Under the revised structure, the board of directors will consist solely of independent directors who will oversee the regulation function and be responsible for governance, compensation and internal controls. The board will be independent from both the exchange's management and the exchange's members and listed companies. The board will be responsible to the investing public and to the community at large for the performance of the NYSE. A board of executives, comprised of NYSE key constituents, will serve in an advisory role to the board of directors.

Intense scrutiny of the self-regulatory process has spread to the futures industry as well, but for different reasons. The futures industry has not been rocked by scandal in recent years. To the contrary, over the last twenty years there has been a 70% reduction in customer complaints during a period in which volume on U.S. futures exchanges increased by over 1,000%. Nevertheless, CFTC Chairman Jim Newsome announced a thorough review of the current self-regulatory structure and his senior staff has undertaken an intensive fact-gathering effort. He stated that there are no particular concerns but given the number of changes that have taken place in the industry over the last 2 or 3 years, it is prudent and responsible for the CFTC to take a look at SROs and make sure that the same principles that applied when SROs were put into place apply now.

Because the CFTC inquiry is not scandal driven, it may present an opportunity to really examine how demutualization of exchanges, the emergence of for-profit exchanges and the changing roles of intermediaries have affected the conflicts of interest inherent in the self-regulatory process and how the government should best manage those conflicts of interest. Take the SRO disciplinary process as an example. The traditional regulatory concern has focused on the "fox watching the hen house" issue. Specifically, the CFTC was concerned that those serving on SRO disciplinary committees might be reluctant to impose necessary sanctions on their buddies, both because of personal relationships and a recognition that the exchange action could set a precedent that could be used against the committee members themselves. The Commission therefore required that at least half of an SRO's disciplinary committee must be drawn from membership categories different than the respondent's. That regulation certainly seems to have been a rational response to the perceived problem.

Now, though, members of the brokerage community may feel that the potential conflict of interest in the SRO disciplinary process has a different twist. With firms trading a wide range of OTC products and seeking to internalize order flow, firms can feel that they are being regulated by exchanges that are actually their competitors.

Clearly, in both the futures and securities industries, self-regulation is under very close scrutiny. Given the need to shore up public confidence and the changes occurring in the markets, it is very possible that the self-regulatory structure may change significantly in the next few years. The CFTC study is one of three about which I am aware; there may be others.

With self regulation under such close scrutiny, it is worthwhile to look at some of the alternatives that are available going forward.

The most radical, and least likely, restructuring of the SRO process would be the elimination of SROs altogether, or at least a reduction in their role. Such a move would not be without precedent. However, in the U.S., the role of the SROs in both the futures and securities industries is so deeply imbedded, and the resources of the government regulators already so strained, that a major reallocation of responsibilities from the SROs to the government seems unlikely. In fact, at least on the futures side, the recent trend has been just the opposite. Over the last several years, the CFTC has been delegating more and more of its frontline regulatory responsibility to NFA.

Another alternative, but not a better one, would be to reduce or eliminate the "self" in the process of self-regulation.

The danger here is that a "private regulator" could become a privately funded bureaucracy - the structure lacks any real fiscal discipline. The very structure of an SRO imposes a discipline on spending that helps bring private sector efficiency to the business of regulation. There's no need to strive for greater efficiency, to be smart in allocating resources, if the private regulator has basically unfettered ability to tax the industry it regulates.

If reducing the role of self-regulation or taking the self out of self-regulation are bad ideas, then what are some good ones?

Some have suggested that self-regulatory duties should be divorced from the operation of a marketplace and vested in an independent SRO. That may be flattering, but I'm not sure it's the right response, at least not now. The exchanges argue that they have a huge stake in maintaining their market's reputation and that certain regulatory functions, such as market surveillance, are core to their brand and their business model. I'm not sure that the argument applies as well to regulatory functions that don't pertain to a particular market. For example, promotional material issues, capital requirements, supervision, books and records are all areas that SROs have to audit for and none of them pertain to the reputation of a particular market. Nonetheless, suggesting that exchanges should be completely out of the self-regulation business strikes me as going too far. If a particular exchange chooses to outsource its regulatory functions, that's their business decision, but it shouldn't be mandated by the government.

The last thing I'll mention may sound odd coming from an SRO but I think we can hold the SRO's feet to the fire by enhancing the oversight function of the government agencies. I think the agencies need to reconsider their enforcement philosophy regarding SROs. Obviously, both the CFTC and the SEC have the authority to bring enforcement actions against SROs that haven't done their jobs correctly. Historically, that authority has been used only in extreme cases, where there has been a highly publicized calamity or meltdown. The agencies need to examine whether that makes sense, whether smaller lapses by SROs shouldn't result in smaller, but more frequent, enforcement actions.

In May 2000, the IOSCO SRO Consultative Committee presented a paper entitled *Model for Effective Regulation.* The paper set forth the general principles for self-regulation, such as industry knowledge and motivation, and why self-regulation should be considered in regulatory frameworks. The SRO Consultative Committee decided at their 2003 mid-year meeting in London that it was appropriate to revisit and update the 2000 paper. Last autumn, we sent out a survey to all SROCC members. The survey sought information regarding the functions of the SRO, their corporate and governance structures, their rulemaking process, oversight, and other activities. A final draft of this updated paper has been submitted to the SRO Consultative Committee and we hope to present and publish this paper shortly.

When going through industry papers and research on SROs and regulatory developments, and in analyzing the survey data, several general themes emerge, despite the varying responsibilities and differing structures of the survey respondents. These themes, somewhat unsurprisingly, reflect the important elements of self-regulation that were elaborated in the 2000 *Model for Effective Self-Regulation*.

SROs are committed to protecting investors and the public interest. Market participants need to know that the markets are well regulated, that there are rules in place, meaningful surveillance to ensure compliance with those rules and vigorous enforcement actions if the rules are violated. SRO members need to be deterred from wrongful conduct and they need to believe in the fairness of the process, in the impartiality and independence of the SRO, in the rulemaking process and enforcement of its rules. Members have to believe that the SRO's regulatory and enforcement authority can't and won't be used as a competitive weapon.

Whatever the changes are to come, it is critical to preserve the "self" in self-regulation. Self-regulation has worked well for many decades and a contributing factor to its success is reliance on the industry's own expertise and by having industry participation in the creation of rules that are effective, reasonable and practical.

Conclusion

As with regulators, everything SROs do is designed to protect customers, protect market integrity and protect the public's confidence in the financial markets. If SROs fail in their regulatory mission, then self-regulation itself will fail and it will vanish. SROs acknowledge that some weaknesses have been identified but there have also been tremendous accomplishments that should not be ignored. Every regulator has to constantly examine whether it can do more to protect market integrity and public confidence. The industry we regulate is changing rapidly and SROs are eager to work closely with their statutory regulators to respond to these changes and correct any weaknesses.

Effective regulation is the best way to assure public confidence, and we have all seen what happens to markets that lose the public's confidence. The best way to preserve that confidence is to deserve it - to ensure that the highest levels of integrity are demanded of all market participants and intermediaries.

When property implemented, self-regulation is an effective and efficient form of regulation. IOSCO Committees and their respective working groups should therefore continue to recognize and incorporate self-regulatory approaches in the guidelines or standards they develop.