REGULATORY ISSUES ARISING FROM EXCHANGE EVOLUTION

FINAL REPORT

OICV-IOSCO

A REPORT OF THE TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

NOVEMBER 2006

A. Introduction

A.1. Background and purpose

Exchanges continue to be the major operators of organised marketplaces for the trading of many financial instruments, particularly equities. Traditionally, exchanges were member-owned and were responsible for the regulation of both the markets they operated and of their members. They were member-owned, self-regulatory organisations in the full sense of those terms. However, in recent years, the rationale and support for continuing mutual ownership has tended to weaken and most major exchanges have now converted into for-profit companies with broader shareholder bases. For securities[1] regulatory authorities these changes in exchange ownership and business objectives have been raising significant issues. Those issues can be grouped under two main headings:

- Issues concerning the regulatory role of exchanges;
- Issues relating more broadly to the regulation of exchanges.

IOSCO Principle 26 articulates the importance of jurisdictions having appropriate supervisory arrangements to ensure that exchanges are properly run. That principle states that "there should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants".[2] In addition, IOSCO Principle 7 refers to self-regulatory organizations (SROs)[3] and provides that "SROs should be subject to oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and responsibilities".

The IOSCO Technical Committee (TC) first responded to the growing interest among exchanges in moving away from mutual ownership in the "Issues Paper on Exchange Demutualization" (2001 paper), published in June 2001. That report reviewed the regulatory issues that could arise following the demutualization of exchanges and their conversion into for-profit entities and concluded that:

- the challenges facing exchange regulators may be heightened when an exchange, operating in a competitive marketplace, decides to restructure its operations as a for-profit entity;
- in practice, regulatory responses to such restructuring vary according to circumstances, and there is no universal right regulatory path to follow; and
- given the importance of an exchange in the financial and economic system of a country, the issues arising on conversion to for-profit status would continue to demand regulatory attention.

Since publication of the 2001 paper, the trend for exchanges to demutualize and, in many cases, obtain stock exchange listings has continued. By October 2006, 19 exchanges or

---

[1] The term "securities" should be understood to include derivatives where the context permits.

[2] IOSCO Objectives and Principles of Securities Regulation (May 2003).

[3] It is stated in IOSCO, *Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation* (October 2003) that: "An organization should be classified as an SRO ... if it has been given the power or responsibility to regulate any part of the securities market or industry".

holding companies for an exchange group operating in jurisdictions represented in the TC Standing Committee on the Regulation of Secondary Markets (SC2)[4] had obtained public listings, including most recently NYSE Group, Inc. (NYSE Group) and Bolsas y Mercados Españoles. Demutualized exchanges have become the dominant providers of securities markets globally. The trend among derivative exchanges is similar. The table below indicates that the business of exchange operation – which, in some cases, includes related activities such as clearing and settlement – is one on which investors place significant value.

Table 1: Listed Exchange/Exchange Operators

Listing date	**Listed exchange/ exchange operator**	**Market value (US$m. equivalent 31.12.05)**
Mar. 1987	OMX Group	1,645
Oct. 1998	ASX	2,407
June 2000	HKEx	4,407
Nov. 2000	Singapore Exchange	1,803
Feb. 2001	Deutsche Boerse	11,028
July 2001	Euronext NV	5,879
July 2001	London Stock Exchange	2,710
April 2002	Sydney Futures Exchange	1,315
Nov. 2002	TSX Group	2,745
Dec. 2002	Chicago Mercantile Exchange	12,651
April 2004	Osaka Securities Exchange	560
Feb. 2005	The Nasdaq Stock Market, Inc.	2,834
Mar. 2005	International Securities Exchange	1,030
Mar. 2005	Bursa Malaysia	497
Oct. 2005	CBOT Holdings Inc.	4,951
Nov. 2005	InterContinental Exchange	2,015
Mar. 2006	NYSE Group	[5]
July 2006	Bolsas y Mercados Españoles	[6]

Now that regulatory authorities have more experience in addressing the issues raised by demutualization, the TC considered it timely to revisit the topic. On this occasion, recognizing that demutualization per se is only one aspect of the changing environment for exchange operation, it requested SC2 to consider any additional issues pertinent to exchange regulation that have followed or accompanied the move to for-profit operation. *These issues, many of which are still only emerging, flow largely from the ways in which for-profit exchanges seek to enhance shareholder value and all exchanges, whether or not demutualized, are now operating in a more competitive market services environment.*

---

[4] The jurisdictions of SC2 members are Australia, Brazil, Canada (Ontario and Quebec), France, Germany, Hong Kong, India, Italy, Japan, Malaysia, Mexico, Singapore, Spain, Switzerland, United Kingdom, United States of America (CFTC and SEC).

[5] This data was not available at the end of 2005. However, as of 15 September 2006, the market capitalization of the NYSE Group totalled approximately $10.43 billion.

[6] On July 14, 2006, Bolsas y Mercados Españoles, the holding company that integrates the Spanish financial markets, was listed with a market value above 3.120 million dollars.

This report complements the report entitled "Exchange Demutualization in Emerging Markets", prepared by the Emerging Markets Committee of IOSCO and published in April, 2005 (2005 Report). The 2005 Report provides a perspective on how the issues raised by demutualization may vary according to the state of development of a market and the specific environment within which the exchange operates. A particular feature of the Report was the view of some regulators that demutualization was not the only way in which to stimulate the development of exchange-operated markets in developing countries, and not necessarily the most desirable. The 2005 Report also noted that the impact of demutualization on the regulatory role and arrangements for demutualized exchanges is quite substantial. The 2005 Report noted that possible approaches to address the potential conflict between the commercial interests and regulatory obligations of an exchange include reducing the regulatory obligations of the exchange by transferring the regulatory functions to the regulator, an independent entity, or an industry SRO.

A.2. Research

The report has been prepared with the assistance of substantial research by SC2 members in their jurisdictions. A detailed questionnaire was completed describing the relevant exchange structure(s), ownership and business model(s), regulatory issues raised and information about exchange linkages and clearing and settlement arrangements.

The report has also benefited from assistance from the IOSCO SRO Consultative Committee. A number of Consultative Committee members have supplied information relating to exchanges' motivations for demutualization, the issues raised and how they had been addressed.[7] The responses[8] provide insights into the reasons why an exchange may consider demutualization and any particular measures it may take to address conflicts of interest. Some of the responses acknowledge the conflicts of interest that are inherent with self-regulation, and some suggest that a number of conflicts of interest may be reduced with demutualization.

A.3. Consultation

In March 2006, the Technical Committee authorized the release of a consultation draft of the report which was made available for public comment on the IOSCO website. A Feedback Statement summarizing and discussing the comments can be found in the Annex.

---

[7] SC2 invited the SRO Consultative Committee members to comment on the following: whether the exchange had considered moving (or had already converted) from a mutual to a demutualized entity and the key factors behind this move; the measures considered to resolve/manage potential conflicts of interest; views regarding the self-regulatory role of a demutualized exchange; and the key emerging issues arising from demutualization.

[8] The following SRO Consultative Committee members provided responses: Amman Stock Exchange, Bursa Malaysia, Chicago Board of Trade, Deutsche Borse Group, Istanbul Stock Exchange, Japan Securities Dealers Association, Korea Stock Exchange, Luxembourg Stock Exchange, National Futures Exchange, Shenzhen Stock Exchange, Sydney Futures Exchange, SWX Group, Taiwan Stock Exchange Corp., Tokyo Stock Exchange Inc. and the Warsaw Stock Exchange.

A.4. Structure

The structure of the report is as follows:

- Section B describes the regulatory role of exchanges and the issues raised for that role by demutualization and the conversion to for-profit business models in combination with the competitive environment existing around them.
- Section C describes the various ways in which securities regulatory authorities have addressed these issues.
- Section D discusses broader issues arising from exchanges' new business models.
- Section E sets out the report's conclusions and recommendations.

B. Implications of changing environment for exchanges' regulatory role

In most of the jurisdictions of SC2 members, exchanges are key market infrastructure entities. Most jurisdictions regard the proper functioning of their exchanges as critical to the efficient operation of their capital markets. They therefore see a strong public interest in exchanges operating their markets in a way that promotes market efficiency and commands market confidence. The 2001 paper described the public interest role of exchanges as follows:

> The fair and efficient functioning of an exchange is of significant benefit to the public. The efficiency of the secondary market in providing liquidity and accurate price discovery facilitates efficient raising of capital for commercial enterprises, benefiting both the wider corporate sector and the economy as a whole. The failure of an exchange to perform its regulatory functions properly will have a similarly wide impact.

B.1. Roles of an exchange

Exchanges have traditionally performed important roles as regulators, making and enforcing rules for a range of market activities. Exchanges' core areas of regulation include rule-making in respect of members/participants, the products admitted to trading and the trading itself. Some exchanges also have regulatory or quasi-regulatory functions in respect of a number of other market services, including clearing and settlement.

As market operators, a core function of exchanges – and often an important part of their branding – is the creation and enforcement of the rules governing the markets they operate. The scope of exchange rule-making and enforcement activity varies considerably, but most exchanges are rule-setters at least in respect of the admission of members, the admission of products to trading and the trading process itself. The full range of these responsibilities is set out below.

(a) Member Regulation

The first main element of the member regulation function, and one which is common to all exchanges, is the setting of the eligibility rules for the admission of members/participants.

A second element of member regulation, which exchanges in some countries still perform, is the comprehensive regulation of member firms. This generally covers the regulation of sales practices and prudential requirements, but may also include setting qualification standards for industry professionals. In countries where this comprehensive regulation of investment firms is undertaken by other regulatory bodies, exchanges normally rely on that regulation and focus their own member regulation on areas relating specifically to the behaviours and systems capabilities needed to participate in the exchange's trading processes.

(b) Product regulation/ listing

The second key area of responsibility for exchanges is determining what instruments to admit to trading and the basis on which to admit them. In some cases, exchanges still have considerable responsibility for setting standards for the listing/admission to trading of securities and for the imposition and enforcement of ongoing (mainly disclosure) requirements on issuers. Derivative exchanges are responsible for designing the products that are traded on their marketplaces. However, in other cases exchange admission rules and processes add little to the rules and processes established by a statutory listing authority.

(c) Trading regulation

The regulation of trading, with a view to ensuring fair, orderly and efficient trading, is normally the core responsibility of all exchanges. The trading (or "market") regulation function generally includes:

- setting trading rules;
- conducting trading surveillance to ensure orderly markets and detect potential market abuse;
- enforcing trading rules and taking disciplinary action against participants in breach of the rules; and
- informing the securities regulatory authority of infractions, where appropriate.

(d) Other functions

An exchange may provide certain services beyond traditional trading services for which it may in some cases act as rule-setter or in a quasi-regulatory role. Although this may be the case whether or not an exchange is demutualized, often the change to a for-profit structure is a motivating factor behind an exchange's focus on developing non-trading services. These services may include, for example, transfer agency, custodian, clearing and settlement, shareholder registry and data distribution services.

B.2. Key issues raised by the changing environment

The move by many exchanges to a for-profit business model, together with increased competition in the provision of market services in most markets, raises a number of questions about the appropriate regulatory role of exchanges. These issues run from the compatibility of for-profit operation with public interest objectives to the adequacy and efficiency of regulation.

Exchanges' new business models and the competitive environment in which they operate have inevitably raised questions as to whether the role that exchanges play as setters and enforcers of rules may need to be modified. The 2001 paper identified four key issues that regulatory authorities should consider in the context of demutualization. All remain central to any consideration of the potential impact of the changing environment on exchanges' regulatory roles. They were:

- Risks to the maintenance of a proper balance between an exchange's public interest obligations and its commercial interests;
- The potential misuse of regulatory powers for commercial purposes;

- Potential threats to the ongoing financial viability of an exchange;
- Conflicts of interest due to self-listing.

Below, these issues are further discussed. We also consider the possible impact of the more competitive, and potentially more fragmented and more complex, market environment on the ability of exchanges to regulate markets efficiently.

(a) Balancing commercial and public interest functions

The central issue discussed in the 2001 paper is the need to ensure that a for-profit exchange maintains a proper balance between its commercial interests and its public interest obligations. Concerns have sometimes been voiced that the commercial pressures to maximise profits are likely to lead to a “race to the bottom” in exchanges' regulatory standards. Although this balance between the commercial interests of an exchange and the public interest is also relevant to mutual exchanges – where the commercial interests of the mutual members may conflict with broader market interests – there is a view that the risk of imbalance may be greater in a for-profit entity. This is in part because for-profit exchanges focus on earnings growth, ideally year-on-year, and the avoidance of profit declines. But it is also because their management and widened shareholder base may be less attuned to, and less interested in, broader market interests. Consequently, they may fail to provide adequately for the recognition and/or representation of those interests in the exchange's decision-making processes.

The risk of imbalance lies principally in two areas. The first, as indicated above, is that the for-profit exchange may be tempted to lower standards to try to generate additional revenue. For instance, it might reduce the eligibility requirements for issuers in order to attract new listings. It should be noted, however, that mutual exchanges seeking to increase trading opportunities for their members can also face pressures to lower their listing standards.

The second potential cause for concern is that for-profit exchanges may reduce the resources they devote to regulation. Worse, they may place insufficient value on the regulatory process, fail to sustain a strong regulatory culture and be less willing to co-operate with their supervisory authorities and other regulatory bodies. Any evidence of these latter elements would clearly be a cause for considerable concern. However, purely in terms of resources, regulators need to distinguish between cuts in regulatory budgets that increase the risk of a regulatory failure and cost reductions that an exchange achieves by increasing efficiency, e.g., by upgrading monitoring technology or by outsourcing. (See, section D.5 below.)

Overall, the central risk in respect of the public interest, equally applicable to both for-profit shareholder-owned exchanges and mutually-owned exchanges, is the extent to which the exchange's short term commercial objectives are likely to overshadow its incentive to preserve its long-term reputational capital as a provider of fair and orderly markets that command investor confidence. The managements of most for-profit exchanges do not regard this as a serious risk. They argue that their incentive to deliver high regulatory standards is, if anything, increased as for-profit companies: they have much to lose, especially in a competitive environment, if participants lose confidence in the protections that exchange trading offers them. This was the view of the 15 Consultative Committee members who responded to our questions. Some recognised that there could be a conflict between a for-profit exchange's short-term and longer term commercial interests, but they believed that exchanges were cognizant of the commercial consequences of compromising high regulatory standards. Several indicated that they considered the conflict as more acute in mutual organisations than listed companies.

In extreme cases, the issue may not be one of a potentially ongoing conflict between an exchange's commercial interests and its regulatory obligations: the exchange may simply decide that it no longer makes commercial sense for it to continue certain regulatory functions. This is most likely to occur when at least one of the following factors is present: Official prohibition on the function being operated on a for-profit basis; tight regulation of permitted charges; and a perception on the part of the exchange that the regulatory function in question adds little or no value to the exchange's commercial branding. To date most transfers of regulatory responsibility have occurred on the initiative of governments or regulatory authorities, but these transfers have not been strongly opposed by the exchanges.

(b) Misuse of regulatory powers

A second key consideration in evaluating exchanges' ongoing regulatory roles is the extent to which they may be able to misuse that role for commercial benefit, particularly where they are subject to little competition or there are already high barriers to entry. The 2001 paper recognized that this could also occur with mutual exchanges but considered that the conflicts of interest that may bring this about are more likely to occur in a for-profit exchange. There are two main ways in which an exchange might misuse its position: 1) by taking regulatory actions that unreasonably disadvantage its competitors; or 2) by using its powers to generate regulatory income to finance its commercial operations. These are explored in more detail below. In either case, one of the mechanisms for such misuse may be implicit in the fee structure. Although regulatory authorities generally do not regulate fee structure, it is important that fees are fair and are not operating as a barrier to access.[9]

i) Regulation of competitors

An intrinsic feature of greater competition in the business of exchanges (and all trade execution services) is that an exchange may increasingly be placed in the position of regulating its competitors. These might include market participants who provide, use or have invested in competing forms of market services. An exchange could be regulating them either as market participants or as listed companies.

The 2001 paper stated that conflicts arising from the regulation of competitors could manifest themselves in a number of ways. Measures promoted in the name of high regulatory standards – for instance, in relation to access, trading or listing requirements – might also be designed with a view to restricting competition. Similarly, disciplinary proceedings and sanctions might be used in a discriminatory manner likely to disadvantage competitors.

While it is possible to over-state these risks, an exchange's regulatory position may, at the least, provide it with insights into its competitors' business that it would not otherwise enjoy. Addressing this last issue is not straightforward. In any regulatory area, an exchange should normally have arrangements to isolate regulatory information from commercial influence.

[9] The Hong Kong SFC has statutory authority to regulate the fees charged by the exchanges as a result of the demutualization. In the U.S., the SEC has the authority to review proposed changes to the fees charged by the exchanges.

For example, when an exchange admits/lists the securities of its commercial competitors, it is important that the exchange's processes operate in a manner that treats all issuers equally and that confidential information held by the admissions/listing department is not passed to the exchange's commercial arm.

ii) Uses of regulatory income

A further way in which a for-profit exchange could abuse its regulatory position would be for it to generate surplus revenues from its regulatory activities that it could then use for commercial purposes. This too is a potentially complex issue, in terms both of market integrity and its potential to distort competition. What comprises regulatory income may not always be either discrete or obvious. There is then the question of what may constitute appropriate uses for regulatory income.

Clearly, regulatory income is readily identifiable in the case of penalty/fine income. It may also be identifiable when an exchange has a specific role in providing general regulatory oversight of member firms and those firms pay a specified fee for that service. Beyond that, it may be more difficult to break out income that might arise from a regulatory function. For instance, trading and transaction reporting fees may cover both the commercial service provided in respect of trading as well as any regulatory aspects of the service, such as market monitoring.

To the extent that a particular function is viewed as being regulatory in nature, with a for-profit entity regulators should consider whether or not regulatory intervention to approve or control fees and charges is appropriate.

(c) Financial risk and exchange viability

The ongoing financial health of an exchange is generally considered important to a jurisdiction's capital markets. It is especially important in situations where an exchange is a country's sole capital market utility, has an extensive regulatory remit and is the main repository of regulatory expertise. Even where that is not the case and the business of a faltering exchange could be transferred to other venues without huge disruption, it is still important that an exchange should be in a position to manage an orderly run-down/transfer of its business without causing investor losses or market disturbance.

Again, this is not an issue solely for a demutualized exchange. However, it is likely to be a more significant issue with for-profit exchanges. This is for two reasons. First, a for-profit exchange may, hypothetically, be more inclined to take greater commercial risks than a mutual (which may also raise the question as to the extent of the regulatory role that such entities should hold). Even if it does not, it may still wish to enhance returns to shareholders by returning cash to shareholders either through dividend payment and/or share buy-back thus reducing its capital base. Second, a for-profit exchange might, in extremis, find it more difficult than a mutual to raise emergency funding. While all exchanges have the option of raising fees to meet a financial shortfall, and a demutualized exchange can always raise capital so long as there are willing investors, many mutual exchanges have a right to assess members and levy a capital contribution.

(d) Conflicts due to self-listing

One of the clearest issues relating to a demutualized exchange's regulatory role is the conflict of interest created when it self-lists. A major potential benefit of exchanges demutualizing is to open their access to a greater pool of capital. This can provide the existing owners – the exchange members – with the opportunity to realise the value of their holdings in the exchange as a business. It also enables the exchange itself to attract new capital from a broader range of investors. Most of the exchanges that have restructured have, either immediately or within a relatively short time, sought a listing for their shares. In almost every case, the listing has been sought on the exchange's own market. (See Table 1: Listed Exchange/Exchange Operators in section A.1 above.)

The key issue when an exchange self-lists is whether it can function effectively as its own regulator. In particular, is it appropriate for the exchange to review and approve its listing documents or those of its parent? Once the shares have started trading, can it credibly act as its own regulator (or that of its parent) if there is a breach of the listing rules? The extent of the risk posed by this conflict of interest depends on an exchange's role and responsibilities in the listing process. However, even where the listing function is the responsibility of an entity other than the exchange, the exchange may in some cases continue to act as the front-line monitor of the trading in its own shares.

(e) Regulatory efficiency

One of the less predictable consequences of the more competitive, for-profit environment in which exchanges are increasingly operating is its implications for an exchange's role as market regulator if there is market fragmentation. A further significant issue for many jurisdictions will be the continuing ability of any single exchange to carry out certain regulatory roles efficiently. Issues may well arise in relation to both the freedom of the exchange to set competitive regulatory standards (e.g. in relation to listing or transparency) or to monitor the whole of the market in any one instrument.

C. Regulatory responses to exchange evolution

No regulatory authority in an SC2 member jurisdiction has so far opposed or prevented their exchanges from demutualizing and converting to for-profit operation. However, although regulatory authorities have generally recognised that competition among market operators should offer market users efficiency benefits, most have also taken the view that the change in the business model, and the more competitive environment in general, can create a number of risks (as described in the previous section) in respect of the specific regulatory roles that exchanges perform in their jurisdictions.

The nature and scale of those risks can vary considerably. Much depends on the overall market structure in a jurisdiction and the way that its regulatory framework has evolved. Although many exchanges originally enjoyed considerable freedom in the way that they regulated as member-owned, self-regulatory organizations, most jurisdictions were progressively increasing the scope of statutory regulation well before the transition to the new exchange business model gathered pace. While this was sometimes in response to specific weaknesses identified in the self-regulatory system, it also reflected governmental recognition of the importance of exchanges in the capital markets – especially in equity markets – and the consequent public interest in exchanges' sound operation and ongoing viability.

Jurisdictions have differed in the degree to which they have circumscribed exchanges' freedom to set their own standards. Some jurisdictions have confined themselves to requiring that exchanges be licensed and meet general requirements to provide efficient markets and investor protection. In other cases, legislators and securities regulatory authorities have specified, in some detail, what they consider to be the key factors in the delivery of efficiency and fairness. Often, they have also imposed much tighter constraints on the freedoms of exchanges as rule-makers and enforcers by establishing market-wide rules and requiring exchanges to have all rule changes approved by the securities regulatory authority. Where this occurred before demutualization arrived, it probably lessened considerably the potential regulatory concerns with demutualization. Nonetheless, most jurisdictions have taken further steps, either through modified regulation or enhanced oversight (or both), to ensure that exchanges continue to fulfil their roles in a manner consistent with public interest objectives. This section sets out the various tools they have used.

Most approaches involve one or more of the following:

- governance arrangements;
- separation of functions within an exchange;
- restrictions on ownership;
- oversight arrangements (including arrangements to deal with self-listing);
- transfer/removal of functions.

Securities regulatory authorities have paid particular attention in their approach to an exchange's self-listing to deal with the particular conflicts and issues that arise in that instance.

C.1. Governance arrangements

Most regulators have focused on governance arrangements as the primary means of ensuring that exchanges have robust arrangements for maintaining a proper balance between the exchange's commercial interests and its regulatory responsibilities.

A primary focus for SC2 members in seeking to ensure that an exchange's decision-making and operational processes pay proper regard to, and protect, the public interest has been to require appropriate corporate governance arrangements. The overall aim is to ensure that the governing body includes individuals directly representing the broader public interest or who at least have the independence to consider whether the exchange is giving due weight to its regulatory responsibilities.[10]

Many jurisdictions of SC2 members have requirements for exchanges to have "public" or "independent" directors (or both).[11] In some cases, the requirement pre-dates demutualization, having usually evolved to deal with the conflicts that may be inherent in self-regulation (e.g. Germany, India, Mexico, the UK, the U.S.). In other cases, SC2 regulators have introduced, or developed, requirements to address the new issues presented by demutualization (e.g. Canada, Hong Kong) or the new requirements have been driven mainly, or additionally, by the standards (or best practices) for listed companies generally (e.g. Canada, the UK, the U.S.).[12]

The terms "independent directors" and "public directors" can carry significantly different meanings in different jurisdictions. More importantly, the legally-defined roles may also differ significantly. In some instances, these directors may have a responsibility for safeguarding the public and/or user interest in relation to the way in which the exchange conducts its regulatory functions. In other cases, the directors do not directly represent specific shareholding interests but nonetheless are elected by the shareholders and owe them the same fiduciary duty as the other directors. Such directors are often chosen from other stakeholder interests (e.g. listed companies) or because they have particular business or regulatory expertise.

---

[10] The International Council of Securities Associations (ICSA) noted in its comment letter that the members of ICSA's Working Group on the Governance of Market Infrastructures have developed a set of Principles for the Governance of Market Infrastructures (currently being discussed by the broader ICSA membership).

[11] In some jurisdictions, there may be a distinction between "independent" and "public" directors. For example, "independent" may mean not related to the exchange or its shareholders and "public" may mean non-industry, or the requirement for "independent" directors may be applicable to all listed companies, while the requirement for "public" directors may be specific to an exchange.

[12] In July 2006, the Commodity Futures Trading Commission (CFTC) published for comment a proposed statement of Acceptable Practices that is intended to promote independence in decision making by self-regulatory organizations in the area of futures trading. 71 Federal Register 38740 (July 7, 2006). Among other recommendations, the Board Composition Acceptable Practice proposed that exchanges minimize potential conflicts of interest by maintaining governing boards having a certain percentage of "public directors." A proposed Regulatory Oversight Committee Acceptable Practice would have exchanges establish a board-level Regulatory Oversight Committee, composed solely of public directors to oversee regulatory functions.

In some SC2 member jurisdictions, although there may be no definition of "independent" and/or "public" directors, there may be requirements that are relevant. For example, in Brazil, the stock exchanges must have two "independent" directors – one representing listed companies and one representing individual investors; however, there is no definition of "independent". In Switzerland and Italy, there is a "fit and proper requirement" for exchange directors, while in the UK the regulatory authority may have regard to both individual board members and the governing body as a whole in determining whether the exchange is a fit and proper person. In India, the Securities Law (Amendment) Ordinance, 2004 provides that the maximum number of broker representatives shall be restricted to 25% of the governing board. Of the remaining, 25% are appointed as public interest directors by the Securities and Exchange Board of India and 50% are elected by shareholders. In Spain, although there is no requirement for "independent" and/or "public" directors, there is a requirement for the boards of exchanges to be composed of at least five persons, with one general director (whose duties are defined by the by-laws of the exchange). On implementation of the Markets in Financial Instruments Directive in the EU (in November 2007), all EU exchanges operating Regulated Markets will be required to have arrangements – implicitly, governance arrangements – to identify and manage the potential adverse consequences of any conflict of interest between the regulated market, its owners or its operators and the sound functioning of the market.

A further governance issue for regulators is the arrangements when an exchange becomes the subsidiary of (or controlled by) a third party. An important principle in the regulatory approach to exchanges is normally that the governing body of an exchange should exist and operate in its own right (i.e. not simply in a nominal capacity implementing decisions taken elsewhere). On the other hand, a holding or parent company may consider it more efficient to centralise the executive management of the exchanges it owns (or controls). It may wish to minimise the size and role of the executive boards in each exchange and appoint boards that simply mirror the group executive. In parallel, it may see little value in the exchange subsidiary having independent or public interest representatives on its board. This may be sound commercial logic from the viewpoint of the controlling company. However, regulators need to assess whether this type of arrangement presents risks to good governance and delivers sufficient accountability. Currently, the number of foreign-owned subsidiary exchanges is relatively small, but in the UK where several exchanges are foreign-owned or controlled, the supervisory approach is to require independent governance of the UK exchange in much the same way as if it were a publicly-owned exchange.

C.2. Separation of regulatory versus commercial functions within an exchange

An important element in ensuring that an exchange's regulatory responsibilities are not compromised by its commercial interests is the maintenance of organisational arrangements that place divisions between the commercial and regulatory functions.

A second key aspect of governance arrangements is the way in which the regulatory function fits within an exchange's organisational structure. In general, it has been perceived as increasingly important that the regulatory function should be organised in a way that permits it to operate with as much independence as possible from the commercial interests of the management and shareholders. This normally involves some form of organisational containment of the regulatory department(s), but may also provide for specific arrangements regarding the appointment (and dismissal) of heads of regulation, regulatory oversight or audit by the independent or public directors, and/or the possibility of the head of regulation reporting concerns to the independent or public directors.

The specific arrangements may vary, but their general intent is the same. At some for-profit exchanges, separation of the commercial activities of the exchange from its regulatory functions has been achieved by establishing separate regulatory divisions that have no involvement in the commercial or business activities of the exchange. In some cases, these regulatory divisions report separately, and directly, to the CEO and Board. For example, the ASX has announced that it will move its market supervision functions into a separate subsidiary headed by a Chief Supervision Officer (CSO). The CSO will report directly to the subsidiary board and the board of the ASX. In Canada, the Bourse de Montréal has established a Special Regulatory Division that is responsible for the regulatory functions and reports to an independent committee of the Board, the Special Regulatory Committee. In France the regulatory functions at Euronext are located in the “Legal Regulatory Compliance Department”, which directly reports to the Board. In Italy, the exchange has established and maintains organizational arrangements to prevent conflicts of interest. In particular, it ensures that the persons responsible for certain departments have complete autonomy in carrying out examinations and putting forward proposals.

Because of the importance placed on the effective performance of regulatory functions by exchanges, some exchanges have also considered the separation of their commercial and regulatory functions while still operating as not-for-profit organizations. For example, the NYSE, even before its announced intent to merge with Archipelago, reorganised its governance. It appointed a Chief Regulatory Officer responsible for the day-to-day management of the exchange’s regulatory functions who reports directly to the Regulatory Oversight Committee of the Board.

C.3. Restrictions on ownership

Most SC2 members have not placed restrictions on any specific type of ownership of exchanges. However, many have various powers in respect of controlling or influential shareholders, ranging from notification, to fit and proper approval requirements.

A further potential option for addressing concerns over governance is to impose requirements or restrictions on the shareholders themselves. While exchanges remain mutual, the market participants who own the exchange have at least some common interest in high regulatory standards and are nearly always investment firms subject to regulation. Once demutualized, an exchange could fall under the control, or influence, of 'inappropriate' shareholders. (Some jurisdictions may also have a more general concern about allowing a key part of the capital market infrastructure to become foreign-owned, or at least without some form of prior approval.)

There have been three main ways of approaching non-mutual ownership to date:

- placing specific eligibility requirements on substantial or controlling shareholders (e.g. fit and proper requirements);

- imposing regulatory notification and/or public disclosure requirements when shareholdings (or the percentage of shares controlled) exceed certain thresholds; and/or
- placing restrictions on the permitted size of shareholdings, with or without discretion to approve higher levels.

Many jurisdictions of SC2 members use one or more of the above. For instance, the UK requirement for an exchange to be a fit and proper person extends to its controllers, while shareholders in a listed exchange must comply with listed company rules requiring notification and disclosure of shareholding of 3% or more. In most jurisdictions of SC2 members, the shareholder restrictions have been imposed specifically for exchanges (and are not a requirement for all listed issuers). The requirements may be imposed by the regulator or may be required by legislation. For example, in Singapore, legislation provides that a person shall notify and obtain the approval of the securities regulatory authority before acquiring a substantial shareholding (defined to be 5% or more of the voting shares) in an exchange. In addition, a person must obtain prior approval before becoming a 12% controller or 20% controller of an exchange. The restrictions are intended to allow the securities regulatory authority to be satisfied that the shareholders owning more than 5% are fit and proper persons, that the exchange will continue to conduct its business prudently and in compliance with its statutory obligations and that it would not be contrary to the interests of the public to have such persons as shareholders. From November 2007, the Markets in Financial Instruments Directive in the EU will require Member States to require persons who are in a position to exercise, directly or indirectly, significant influence over the management of a Regulated Market to be suitable. Member States will be required to refuse to approve proposed changes to controlling interests where there are grounds for believing that the change would pose a threat to the sound and prudent management of the market. Currently, in Italy, although the law does not prescribe any restrictions as to the type of ownership of exchange operators, there are general integrity requirements imposed in legislation.

In Hong Kong, the shareholder restrictions are imposed by statute and provide that no person can become a minority controller (designated as a person that is entitled to exercise or control the exercise of 5% or more of the voting power) of the exchange without the prior approval of the securities regulatory authority. In Australia, there is an obligation on the licensee, or its holding company, to take reasonable steps to ensure that a person does not hold more than 15% (or a higher amount approved by the Minister) of the voting power in the licensee or its holding company. There is also an obligation to take reasonable steps to ensure that no disqualified individual becomes or remains involved in the licensee.

In Canada, shareholder restrictions are imposed on exchanges either by legislation or by the regulator. For the TSX, the shareholder restriction is imposed by legislation and provides that, without the approval of the securities regulatory authority, no person or company and no combination of persons or companies acting jointly shall beneficially own or exercise control or direction over more than 10%. For the Bourse de Montréal, the shareholder restriction is imposed by the Autorité des marchés financiers and provides that no person, including persons associated with that person, shall be allowed to hold, own or exercise control, either directly or indirectly, over more than 10% of any class or any series of voting shares of the Bourse.

Most jurisdictions of SC2 members do not require or prohibit any specific type of ownership of an exchange. However, in Mexico, legislation prohibits certain individuals from participating as shareholders of an exchange (for example, foreign investors that have government powers). India prohibits any foreigner from acquiring shares in an exchange.

See Table 2 below for further information about shareholder restrictions in the jurisdictions of SC2 members.

Table 2: Shareholder Restrictions

Country	Exchange/ Exchange Operator	Shareholder disclosure requirement*	Shareholder ownership restriction	Notification/ disclosure of change in ownership*
Australia	SFE[13]	5%	15%	Written notice when a person has, or ceases to have, 15%.
	ASX	5%	15%	Written notice when a person has, or ceases to have, 15%.
Canada	TSX Group Bourse de Montréal	5% The Bourse shall submit to the AMF a list of its shareholders on a semi-annual basis	10% 10%	Notice and approval by regulator to own more than 10%. The Bourse shall inform the AMF immediately if it becomes aware that any person owns or exercises control, either directly or indirectly, over more than 10% of any class or series of voting shares of the Bourse and shall take the necessary steps to immediately remedy the situation.
France	Euronext Paris Additional requirements apply under Dutch law to EuronextNV, the Dutch holding company listed on Euronext Paris.	10%	Fitness and propriety	Disclosure to regulator when thresholds reached.
Germany	Deutsche Borse	5% (first threshold)	10%	After notification of thresholds, regulator has discretion to prohibit acquisition.
Hong Kong	HKEx	5%	5%	Disclose where increase or decrease is across a whole percentage (e.g. 6%, 7%, etc.).
India	BSE Limited	More than 5%	5%	Persons acting in concert cannot hold more than 15%.
Italy	Borsa Italiana	5%	fitness and propriety requirements	Notification to regulator of 5% threshold reached
Japan	TSE, OSE,	5%	20%	Person who retains shares in excess

[13] ASX and SFE merged, effective July 25, 2006 and ASX obtained the necessary approval to acquire all of the issued capital of SFE.

Country	Exchange/ Exchange Operator	Shareholder disclosure requirement*	Shareholder ownership restriction	Notification/ disclosure of change in ownership*
	NSE, Jasdaq			of 20% require approval of regulator[14]; notification if 5% ownership.
Malaysia	Bursa Malaysia	5%	5%	Approval by Minister of Finance to own 5% or more.
Mexico	Mexican Stock Exchange	10%	10%; foreign investors that have government powers; or individuals that directly or indirectly possess more than 10% of a financial institutions equity.	N/A
Singapore	SGX	5%	5%	A substantial shareholder (5%) must advise the listed entity and the exchange of change in percentage or it ceases to be a substantial shareholder.
Spain	BME	1% (first threshold)	1% (significant shareholding)	Notified at certain thresholds above 1%.
U.K.	All listed exchanges	3% (and additional 1% increments)	Not required by law. Restrictions would be likely to contravene UK listing rules.	Notification of all changes affecting governance.
U.S.	CHX, ISE, Nasdaq, NSX, NYSE Group (NYSE and NYSE Arca,Inc.) Phlx	Exchanges have different standards that have been approved by the SEC. If the exchange is a publicly-traded company, a shareholder	Exchanges have different standards that have been approved by the SEC.	Exchanges have different standards that have been approved by the SEC. If the exchange is a publicly-traded company, shareholders also must file amendments to initial disclosure reports filed with the Commission under Section 13(d) of the Exchange Act.[15]

[14] Holding 20% or more will be, in principle, prohibited in Japan when the 2006 law amendment is in force in 2007.

[15] If the exchange is a publicly-traded company, the rules and regulations of the U.S. Securities and Exchange Commission require a shareholder of the exchange who owns more than 5% of a class of equity security to promptly file with the U.S. Securities and Exchange Commission notice of any material increase or decrease in the percentage of the class beneficially owned, unless at the time of the initial filing the shareholder satisfied certain passive investor requirements, in which case the shareholder only would need to file annually (unless such shareholder's ownership increases to more than 10% of the class of securities outstanding).

Country	Exchange/ Exchange Operator	Shareholder disclosure requirement*	Shareholder ownership restriction	Notification/ disclosure of change in ownership*
		that owns more than 5% of any class of equity securities must file a disclosure report with the U.S. Securities and Exchange Commission pursuant to Section 13(d) of the Exchange Act.		

** Please note that, in some jurisdictions, the disclosure requirements may not be specific to exchanges but may apply generally to all listed companies.*

C.4. Oversight arrangements

In general, regulators have intensified their oversight of for-profit exchanges and taken greater interest in areas such as financial resources. All have required special oversight arrangements in respect of self-listed exchanges.

An important part of the regulatory response has been the establishment of additional oversight arrangements. Depending on the issue to be addressed, these often include one or more of the following:

- increased oversight by the securities regulatory authority;
- special oversight arrangements (including arrangements to deal with self-listing);
- specific terms and conditions added to an exchange's authorization.

a) Increased oversight by securities regulatory authority

One response by securities regulatory authorities to address issues raised by new ownership and business structures has been to increase the level of regulatory oversight of exchanges. For example, some jurisdictions of SC2 members noted that, as part of their on-site reviews of an exchange, they now assess whether the exchange has sufficient resources to carry out its regulatory functions effectively (Canada, Malaysia, Singapore). As part of the general oversight of an exchange, many jurisdictions of SC2 members require an annual regulatory report to be completed (Australia, Canada, France, Italy, Malaysia, Singapore, Spain). In

France, the head of compliance and the persons responsible for trading surveillance and member regulation are each required to complete an annual report. [16]

b) Special oversight arrangements to deal with self-listing

To address the potential conflicts of interest arising for a self-listing exchange, many regulators have established special oversight arrangements. Some of these arrangements have also covered the listing or oversight of trading activity of companies that could be considered to be competitors of an exchange.

The approach favoured by many regulators in respect of initial listing has been to remove the exchange entirely from any decision-making role in its own listing process. Instead, the regulator has normally taken on that role. (See, for example, Australia, Canada, Hong Kong, Japan, Malaysia, Singapore.). In the U.S under NYSE rules, prior to the initial listing of an affiliate's security on the NYSE, NYSE Regulation (the regulatory affiliate of NYSE Group) must determine that such securities satisfy NYSE rules for listing, and such finding must be approved by the NYSE Regulation board of directors.

With respect to ongoing listing requirements and oversight of trading in the securities of the listed exchange, regulators have adopted different approaches. In some jurisdictions, the regulator is responsible for monitoring the ongoing compliance of the self-listed exchange with listing rules (Australia, Hong Kong[17], Malaysia, Singapore) and the trading surveillance on the securities issued by the exchange. This includes monitoring compliance with the information disclosure provisions of the exchange rules as well as identifying and evaluating abnormal trading patterns. In Hong Kong, where the regulator has all regulatory powers and functions with respect to ongoing listing procedures for the self-listed exchange, the exchange has power to proceed in a matter if the regulator has stated that a conflict of interest will not arise if a particular action or decision were to be taken. In Canada, a conflicts committee has been established to review any matter regarding a conflict of interest or potential conflict of interest relating to the continued listing of the exchange. Any recommendation of the conflicts committee is sent to the regulator for approval. In Canada, since the independent market regulator (Market Regulation Services Inc. (RS)) was acting as agent of the exchange prior to self-listing to monitor trading of all listed issuers and to monitor compliance with timely disclosure requirements, it continues to perform these functions with respect to the listed exchange's securities.

In the U.S, the Pacific Exchange (now, NYSE Arca, Inc.) and Nasdaq adopted rules that require each to provide the SEC with: 1) periodic reports of its surveillance of the listing and trading of its own or any affiliate's securities on its market, and 2) notice of any non-compliance by such security with any listing standard. In addition, the rules of the NYSE Arca, Inc. and Nasdaq require an independent accounting firm to review, once each year, the listing standards for such security, to confirm that such security was in compliance with the listing standards.

---

[16] These three persons are required to hold a professional licence, which is issued by the AMF on application by the exchange.

[17] In Hong Kong, the regulator is responsible for the trading surveillance of all listed securities, including the securities issued by the exchange.

In addition, NYSE Rule 497 imposes additional requirements for listed securities issued by the NYSE Group or its affiliates, such as quarterly reports to the NYSE Regulation board of directors regarding NYSE Regulation's monitoring of NYSE Group's or its affiliates' compliance with NYSE's listing standards and trading , annual review by an independent accounting firm of the listing standards of NYSE Group's or its affiliates' securities and, in the event that NYSE Regulation determines that NYSE Group or its affiliates' securities are not in compliance with the exchange's listing standards, there are notice requirements to the issuer and the SEC.

The SEC has not promulgated its own rules on self-listing. However, the SEC will monitor SROs with regard to compliance with their own self-listing rules.

With respect to companies that could be considered to be competitors of an exchange, one approach has been to establish some special oversight arrangements. For example, in Canada, any initial or ongoing listing matter or a complaint of a competitor must be immediately brought to the attention of the conflicts committee who must notify the regulator. In Singapore, there is also a conflicts committee whose principal responsibility is to identify conflicts of interest or possible conflicts of interest that may arise in the course of performance of regulatory functions. In Japan, the regulator gives advice to the exchange in respect of its oversight of the listing and trading of competitors generally. In Hong Kong, if an applicant for listing or a listed company considers that a conflict of interest may exist between the interests of the exchange and the interests of the proper performance of any regulatory function, it can bring the facts of the matter to the attention of the regulator.

c) Specific terms and conditions added to an exchange's authorization

In some jurisdictions, terms and conditions have been imposed to deal with specific issues. For example, in order to address financial viability concerns, many jurisdictions of SC2 members have general requirements for the exchange to have adequate financial resources (Australia, Canada, Germany, Hong Kong, Singapore, the UK). Some SC2 jurisdictions have set minimum capital requirements for exchanges to maintain. In the UK, exchanges are required either to meet a standard capital requirement or to negotiate a customised requirement that may better reflect the risks of their business. In Canada, exchanges must meet specified financial ratios on a regular basis and report to the regulators in the case of a shortfall. In France, although no longer required by law, Euronext Paris is still a credit institution subject to prudential capital requirements.

Some SC2 jurisdictions also have specific requirements relating to regulatory resources. For example, in the U.S., all exchanges are required to have the capacity to carry out the purposes of the law and to comply and to enforce compliance by their members with the securities laws and the exchange rules. In other jurisdictions (Australia, Canada), there are general requirements that exchanges have the ability to perform their regulation functions. In Canada, a specific term and condition has been included in the authorization order of one of the for-profit exchanges to provide that the regulatory division should have a separate budget that is subject to approval of the board.

Some jurisdictions may also specify how certain types of regulatory income may be spent, in effect setting out to prevent such income becoming a source of profit. In the UK, for instance, an exchange may use income from disciplinary actions in one any of three ways: to offset the costs of bringing the action; for the benefit of the market's users, or for charitable purposes.

In Canada, the Bourse de Montréal has requirements that fines, fees and other costs imposed by a disciplinary committee or by the Special Committee be attributed to the Regulatory Division and cannot be used to fund commercial activities of the exchange.

C.5. Transfer/removal of regulatory functions

Jurisdictions might choose to remove a regulatory responsibility from an exchange either because they perceive an unacceptable conflict of interest in a for-profit exchange retaining that responsibility or because they consider that granting an exchange an exclusive regulatory franchise might impede competition.

In certain circumstances, a jurisdiction may decide that it is better to transfer a specific regulatory responsibility from an exchange to a different body. In some jurisdictions, transfers may be within the powers of the regulatory authorities. In others, they may require a governmental decision or new legislation.

Transfers are particularly likely to be considered in situations where allowing the exchange to perform a regulatory function or to regulate emerging competitors is considered likely to distort or prevent competition in the marketplace. For example, in 2001 the UK government transferred the role of UK Listing Authority, a public function previously assigned to the London Stock Exchange, to the Financial Services Authority, the statutory regulator. It did this to remove a perceived competitive advantage of the LSE at a time when competing exchanges were emerging in the UK and the LSE had announced its decision to demutualize.

In the European Union, it was decided that certain tasks should rest with administrative authorities rather than private law bodies. For example, the Market Abuse Directive requires that the responsibility for detecting and preventing market abuse rests with a single administrative authority. According to the Prospectus Directive, member states must designate a central competent administrative authority responsible for the approval of prospectuses.

In addition to listing, the question of whether an exchange should continue to exercise specific regulatory responsibilities may also be particularly relevant in respect of exchanges that have an extensive role in member regulation. In Hong Kong, following the demutualization and merger of the stock exchange and the futures exchange, the securities regulatory authority assumed the role of front-line regulator of exchange participants including monitoring compliance with capital requirements. The exchange continues to be responsible for monitoring compliance with its trading and clearing rules. In Singapore, since July 2003, the securities regulatory authority has taken over the responsibility for on-site inspection of brokers. The transfer was to provide greater clarity in regulatory responsibilities and to reduce duplication of work.

Some jurisdictions have also addressed the issue of the practicability and desirability of an exchange continuing as the main market monitor in a more competitive, and thus fragmented, trading environment. For example, in Canada, following the implementation of the alternative trading system (ATS) rules, RS, a separate SRO (owned jointly by the TSX and a member regulation SRO) was established to perform market regulation of exchanges and ATSs; exchanges such as TSX have contracted with this SRO to perform certain regulation functions. The exchanges retain responsibility for these functions and are required to monitor their performance by RS. In the U.S., some exchanges have outsourced certain regulation functions to the NASD; however, each exchange retains responsibility under the U.S. securities laws.

In general, a transfer of responsibilities is a major decision that may have many direct and indirect consequences and should not be made lightly. Most countries continue to regard - and value - exchanges as front-line regulators of their markets, often providing them with legal protection in discharging any regulatory responsibilities imposed on them under legislation.

D. Broader regulatory issues arising from the new business models

Exchanges' transition to a for-profit business model and more competitive operation raise a second, broader set of regulatory issues. Some of these issues are not necessarily new issues but may have a different focus in a more competitive and commercial environment. This may require new supervisory approaches as a result of the changing manner in which exchanges operate, develop and structure their businesses. The issues are wide-ranging. In areas relating to competition and cross-border business, they are also challenging.

D.1. Background

For-profit exchanges have a strong incentive to be active commercially. They have a broader base for funding and there is pressure to deliver returns to their shareholders - whether by raising income or cutting costs.

Active business development is not an innovation of for-profit exchanges. Mutual exchanges seek to broaden or improve their businesses where it benefits their trading members. For example, many of the major mutual exchanges competed actively for international listings; Deutsche Börse forged its links with the Swiss Stock Exchange (SWX) to create a jointly owned derivatives business, Eurex, some three years before it listed its shares. In the U.S., NASDAQ embarked on several new projects outside the US before it completed its private offering in January, 2001. In addition, the U.S. futures exchanges were actively developing business through innovation prior to demutualization (for example, Chicago Mercantile Exchange’s Globex trading system and various linkage arrangements).

For-profit exchanges are likely to continue to accelerate commercial activity. Above all, they need to deliver increasing returns to investors. They also enjoy broader access to funding than mutual exchanges and have greater freedom to pursue opportunities unrestrained by the interests of any particular group of participants (although this broader access may be accompanied by a greater degree of shareholder activism).

In addition to more aggressive competition to win business, several exchanges have made more strategic moves, generally with the aim of expanding business and achieving economies of scale. These moves have included the creation of the transnational Euronext group and the subsequent acquisitions by the listed company of the Lisbon exchange and the London International Financial Futures Exchange (LIFFE). Deutsche Börse followed its listing with the acquisition of the 50% of Clearstream International, the international securities depository, it did not already own. In recent years, a number of exchanges have expressed interest in acquiring the London Stock Exchange. In northern Europe, the OM Group has also created a transnational group by acquiring the Helsinki, Copenhagen and several Baltic exchanges. The Nasdaq Stock Market, Inc. acquired Brut, LLC, the owner and operator of Brut ECN, in September 2004 and acquired Instinet, the owner and operator of the INET ECN, in December 2005. In March 2006, the NYSE merged with Archipelago to form NYSE Group.

D.2. Competitive behaviour

More aggressive competition to increase market share in trading can increase the use of incentive schemes. It is important that they remain compatible with the integrity of pricing and investor protection.

Active competition among exchanges – and between exchanges and other trading venues – offers market participants (and their clients) the possibility of enhanced and more finely-priced levels of service, especially in the U.S. and European markets. The potential scale of the benefits to be generated from competitive service provision inevitably depends on the extent to which a market-place is already delivering an efficient service that meets user requirements. In rare cases, the strength of the competitive offering is so great that the provider wins significant market share - and forces those losing market share to seek ways of becoming more efficient. This phenomenon has been particularly evident in the huge impact of ECNs in the U.S. over the past decade. And in Europe, Eurex was notably successful in winning the on-exchange bond futures business from LIFFE. But even where a new, more competitive offering fails to gain market share, the simple fact that it poses a threat is often enough to force incumbents to become more competitive. In Europe, aggressive attempts by some exchanges to win trading from other exchanges have not so far caused material transfers of trading, but they have played a significant role in holding down charges. Similarly, in the US, Deutsche Börse's launch of Eurex US in 2004 sparked major reductions in the CBOT's trading fees – although they have recently increased them following Eurex U.S.'s failure to win a significant share of the market.

While the efficiency benefits of competition are to be welcomed, it is also important that competition is conducted in a manner consistent with market integrity and investor protection. Frequently, the potential benefits for a market participant in transferring its business to another exchange are only marginal. There may also be a transitional risk if liquidity does not accumulate on the rival platform as expected. Like other companies, exchanges aiming to capture business from competitors may feel they need to offer incentives and exchanges under attack often respond to the competition with new incentive schemes of their own.

Regulators in some countries have found that they have had to review their approach to incentive schemes and devote considerably more time to the review of individual incentive scheme proposals than was the case only a couple of years ago. The challenge for regulators is to allow normal commercial practices as much freedom as possible but to recognize that in the exchange environment they also need to protect the principles of pricing integrity, client interests and best execution. This requires regulators to have both clear principles in respect of incentive schemes and a good understanding of the incentive schemes being used by trading platforms, whether located in their own jurisdiction or offering competing services from external locations.

D.3. Extension of exchange activities

In seeking to expand their businesses, exchanges may wish to move into unregulated activities or expand present services in a way that may not be explicitly provided for under their existing authorisation and which in some cases increasingly blurs the line between exchange and OTC activity.

When seeking business expansion opportunities, exchanges may create a number of new "big picture" questions for regulators in terms of the nature of business expansion.

A first issue can arise over the extent to which it may be appropriate for an exchange group to diversify into totally new areas, and in particular "unregulated" activities. To date, there seems to be little evidence of exchanges/exchange groups wanting to diversify outside financial market services (and related technology) fields. If that were to change, reputational risk should provide protection against some forms of diversification. Whether or not an exchange is permitted to operate other activities within the same corporate entity may be a matter of established national law. In policy terms, the issue may be the extent of the risk to the exchange of allowing multiple activities to take place within the same legal entity as the exchange. One obvious source of risk where this is permitted would lie in the availability of financial resources to discharge the specific responsibilities of the exchange.

A second issue may arise when an exchange wishes to expand into services slightly outside the traditional (regulatory) scope of its activities. Such expansion might raise either of the following issues. In the first case, it may be that the definition (if there is one) of an exchange and its activities creates difficulties because it is too restrictive, too permissive – or, simply, too unclear. In the second, the exchange may wish to move into activities that raise conflict of interest issues with regards to the exchange's "core" services (e.g. OTC clearing) or vis-a-vis exchange participants providing the same services (e.g. broker or dealer services).

D.4. Cross-border activity and affiliations

Electronic trading gives exchanges considerable scope to build cross-border, even global, businesses. The development of cross-border trading and the creation of multinational exchange groups raise a considerable challenge for regulators to maintain an appropriate regulatory framework while fostering market development.

Perhaps the development raising the most regulatory issues is cross-border business development. So far, this has taken three main forms:

- the expansion of remote membership;
- the establishment of new market facilities in foreign countries;
- mergers with, or acquisitions of, exchanges in other countries.

a) Remote membership

Not all electronic exchanges offer remote membership, but it has become increasingly common in recent years and for some exchanges has been a major source of revenue. For example, in 2004 Eurex had more than three-quarters of its members outside Germany and these members accounted for a substantial proportion of its business.

For regulators of exchanges offering remote membership, the main considerations have normally related to the "status" requirements of the foreign participant (e.g. whether they always need to be licensed and, if so, whether in the jurisdiction of the firm, the jurisdiction of the market, or both), the information-sharing and co-operation arrangements in place with the regulatory authorities of the participants and the adequacy of the clearing and settlement arrangements. (Regulatory approaches on the part of jurisdictions whose firms may wish to participate electronically in foreign exchanges vary considerably.)

b) Establishing subsidiaries

So far, there have been relatively few attempts at expansion through the establishment of foreign subsidiaries. Exchanges have generally considered this option, in preference to remote membership, when their trading model may not lend itself to remote membership, when they may have preferred to create a joint venture with local investors, or when they perceive commercial and possibly legal and regulatory benefits in having a locally incorporated and regulated exchange.

For the regulatory authorities where the subsidiary is authorised and operates, the exchange is subject to the same regulatory requirements as other (similar) domestic exchanges. The main difference may be in respect of any governance and other conditions imposed as a result of foreign or group control.

c) Cross-border corporate groups

Some exchanges have set about expansion through merger with, or acquisition of, exchanges (or trading platforms) in other countries. This has been particularly the case in the EU, where there has been a widespread view that the EU, as an evolving single capital market, has an over-supply of exchanges, or at least exchange infrastructure, for the longer term. There both the Euronext and the OM group have expanded cross-border via merger and acquisition.

The issues raised in each instance of cross-border infrastructure vary, depending on the nature of the corporate structure and the way in which the group intends to operate its business. In general, they include some, or all, of the following:

- the fitness, governance, management role and regulatory status, if any, of the top/controlling entity;
- the status and responsibilities of the subsidiary exchanges/market venues;
- specific provisions and supervisory arrangements where all or part of the market activity is effectively transferred to another country (and, possibly, the exchange closed down completely);

- specific provisions and supervisory arrangements when an exchange group centralises one or more of its exchanges' regulatory functions (e.g. market monitoring) in one country;
- information sharing and co-operation agreements.

The nature of the issues for regulators in the different countries which have some legal jurisdiction over the new structure will also vary, according to the requirements of their national law. As groups come to operate in a more integrated way, a major challenge for regulators will be to ensure that the elements of the group for which they have legal responsibility comply with their national regulatory requirements but also to find ways to collaborate with other regulators that enable regulation to be conducted effectively, and also efficiently. One part of that process may involve new working arrangements among the relevant regulators. A further element may be to persuade cross-border groups to organise their internal structures in a way that facilitates regulatory efficiency.

D.5. Outsourcing

Exchanges may seek to outsource certain functions for a variety of reasons. In such cases, it should be clear which entity is responsible for a particular function.

Outsourcing[18] raises a number of issues. More complex issues may arise in this context when exchanges propose to outsource activities relating to regulatory functions. Outsourcing may be considered for a number of reasons including cost reduction or as a way to address certain conflicts of interest. In such cases, the critical test for most regulatory authorities will be clarity as to where regulatory responsibility for the function resides and the extent to which the outsourcing is consistent with the exchange's ability to continue to discharge that responsibility. If a third party is performing key regulatory functions, regulators may also want to consider whether the entity is appropriately regulated.

In addition, an emerging issue is the degree to which an exchange should outsource its key operational functions. This could involve outsourcing to a third party provider or, where relevant, to other parts of the group. This may make sound commercial sense and, in general, be in the interests of market users. However, if an exchange outsources the whole of its trading platform, regulators will want to take any appropriate steps to help ensure that the platform is operated in conformity with all regulatory obligations, and will want to focus on the risk assessment and management of such outsourced services. Regulators may also need to assess the extent of outsourcing that they consider to be consistent with the statutory and other requirements for registration as an exchange.

[18] See generally, "Principles on outsourcing of financial services for market intermediaries", Report of the Technical Committee, February 2005.

D.6. Maintenance of unprofitable markets

Exchanges may decide to withdraw from some market sectors in which they cannot operate sufficiently profitably.

To date, there have been few cases of exchanges closing down market segments because those segments have ceased to be commercially attractive to them. This could happen more in the future, particularly during a prolonged downturn in activity. Some exchanges may resist closure or sale of a sector if they consider it as an important part of the brand value, regardless of its level of profitability. From a national viewpoint, there could be concerns about such a withdrawal unless there was another entity prepared to take on that business. From a regulatory viewpoint, the issues would focus on the orderly transfer or closure of the activity.

D.7. Monopoly operation

It is difficult to know whether a more contestable environment for market operators (whether or not exchanges) will lead to sustained competition or whether the natural tendencies of both market liquidity and for-profit companies to move towards concentration will lead to a very small number of dominant for-profit market operators.

One of the paradoxes of competition among trading venues is that the tendency for liquidity to concentrate imposes a natural constraint on the scope for competition among trading venues. So, while competition between exchanges (and other trading venues) may be healthy in the general context of fostering efficiency, there may well be a tendency in many markets for competition to diminish once any significant inefficiency in the delivery of trading services have been minimised. When that point arrives will vary considerably from market to market, but listed exchanges do now have both the commercial motivation and the access to capital that may hasten consolidation (in whatever form) between exchanges and, ultimately, bring monopoly issues higher up the agenda. [19]

How and when those issues arise will depend in large part on the way in which individual markets operate. They may be affected by a wide variety of factors, such as the structure of the value chain (from listing through trading to post-trade services), the commercial incentives for competition in listing, and the controls of data revenues. There may also be issues with respect to the fee-setting process. Where there is little or no competition, the possibility exists that fees may be used in a discriminatory manner. In some countries, these issues fall directly within the remit of the regulatory authority; in others, they are the

[19] For example, the U.S. Department of Justice opened an investigation into the possible anti-competitive issues raised by the proposed merger between the NYSE and Archipelago. In November 2005, the NYSE announced that the Department of Justice Antitrust Division closed its investigation of the NYSE/Archipelago merger with no further action. On the other hand, in 1999, the ASX and SFE announced a proposed merger. However, the Australian Competition & Consumer Commission did not allow the merger to proceed because of concerns about the lack of competition and monopolistic power of a single market operator in Australia.

responsibility of the competition authorities, or a shared responsibility. Regardless of where the legal responsibility lies, this is an issue that is likely to be rising up regulators' agendas over the medium-term.

D.8. Pressure on regulatory authorities

Exchanges' need to react speedily to new business opportunities and challenges is increasing the need for regulatory authorities to be able to respond promptly in dealing with regulatory approvals and inquiries from exchanges.

For some regulators, a particular feature of the recent changes taking place in exchange markets has been the increased level of commercial initiatives by exchanges and the increased pressure on regulators to approve new initiatives and rule changes rapidly. Regulatory authorities may therefore need to give some thought to how they consider approvals, particularly given that some of the issues that they now need to deal with are novel and complex.

D.9. Conflicts between exchange and listed company regulation

An exchange that is listed may be subject to overlapping listed issuer requirements and exchange requirements.

Changes in listed company regulation may have an impact on the requirements imposed on a listed exchange. In some cases, these requirements may conflict with the existing requirements imposed on an exchange and therefore cause practical difficulties with compliance. For example, an exchange may have certain corporate governance requirements (i.e., independent director requirements). Listed company regulation may also impose corporate governance requirements, which may be different from that imposed on an exchange. It is necessary to ensure that these requirements are consistent, although it may be the case that additional requirements are imposed on a listed exchange.

E. Conclusions and recommendations

Since publication of the 2001 paper, the trend for exchanges to demutualize, and, in many cases, obtain exchange listings has continued. The changes in exchange ownership have highlighted certain regulatory issues. However, demutualization is only one aspect of the changing environment for exchanges. Many exchanges, whether demutualized or not, are operating in a more competitive environment. Exchanges have been more active in seeking ways to expand their business, whether by developing or competing for products and services, by expanding their reach to participants beyond their home borders, or by seeking mergers with, or acquisitions of, other market operators. Several key issues relating to the operation of exchanges, and the development and structure of their business are still emerging.

The fact-finding exercise among SC2 members revealed that:

1. All exchanges continue to perform all or some of the regulatory functions traditionally assigned to them;

2. Most securities regulatory authorities have taken steps, either through modified regulation or enhanced oversight, to ensure that exchanges continue to perform regulatory functions in a proper manner;

3. The steps taken have tended to be customised and pragmatic, based on an assessment of the particular circumstances in a jurisdiction; and

4. When exchanges have decided to self-list, all the jurisdictions of SC2 members have considered specific measures and taken appropriate steps to deal with the particular conflicts and issues that arise.

As exchanges have evolved, there are a number of additional issues that regulatory authorities have been considering. As noted, this paper discusses emerging issues resulting from increased competition, extension of exchange activities, cross-border activity and affiliations and outsourcing, among others. The main questions that arise are as follows:

(i) Do the existing regulatory requirements for exchange licensing/registration and operation continue to be adequate and easily adaptable to the emerging issues or are new tools necessary?

(ii) How should the new business activities of exchanges be considered and included in the regulatory framework?

The answers to these questions are often far from straightforward. Some touch on much larger issues relating to the future of exchanges, the relationship between exchange regulation and exchange branding, the desirability of competing standards, and the case for a more functional rather than institutional approach to market regulation. However, it is clear that regulatory authorities must at least have the ability to identify regulatory concerns arising from market developments and clearly developed principles for determining what, if any, measures are appropriate in a particular situation. The following recommendations can be made at this time:

1. **Regulatory authorities should have adequate arrangements to enable them to keep the changing market environment under review and to identify emerging issues in a timely fashion. These arrangements should include ongoing dialogue with exchanges (which could include regular meetings with exchange boards and/or management or specific reporting obligations) to help ensure an understanding of their businesses and practices**. To promptly evaluate the impact of any changes, regulatory authorities need to be in a position to obtain up-to-date information about any developments or changes to exchange operations. In some cases, in addition to the dialogue with exchanges there may be a need for regulators to hold discussions with key stakeholders, including users of exchange services, to determine if the new initiatives or activities of exchanges require regulatory responses.

2. **Regulatory authorities should assess whether the changes being made by exchanges require any adjustments to the regulatory framework for an individual exchange or for exchanges generally, and should address any such need for changes promptly.** Various approaches have been described in this paper: governance arrangements, separation of functions within an exchange, restrictions on ownership, oversight arrangements (i.e., increased oversight, special self-listing arrangements and the addition of specific terms and conditions to authorization documents such as those relating to minimum capital or financial viability more generally) and transfer/removal of functions. These approaches should be considered as regulators seek to re-evaluate their own regulatory scheme. In making any adjustments, new tools may become necessary and a survey of actions taken by supervisors in other jurisdictions may be of assistance as these issues are constantly evolving.

3. **Regulatory authorities should carefully assess the impact on resources of any changes to the regulatory model for exchanges, and ensure that the core regulatory obligations and operational functions of exchanges are appropriately organized and sufficiently resourced.** This assessment should include the impact on both financial and human resources (e.g., sufficient funding, number of people and expertise) of any changes to functions performed by exchanges. While regulatory authorities may be able to address some issues through existing supervisory powers or by developing modified supervisory arrangements with exchanges, there may be circumstances (when permitted by the legislative structure) where a regulatory function is transferred to a different entity. In the case of a transfer of functions it is especially important to carefully consider and analyze the impact on resources at the entity to which they have been transferred, whether at the regulatory authority, other exchange or SRO or other entity as well as whether the appropriate systems are in place to perform the regulatory function.

4. **Securities regulatory authorities should be prepared to share relevant information concerning cross-border activity.** With increased cross-border activities, whether by exchanges or competing infrastructure providers, regulatory authorities should consider whether all necessary information sharing arrangements are in place to facilitate the exchange of relevant information. There may be a need to obtain information for market oversight purposes or more generally (for example, information on listing processes, settlement procedures or trading systems).

5. **Regulatory authorities should consider competition issues that may arise in connection with the evolution of exchanges as discussed above where such evolution impacts market integrity, efficiency or investor protection.** This is an important consideration given the complex competition issues that may be raised by market structure developments and their interaction with market integrity and investor protection.

ANNEX

FEEDBACK STATEMENT
IOSCO Technical Committee Consultation Report – *Regulatory Issues Arising from Exchange Evolution*

Comments were submitted by the following organizations in response to the IOSCO Technical Committee consultation report entitled *Regulatory Issues Arising from Exchange Evolution*:

1. Advisory Committee of the CNMV – Spain
2. Amman Stock Exchange
3. Australian Stock Exchange (ASX)
4. Chicago Mercantile Exchange (CME)[20]
5. Deutsche Börse Group
6. European Association of Listed Companies (EALIC)[21]
7. Federation of European Securities Exchanges (FESE)
8. French Association of Investment Firms (AFEI)
9. International Capital Market Association (ICMA)
10. International Council of Securities Associations (ICSA)[22]
11. London Stock Exchange (LSE)
12. National Futures Association (NFA)
13. NYSE Regulation
14. SWX Swiss Exchange
15. World Federation of Exchanges (WFE)

The TC took these comments into account in preparing the final report entitled *Regulatory Issues Arising from Exchange Evolution*. We have set out our views in response to the comments raised and have noted where any changes have been made to the report.

A. General comments

In general, the commenters were supportive of the draft report and the key recommendations raised in it. In addition to expressing support for the draft report, a few commenters noted the need for ongoing work in this area. For example:

- "We support IOSCO's initiative on this issue and urge IOSCO to continue to examine the ramifications of exchange demutualization and consolidation." (ICSA)

- "AFEI welcomes the recommendations put forward in the IOSCO consultation report. In the light of the issues identified and of the concerns expressed by market users,

[20] The Chicago Mercantile Exchange submitted their comment letter on the Commodity Futures Trading Commission's (CFTC) ongoing review of self-regulatory organizations and did not specifically comment on the IOSCO report.

[21] The European Association of Listed Companies submitted two statements referring to the topics raised by the IOSCO report but did not specifically comment on the IOSCO report.

[22] The ICSA Working Group on Self-Regulation provided a separate comment letter.

AFEI urges IOSCO to continue investigating the topic and to promote close cooperation between national regulators, in particular with jurisdictions where exchanges are contemplating demutualization and listing. Regulatory authorities should carefully consider competition issues and liaise with relevant domestic or regional competition authorities. Finally IOSCO should serve as a forum to discuss the impact of the emergence of global exchanges on the evolution of the national and international regulatory framework." (AFEI)

- "We acknowledge of course that practices vary widely among IOSCO members. However, we believe that it could be most valuable and in the interest of both the regulatory and market communities, if SC2 made increased efforts to work out more definitive consensus on important questions." (ICMA)

- "…it would be appropriate if IOSCO issue a complementary report in the future that discusses the most appropriate scenarios for Exchange Demutualization with real cases given." (Amman Stock Exchange)

The TC appreciates the suggestions for ongoing work in this area However, it also notes that one of the central messages of this study is that the form of market evolution in each country, and the structural context within which it takes place, are sufficiently different that standardised responses will not be appropriate. Indeed, a number of commenters stated strongly that there is no single solution for the issues discussed in the draft report. For example, the WFE emphasized that, although there are some obvious common issues for exchanges around the world, it believes that there are no "one size fits all" solutions (see also ASX). Similarly, NYSE Regulation noted that "there exists no single correct approach to the details of government regulation or self-regulatory models".

The TC agrees with the comments that there is no single correct approach to the issues raised in the report. The TC will, of course, continue to explore issues where it sees value in exploring the possibilities for greater regulatory convergence as markets become more international.

Some commenters identified some additional relevant initiatives. For example, the ICSA stated that, in response to concerns raised by the demutualization and consolidation of exchanges, the members of ICSA's Working Group on the Governance of Market Infrastructures have developed a set of Principles for the Governance of Market Infrastructures.[23] The Principles are intended to provide a framework for the implementation of governance arrangements at exchanges and other market infrastructures that would promote greater efficiency and increased transparency in the operations of those organizations. In addition, Deutsche Börse noted that many of the final recommendations discussed in the report are being addressed at the European level through legal initiatives under the EU Financial Services Action Plan, such as the Prospectus Directive, the Market Abuse Directive and the Markets in Financial Instruments Directive, among others. Similar comments were made by FESE, LSE and WFE.

The TC has updated the paper to reflect recent regulatory initiatives.

[23] However, the Principles are currently being discussed by the broader ICSA membership and cannot yet be distributed.

A few commenters highlighted specific issues that are not raised in the draft report. For example, since Europe has a number of trading platforms that are not regulated markets, the CNMV Advisory Committee considers that the principles governing the markets or which may be established for the markets should apply to all operators. In addition, the CNMV Advisory Committee notes that the draft report does not analyze the record-keeping, clearing and settlement functions which are not even minimally harmonized yet. AFEI noted that concerns in Europe are now focused primarily on competition issues including the organisation of post-trading services and potential conflicts of interest between users and shareholders. Although the IOSCO report touches on competition problems, AFEI believes it does not fully account for the concerns of market users in Europe and possibly in other regions of the world.

The report focuses specifically on exchanges as the principal market organisers and price-setting centres in many markets, particularly equity markets. However, in doing so, it considers a number of issues in which the exchange's relationship with the wider marketplace is often of increasing importance as markets evolve. These range from the potential for an exchange to misuse its regulatory position to restrict competition to the ability of an exchange to monitor a market of which it may have a decreasing share. Recommendation 1 states that regulatory authorities need to be able to keep the changing market environment under review, and the conclusion notes that an ongoing issue in a changing market environment is the extent to which changing market structure may make it desirable to move to a more functional than institutional approach to market regulation.

B. Implications of changing environment for exchanges' regulatory role

Balancing commercial and public interest functions

Exchanges generally were of the view that there is not necessarily an incompatibility between the for-profit operation of an exchange and its public interest and other regulatory obligations (for example, LSE, Deutsche Börse, WFE). The exchanges stressed that their ongoing success, reputation and branding was contingent on having high regulatory standards and good regulation and some argued that the incentives to focus on regulation were, in fact, higher. However, the ICMA did not agree that for-profit exchanges have increased incentives to deliver high regulatory standards compared with mutual exchanges.

FESE noted that there are factors specific to the EU that mitigate potential conflicts of interest. The AFEI also noted that in Europe, the potential conflicts between an exchange's commercial and regulatory activities has become less of an issue as the general trend has been to reduce the self-regulatory role of exchanges following demutualization, with government regulators assuming most of the exchanges' regulatory role.

The TC identified in the report the potential for conflicts of interest which, although they can be – and often are – managed, are a valid regulatory concern. The factors specific to the EU have been included in the report.

Misuse of regulatory powers

Exchanges generally did not share the concerns about possible misuse of regulatory powers by profit-driven exchanges (for example, Deutsche Börse, WFE). ASX provided examples of how it has addressed the perception of possible misuse of regulatory powers for commercial benefit (including extensive policies and procedures governing the separation of supervisory and commercial operations and the management of conflicts, an internal unit to review supervisory decision-making processes, and the establishment of a subsidiary that reviews and reports to the ASX Board on whether ASX adequately complies with its obligations). It also noted independent external oversight by the securities regulator.

On the other hand, the ICMA noted its views that the analysis section is correct and the two issues identified are of high relevance. However, it stated that a truly comprehensive analysis should include an additional factor: lobbying strategies by exchanges to legislators and regulators may seek changes to regulation which will damage the competitive position of new, more efficient competitors.

The TC set out this issue to provide a basis for an analysis of the various concerns raised in the context of a for-profit exchange. The TC remains of the view that the potential for the misuse of regulatory powers is a concern, in general, but agrees that there are various ways to deal with these concerns.

A few commenters responded to the discussion about uses of regulatory income and where it was stated in the report that although securities regulators "generally do not regulate fee structures, it is important that fees are fair and are not operating as a barrier to access". The ASX noted that fee-setting is a commercial matter for exchanges subject to oversight. The WFE stated that it would be attentive to any barrier put on exchanges' freedom to define their commercial policy.

The TC reiterates that, although regulatory authorities generally do not regulate fee structure, it is possible that there may be regulatory issues that arise in relation to fees. One example is if an exchange uses its fee structure to disadvantage competitors.

Financial risk and exchange viability

The Deutsche Börse submitted that the report assumes that a for-profit exchange will be inclined to take on greater commercial risk and noted they have the requirement, incentive and ability to manage risks. Similarly, the ASX referred to measures designed to manage financial and other types of risk and ensure ongoing exchange viability.

The TC did not intend to imply that a for-profit exchange *will* be inclined to take on greater commercial risk but raised the possibility (whether by business expansion or capital restructuring) as an issue for regulatory authorities to consider. Many exchanges may not view this issue and other issues set out above as a concern because they have created processes to deal with them.

Conflicts due to self-listing

The ICMA submitted that the conflicts of interest inherent in self-approval of initial listing and ongoing regulation of the exchange as an issuer cannot be solved in any way that generates confidence in investors and other market participants as to the independence of the functions and IOSCO should firm up its recommendations and conclusions. The WFE stated that this question is resolved in most jurisdictions – there are several examples of where an exchange's listing is regulated by its regulator and that appears to be a satisfactory solution.

The TC reiterates that the extent of the risk posed by this conflict of interest depends on an exchange's role and responsibilities in the listing process. SC2 jurisdictions have taken measures to address conflicts of interest with self-listing (even if an exchange has retained the initial listing function).

C. Regulatory responses to exchange evolution

Governance arrangements

AFEI suggested that exchanges should adopt robust and durable systems of corporate governance which give users a strong and effective voice. The NFA stated that the most important guiding principle for board composition is that the board should be diverse so that no one constituency, including the public, can dominate board actions. The WFE supported the position that exchanges should meet world-class corporate governance standards but cautioned against a regulator prescribing the kinds of representatives who should sit on the governing body of an exchange.

The TC agrees with the commenters. As was stated at p.12 of the report "The overall aim is to ensure that the governing body includes individuals directly representing the broader public interest or who at least have the independence to consider whether the exchange is giving due weight to its regulatory responsibilities". We reiterate our view that regulatory authorities should not prescribe the types of representation beyond including public interest representatives.

Separation of functions within an exchange

Deutsche Börse requested clearer terminology for the heading and suggested "separation of regulatory versus commercial functions within an exchange".

The TC has clarified the heading as suggested.

NFA submitted that statutory regulators should not mandate a particular structure. Instead, regulators should use their oversight role to monitor each SRO's ability to manage conflicts between the SRO's regulatory and business functions and between its interests and those of its members and require the SRO to take corrective action when necessary. The WFE stated that "there are no two identical models being used by WFE members. Each jurisdiction has responded to this concern to the extent necessary".

This is consistent with the views expressed in the report.

Restrictions on ownership

ICMA notes that many regulators have powers to approve owners of significant shareholdings but that these powers are often undefined and might be used in an anti-competitive manner. ICMA submits that such powers should be objectively justifiable and commends an evidence based “fit and proper” approach.

The TC believes that this is a matter to be considered by individual jurisdictions as the approach will vary depending on the particular circumstances.

Oversight arrangements

The report notes that: “Some jurisdictions of SC2 members have set minimum capital requirements for exchanges to maintain”. Deutsche Börse, WFE and FESE submitted that minimal capital requirements are not relevant for exchanges which facilitate transactions and do not take on the risk of counterparties meeting their obligations. ICMA noted that the discussion on financial resources does not seek to justify or explain why in many jurisdictions exchanges are not subject to specific and detailed regulatory capital requirements. ICMA suggest recommending a change or explaining why the status quo is deemed acceptable in terms of achieving regulatory objectives.

The TC notes that the approach to the ongoing financial viability of an exchange varies in different jurisdictions and that different risks may need to be considered depending on the nature of an exchange's operations. What is important is that regulators have analysed those risks, how the risks might change in a more competitive environment and what, if any, tools they consider necessary to mitigate the risks. Some regulators have set minimum capital requirements, while other jurisdictions have used other tools to deal with ongoing financial viability issues (for example, setting specific financial ratio thresholds and reporting to the regulators in case they are not met).

Transfer/removal of regulatory functions

The WFE noted that, historically, most exchanges have felt strongly that the transfer or removal of regulatory functions should be a last resort and are glad to see that the IOSCO paper stresses that this is a radical move and should not be taken lightly. Most have been supportive of the view that such a move is completely driven by the specific circumstances of a jurisdiction and frequently for reasons other than the demutualization, listing or for-profit motive of an exchange. The ASX submitted that moving regulatory functions from the exchange to the regulator also has the potential to diminish regulatory responsiveness to changing market practices.

The TC reiterates that a transfer of responsibilities is a major decision and should not be made lightly. However, we note that where evolution has led to removal of functions, it appears that the exchanges have been able to adjust to this shift.

D. Broader regulatory issues arising from the new business models

Competitive behaviour

Some commenters noted that competition regulators should consult with securities regulators when considering competition issues within the exchange industry but stated that it would place an unnecessary burden on exchanges if both competition and exchange regulators were to regulate exchanges (ASX, WFE). FESE agreed in principle with the approach taken in this section and noted that, as these regulatory principles are already addressed in the EU context, there is no need for the authorities to consider additional measures.

The TC notes that any formal involvement of competition authorities in exchange matters varies in different jurisdictions. The general point made in the report is that, increasingly, regulators need to be aware of competition issues and how they may impinge on regulatory objectives. Clearly, it is desirable for competition authorities examining competition issues in securities markets to consult with market regulators.

The ICMA stated that it believed that the draft report exaggerates the extent to which exchanges compete with each other and non-exchange competitors for trading volumes and emphasized that there is a major role in many jurisdictions for the competition authorities to be more vigilant and interventionist than has generally been the case to date.

The TC notes that there is no assessment in the report about the degree of competition between exchanges and other non-exchange competitors. The report only reflects on the need to ensure that "[w]hile the efficiency benefits of competition are to be welcomed, it is also important that competition is conducted in a manner consistent with market integrity and investor protection".

Extension of exchange activities

The WFE noted that the requirement should be that other activities must not interfere with the exchange's ability to fulfil its mandated functions. The FESE noted that the extension of exchange activities to new fields is positive for shareholders and users as such innovation creates benefits to customers and to the market.

There may be issues for a regulator to consider where an exchange wishes to expand into areas slightly outside of its mandated functions, but this will depend on the particular facts.

Cross-border activity and affiliation

AFEI submitted that cross-border consolidation of exchanges may be desirable insofar as it would yield significant benefits through economies of scale and cost reduction for users; however, other concerns arise regarding the consideration of the specific needs of the constituent domestic markets by the consolidated entities and the applicable regulatory framework. AFEI indicated that the local requirements are important in such areas such as rules for market access, listing and trading together with surveillance arrangements, index composition and the design and implementation of technical systems. AFEI also noted that the emergence of global exchanges calls for close cooperation between regulators. EALIC pointed out that as far as consolidated exchanges are concerned, counter-productive competition between national regimes should be avoided. Priority should be given to more advanced and better structured harmonization, coordination and cooperation between national and European regulators and stakeholders, including issuers.

The issues raised will vary, depending on the structure and the way in which the exchange intends to operate its business. The TC agrees that one key challenge will be to find ways to collaborate with other regulators. To this end, SC2 is working on a mandate dealing with "Information sharing for market oversight".

Outsourcing

FESE noted that outsourcing is a positive outcome for the exchanges' customers since it allows exchanges to use specialist expertise. As the regulatory obligations remain with the regulated entity, FESE submitted that there is no risk of reduced oversight of the activity that is outsourced. WFE noted that reputation risk would prevent the outsourcing process to result in any breach of exchanges' regulatory obligations. The LSE pointed out that outsourcing allows it to rely on a wider base of expertise than a traditional in-house function.

The TC notes that outsourcing may be considered for a number of reasons and the critical test for most regulatory authorities will be clarity as to where regulatory responsibility for the function resides. As this is addressed in the report, we do not believe any additional changes are necessary.

Monopoly operation

In response to the comments in the draft report about the fee-setting process in a situation of little or no competition, Deutsche Börse noted controls in place (for example, the involvement of the Exchange Council and growing competition at a global level that enhances competitive pressure on all exchanges). AFEI submitted that demutualization and ongoing consolidation heighten concerns that a small number of infrastructures may emerge as dominant players in a number of markets leading to the potential for monopolistic pricing and other forms of uncompetitive behaviour. In particular, AFEI stated "failing appropriate arrangements and safeguards, demutualized for-profit exchanges may be tempted to benefit from their quasi-monopolistic situation by charging non-competitive prices and reducing services. Such practices would increase transaction costs for final investors and decrease the overall efficiency of markets".

The TC acknowledges the various controls that may be in place so that fees are not used in a discriminatory manner where there is little or no competition. As stated in the paper, "Where there is little or no competition, the possibility exists that fees may be used in a discriminatory manner. In some countries, these issues fall directly within the remit of the regulatory authority; in others, they are the responsibility of the competition authorities, or a shared responsibility. Regardless of where the legal responsibility lies, this is an issue that is likely to be rising up regulators' agendas over the medium-term". The observation in the report is consistent with the comments noted above.

E. Conclusions and recommendations

The commenters were generally supportive of the key recommendations in the draft report. Set out below is a discussion of specific comments on the particular recommendations.

Recommendation 1 *– Regulators should have adequate arrangements to enable them to keep the changing market environment under review and identify emerging issues in a timely fashion. These arrangements should include ongoing dialogue with exchanges (which could include regular meetings with exchange boards and/or management or specific reporting obligations) to help ensure an understanding of their business and practices.*

Several commenters expressed support for this recommendation (for example, ASX, FESE, LSE, WFE). The TC shares the views of commenters that regular contact between an exchange and its regulator is important to ensure the regulator is informed of significant initiatives and market developments.

Recommendation 2 *– Regulators should assess whether changes being made by exchanges require any adjustments to the regulatory framework for an individual exchange or for exchanges generally, and should address any such need for changes promptly.*

Some commenters expressed the view that there is no "one size fits all" solution (ASX, WFE). The TC agrees with these comments and reiterates that regulatory responses may vary. However, as the situation is evolving, it is important to consider the approaches set out in the draft report (for example, governance arrangements, oversight arrangements) and assess whether any new tools are necessary in the circumstances.

Recommendation 3 *– Regulatory authorities should carefully assess the impact on resources of any changes to the regulatory model for exchanges, and ensure that the core regulatory obligations and operational functions of exchanges are appropriately organized and sufficiently resourced.*

Although there was general support for the recommendation, some commenters cautioned against overregulation and for leaving as much leeway as possible for self-regulatory arrangements (Deutsche Börse, FESE, WFE). In this recommendation, the TC refers to circumstances where a regulatory function is transferred to a different entity. However, this recommendation should be read in light of the earlier comments in the draft report (at p.21) where it is stated that "a transfer of responsibilities is a major decision that may have many direct and indirect consequences and should not be made lightly".

Recommendation 4 *– Securities regulatory authorities should be prepared to share relevant information concerning cross-border activity.*

Many commenters agreed with this recommendation (ASX, FESE, WFE). FESE noted that it believes that CESR sets the appropriate context for such exchange of information to occur in Europe. ASX agreed that cross-border cooperation between securities regulators is important and noted that ASX also shares information with other exchanges on cross-border activity and that regulators should also be prepared to share relevant information with the exchanges they regulate (especially where regulators are referring possible disciplinary cases to the exchanges).

The TC agrees that the ability to obtain information concerning cross-border activity is important and notes that there is an ongoing SC2 mandate considering Information Sharing for Market Oversight.

Recommendation 5 *– Regulatory authorities should consider competition issues that may arise in connection with the evolution of exchanges as discussed above where such evolution impacts market integrity, efficiency or investor protection.*

There was general support for this recommendation. The ASX noted that competition between exchanges is welcome and should be overseen by competition regulators where necessary. Any impact competition may have on market integrity or market supervision should be monitored by the securities regulator – not the competition regulator. The WFE expressed its support for this recommendation but noted that unintended impacts on market integrity, efficiency and investor protection must be carefully monitored. The TC agrees and notes that it is important to consider competition issues that may be raised by market structure developments (in some jurisdictions, this may be the responsibility of the regulatory authority; in others, it may be the responsibility of competition regulators, or a shared responsibility) and their interaction with market integrity and investor protection (but there would not be overlap between the regulators considering the same issues).