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Mergers, Demutualization and Governance of Securities
Exchanges

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**PANEL: MERGERS, DEMUTUALIZATION AND
GOVERNANCE OF EXCHANGES**

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1. I would like to thank IOSCO and the Jordanian Securities Commission for inviting me to be a participant on this panel. In my remarks this afternoon, I was asked to provide some comments from an emerging markets perspective on the subject of demutualisation. In doing so, I will draw on some of the findings and issues arising from the work that the working group I chair is currently doing, through a survey of several emerging markets, on their demutualisation experiences.
2. Demutualised exchanges in emerging markets are still relatively limited although an increasing number are in the process, or are considering demutualisation. In the survey that was conducted, 14 jurisdictions participated, and include, Brazil, China, Chinese Taipei, India, Indonesia, Hungary, Malaysia, Pakistan, Philippines, Poland, South Africa, Sri Lanka, Thailand and Turkey. Clearly one cannot generalise the experiences across all emerging markets given the wide spectrum and level of development across these markets. In addition, the choice of whether an exchange ought to demutualise is one that has to be carefully considered within the context of the relevant market. However, some of the findings from this work will, it is hoped will be instructive to those who may be at similar levels of development.
3. I will also make some remarks on the recent demutualisation of the exchange in Malaysia.

What drives demutualisation in emerging markets

4. The survey findings show that one of the main drivers for demutualisation in many emerging markets was the increasing competition for global order-flow. More specifically, concerns were expressed about the lack of liquidity and the threat of marginalisation of their domestic markets and cited this as one of the main reasons that led to the efforts towards demutualisation.
5. This is of course, not surprising. The two major forces reshaping the world - globalisation and technology impact the world of securities markets in a similar way. Local and regional markets are forced into more direct competition regionally and internationally. Overall market size is increased and cost of capital is lowered, as issuers are enabled access to multiple markets. And it permits order flow and liquidity to migrate quickly to major markets with sometimes adverse consequences for many smaller markets.
6. Emerging markets as a group make up about 12.7% of the total global market capitalisation and individually many of these markets are less than 0.1%. The Asia-Pacific emerging markets are, around 10% of the global market capitalisation, the

Middle-East and African region represents 1.4%, Central and South American markets are 1.5% and the European emerging markets are less 0.5%. Despite the numbers the size of these markets remain small.

7. Demutualisation therefore was seen as providing the necessary catalyst to enable a transformation of the exchange business model to facilitate a more effective response to forces re-shaping the exchange business and competition for investment capital.
8. Similarly, the pressures to reform the exchange's governance structure as part of a broader trend reflecting increased public expectations for higher standards of governance was also evident. It was seen as becoming increasingly unacceptable that an exchange can function as a members club and operate without appropriate governance structures.
9. In some of the jurisdictions, the issue of reforming the governance structure was seen as paramount and after making the necessary reforms, it was felt that there was no pressing need to demutualise the exchange. However, the question that arises in this case is whether this change in governance structure is sufficient to provide the right environment for the exchange to be able to effectively manage the competitive forces impacting on exchanges.

Who drives demutualisation

10. One interesting feature of demutualisation efforts in many of the emerging markets is that they are typically driven by either the government or the regulator. This contrasts with the position in many of the developed markets where the process has been in most instances driven by the exchange or industry.
11. This probably reflects the more significant role played by the government or regulator in initiating reform efforts towards enhancing the overall development of capital markets.¹ However, concerns have been expressed that this prescriptive approach could force a pre-mature solution in an environment where the necessary pre-conditions for demutualised exchanges to thrive successfully may not be present.
12. For instance, if there is still a fairly closed and insufficiently liberalised capital market environment, then creating a for-profit exchange, where its ability to implement business strategies, including those across borders are constrained would be leading the exchange to failure. In one jurisdiction, this issue was seen to be a sufficiently important consideration that the effort to demutualise the exchange was abandoned.
13. But undoubtedly, in many of these markets, the political will and support of the government is critical irrespective of who drives the efforts to demutualise. This also helps on many levels, including managing the often conflicting demands of the various stakeholders in the process, or to ensure, the right decisions are made in relation to instituting the appropriate framework for balancing the commercial and regulatory considerations.

¹ In some countries exchanges are owned by the government and therefore the demutualisation exercise is a really a privatisation of a state owned entity.

Resolving tensions between commercial and regulatory objectives

14. The boundaries of what is deemed an exchange business is being substantially re-defined, with greater leveraging of the information aspects of the business and expansion across borders. Many exchanges have also begun to re-configure their corporate structures through mergers and strategic alliances and in some cases seek either greater vertical or horizontal integration of operations. The reverse trend of divesting regulatory units or outsourcing of certain exchange functions to global specialists in technology is also evident. These are global trends that are irreversible and are manifested in markets regardless of whether they are classified as developed or emerging.
15. The changing landscape dynamics is placing the traditional exchange business model under tremendous stress. The tensions are usually accentuated by demutualisation as it shifts the focus to profitability requirements. In the past, exchanges were seldom burdened with commercial objectives. They generally focused on conducting their self-regulatory functions with a view to creating a thriving market in line with the needs of their members. Exchanges also enjoyed the luxury of a stable and profitable business model.
16. As an outcome, this clarity of purpose in managing an exchange suddenly becomes blurred. Regulators and exchanges are still grappling with the difficult task of balancing commercial and regulatory objectives.
17. In fact there are some observers, who feel that the notion of a for-profit regulator is itself an oxymoron. But, I think there are sufficient natural incentives in place for exchanges to pursue high regulatory standards and enhance their reputational capital, if they are to attract quality listings and investor interest. And whilst some may perceive a for-profit regulator as an oxymoron, cost-effective regulation is not, and this is essentially what these exchanges should be pursuing.
18. There are a range of issues related to what degree demutualised exchanges can carry out the range of regulatory responsibilities that are typical of a front-line regulator. These range from whether listings approvals remain with the exchange or are transferred to the regulator, what is the role as far broker supervision is concerned, and surveillance of corporate disclosure. Market surveillance is probably one area where there is some resolution.
19. I won't go through these but suffice it to say that there are a variety of practices from the experiences from demutualised exchanges elsewhere that does not necessarily provide a clear solution for emerging market exchanges that are in the process of addressing these issues.

Change in regulatory model may be required to match changes in exchange business model

20. Although it has been over 10 years since the first exchange was demutualised, there still remain some differences arising either from the differences in commercial and regulatory objectives as well as the radical re-shaping of the exchange business that need to be bridged.

21. But we may need to acknowledge that our thinking on the regulatory duties of an exchange tend to be anchored to the legacy of the traditional SRO model. It is possible that a radical shift away from thinking about regulating exchanges as an institution towards an approach that focuses on functional regulation of exchange services may be the way forward.
22. In other words, given that exchanges are increasingly likely to substantially expand their range of services and that non-exchanges may increasingly offer exchange-type services, it may be more appropriate to regulate specific services or products where it is deemed that there is a public interest element.
23. The solution seems to lie in providing greater clarity as to the regulatory obligations and constraints of the exchange.
24. The real problem is that the re-definition of an exchange's regulatory obligations and constraints cannot be achieved looking at the rear mirror. A stand-off situation occurs because the regulator can't be precise in defining these regulatory obligations because it can't be sure what the exchange will do in the future while the exchanges argue that they can't plan with certainty because it can't be sure what the regulators intend to do in the future.
25. It is probably pre-mature and certainly too ambitious a task to attempt to overhaul the regulatory framework for the exchange at this point. But what this suggests is that whatever solutions being adopted now are likely to be interim solutions enroute to a more comprehensive approach over the longer term.

Approaches to minimising the regulatory obligations of an exchange

26. There is a proposition that some would put forward that perhaps, following on from demutualisation, exchanges be left to concentrate on their goal of building the business and enhancing the value of the exchange. This would imply that the natural approach is to minimize the regulatory duties of an exchange.
27. This could be achieved either through a transfer of many of the regulatory functions conducted by the exchange over to the regulator, or to create semi-autonomous entities where the regulatory functions can be separated from the exchange and bundled into a new entity as has been the experience with the Australian Stock Exchange (ASX) and the Toronto Stock Exchange (TSE).

Managing a gradual transition

28. In the interim, recognising that demutualisation is a massive exercise involving a substantial amount of legislative and organisational work, some demutualisation efforts within the emerging markets surveyed have adopted a pragmatic solution of trying to streamline, and to the extent possible demarcate regulatory responsibilities. This is probably the more practical and gradual approach to adopt in defining regulatory arrangements, as most jurisdictions have, by fine-tuning "as-is" arrangements.
29. This has been achieved in some cases, through non-binding agreements, usually called Memorandum of Understandings (MoUs), between regulators and exchanges

to delineate regulatory responsibilities. It should be noted that such agreements are unusual in that typically regulators do not enter into MoUs with regulatees and there can be concerns over whether the MoUs in any way bind the powers of the regulators.

30. One cautionary note arising from this is that there are likely to be differences in perceptions between what the regulator and the exchange hopes to achieve with these type of arrangements. Exchanges typically use the MoUs to cap their regulatory duties and obligations to the regulators with a view to reducing their regulatory costs.
31. The risk is that these if these MoUs are not carefully structured, they may end up imposing unnecessary constraints on regulatory powers – which shouldn't be the intention because it is likely that further refinements to regulatory arrangements may be needed arising from the future changes in the exchange business model.
32. Despite this, such arrangements are useful as a means of clarifying in an explicit manner the regulatory duties of the exchange to assist the operational staff both at the exchange and the regulator as well as for communication purposes to potential investors in the exchange. This would assist in mitigating the uncertainties arising from the conversion of the status of an exchange from a SRO to a commercial entity.
33. While it is conceptually easy to demarcate regulatory duties, the reality is that there are many functions that either involves both parties or where it is more practical and efficient for the exchange to conduct regulations on behalf of the regulator. In relation to this, it is important that these arrangements be designed based on principles and not become too operational.

Creation of industry SROs in emerging market jurisdictions

34. In developed market jurisdictions, self-regulation typically preceded government regulation. In many emerging market jurisdictions, regulation and even industry development tends to be led by the government and self-regulation is typically almost non-existent.
35. Arising from this, the regulation of industry in some emerging market jurisdictions can be conducted by the exchange, for example, the regulation of business conduct by intermediaries. Post-demutualisation, this is seen in some cases, as a regulatory duty that can be transferred out of the exchange.
36. There are two approaches depending on the overall regulatory philosophy. The first is to transfer these duties to the statutory regulator, which is more closely aligned with the view that regulatory duties are best centralised with one organisation.
37. The other approach is to create an industry SRO and to migrate the relevant regulatory duties from the exchange to the industry SRO over time. This is consistent with the approach favouring market-based regulation.
38. Some of the emerging markets surveyed, have chosen the second approach. Some general principles are established for the formation of industry SROs – including requiring the SRO to adopt the objective of protecting investors and safeguarding market integrity, ensuring fair and transparent governance structures and ensuring appropriate oversight powers.

Malaysian experience

39. Allow me to say a few things about the experience in my own country, where the Kuala Lumpur Stock Exchange, as it was then called, demutualised in January of this year. The exchange has a market capitalisation of US\$180 billion, has over 900 listed companies, is the biggest stock exchange in South East Asia and is one of the biggest emerging market exchanges in the world.
40. Demutualisation of the exchange was identified as one of the key recommendations from the capital market masterplan, a 10-year strategic blueprint formulated to strengthen and enhance the competitive position of the Malaysian capital market. Demutualisation was seen as a key enabler towards restructuring of the exchange to better position it to face external competition. It was also designed with a view to allow the exchange to be more customer focused towards enhancing the quality and efficiency with which it delivers its services.
41. Preceding efforts to demutualise, all the 5 exchanges and 3 clearing houses in Malaysia were consolidated within one exchange group under the KLSE. Although, conscious of the fact that it would have monopolistic powers, we felt that this had to be balanced with the need to strengthen the position of the exchange vis-à-vis external competition, ensure it was also seen as an attractive partner for alliances and to avoid fragmentation of liquidity which we saw in the case of some of the markets.²
42. The process of demutualisation was effected through the Demutualisation (Kuala Lumpur Stock Exchange) Act 2003 leading to the conversion of the KLSE from a company limited by guarantee to one limited by shares. Amendments were also made to relevant securities laws to cater for the change in the structure of the exchange and to provide for an appropriate regulatory framework. Stronger legislative controls were put in place to ensure a commitment to continue its regulatory and public interest responsibilities.
43. The shares in the company were distributed as follows: 40% to the brokerage industry (10% of this went to commissioned dealers representatives), 30% to the government and 30% to a capital market development fund (CMDf). The ownership structure was based on a value allocation exercise determined through an assessment of past contributions towards the development of the exchange. The idea of a development fund was proposed to provide a way to distribute value to the broader range of stakeholders who had contributed to the growth of the industry including investors, issuers and a range of market intermediaries.
44. The governance structure reflected public interest considerations as well as drawing from corporate governance best practices. Chairman and chief executive officer (CEO) functions were separated. Board composition consisted of one-third comprising public interest directors, one-third independent directors, and one-third shareholder directors.
45. Clear statutory obligations were imposed on the exchange on the conduct of its functions with clear provisions in place to enable the Commission to direct the exchange to take the appropriate course of action.

² A single exchange would also be able to take advantage of economies of scale by saving on operational costs. It would be able to reap economies of scope by offering a wider and more fully integrated range of products and services.

46. To ensure that information relating to the discharge of its function is transparent, the legislation requires the exchange to submit a regulatory report on an annual basis to the Minister and the Commission. Upon receipt of the report, the Commission may also at any time conduct a regulatory audit of the stock exchange. The legislation also encapsulates provisions to capture the ability of the Commission to issue directions to the exchange in the event of any conflict between its commercial and regulatory obligations. Additional aspects of the public interest framework relate to self-listing, and ownership limitations.
47. To provide for flexibility and clarity in the implementation of the regulatory framework, a series of MoUs or agreements will be signed to streamline and clarify the regulatory responsibilities. The listings approval function, in the main, remains with the SC, whilst broker compliance functions is with the exchange. Corporate and market surveillance work will also remain with the exchange.

Assessing performance³

48. Have we seen any change? Well it is really too early to tell but the signs look promising. Since this process began, we've seen the exchange embark on a review of its internal organisational structure to further enhance efficiency and reduce costs. It has embarked on a cost cutting exercise and has looked towards hiring in key areas where internal skills were lacking.
49. The exchange has also signed a joint venture agreement with Euronext to jointly develop a common trading platform and other enhancements are being made to the trading and settlement systems. This is also being looked as a business proposition towards providing these solutions for other exchanges within the region.
50. It has embarked on discussions with the Singapore Exchange (SGX) for a trading alliance and is exploring the possibility of doing similar arrangements with other exchanges within and possibly outside the region.
51. In addition, the exchange has gone through a re-branding exercise with a name change to Bursa Malaysia (or Malaysian exchange) and has embarked on various promotional efforts towards attracting investors and quality issuers to the exchange.
52. Recognising that there are still formidable challenges ahead, we formed a high-level strategic committee comprising of the senior management of the Commission and the exchange to ensure that there was frequent contact and regular consultation in many of the more "difficult" areas.
53. In this regard, maybe one of the most important tasks between the regulator and the exchange is to carefully manage expectations and relationships to ensure convergence in thinking. At the end of the day, this may be the most critical factor in determining the success of the demutualisation exercise in this increasingly challenging times for regulators and exchanges.
54. Thank you.

³ One of the difficulties in assessing performance of demutualised exchanges is trying to determine what should be the appropriate key performance indicators or measures of success for such entities. This is perhaps one area where some additional work needs to be done in obtaining some clear definitive measures.