

**EXCHANGE DEMUTUALIZATION
IN
EMERGING MARKETS**



OICU-IOSCO

**Emerging Markets Committee
of the
International Organization of Securities Commission**

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Chapter 1: Objective and Approach

Background

During its October 2002 meeting the IOSCO Emerging Markets Committee (EMC) approved a mandate a mandate to be conducted by its Working Group on the Regulation of Secondary Market Regulation (WG2) to examine broad issues and challenges arising from exchange demutualization in emerging market jurisdictions which are of concern to securities regulators. The detailed terms of reference of this mandate were subsequently approved by the EMC Advisory Board during its February 2003 meeting.

Specifically, the mandate seeks to examine whether there exist pre-conditions for an exchange in emerging markets to consider demutualizing. In addition, it examines many strategic and regulatory issues of interest to securities regulators in relation to the demutualization process with focus particularly on the implications of demutualization on regulatory arrangements and the relationship between the securities regulator and the demutualized exchange.

Approach

A project team comprising selected members of WG2¹ was formed. This was followed by a survey to selected jurisdictions of EMC members where the exchanges had demutualized or were considered potential candidates for demutualization².

The survey questions focused on the following areas:

- Where exchanges had demutualized or were in the process of demutualizing, the survey covered issues relating to the decision-making process as well as issues and challenges arising during the process and following the completion of the demutualization exercise.
- Where exchanges were not considering demutualization, the survey sought to explore their views on demutualization.

In addition, preliminary findings from this exercise were presented in a paper at the IOSCO Annual Conference in Amman, Jordan in May 2004.³ Findings in this report are also supplemented by discussions which took place in a Colloquium on Demutualization held in Jakarta, Indonesia in October 2004 where regulators from several emerging and developed market jurisdictions met to discuss regulatory issues and challenges arising from demutualization, as well as the specific issues faced by the exchanges in these markets contemplating demutualization⁴.

¹ India, Indonesia, Jordan, Malaysia, Pakistan, Thailand and Turkey.

² Respondents to the survey were Brazil, China, Chinese Taipei, Hungary, India, Indonesia, Malaysia, Pakistan, Philippines, Poland, South Africa, Sri Lanka, Thailand and Turkey. Some of these respondents also provided detailed case studies covering macro-economic factors affecting the domestic capital market and the exchanges, and the issues relating to demutualization.

³ Paper outlining some of the issues arising from the survey findings was presented by Mr. Ranjit Ajit Singh Director of the Securities Commission of Malaysia, which chairs the IOSCO EMC Working Group on the Regulation of Secondary Markets

⁴ Securities regulators and exchanges from Australia, India, Indonesia, Japan, Malaysia, Singapore, Sri Lanka, Thailand and Turkey provided valuable input and significantly helped to shape the findings in this report.

Following receipt of formal responses to the survey, follow-up discussions were conducted with the relevant regulators to gain further insights and details on specific aspects of the survey responses that required further clarification.

Chapter 2: Demutualization - strategic issues for emerging market regulators

This chapter provides a broad overview of the progress of emerging markets in implementing demutualization as well as a review of related strategic issues for regulators in relation to these jurisdictions. Within this context, it explores possible reasons why the phenomenon of demutualization is uneven between developed and emerging markets – with insights from jurisdictions that have considered but decided not to demutualize.

In addition, this chapter provides coverage of the decision-making processes for demutualization which appear to be largely policy-led in emerging market jurisdictions and also explores issues in relation to managing stakeholder buy-in highlighted in the survey.

Overall, within developed markets, demutualization is generally explored within the context of the dynamic changes taking place in the global exchange industry. From this perspective, demutualization is typically reviewed hand-in-hand with the restructuring of market institutions including mergers and acquisitions. However, the degree to which global forces impact emerging markets may not be at the same level as developed markets, and exchange restructuring issues are usually considered from the perspective of national policy.

This chapter also offers unique perspectives from emerging market regulators relating to opportunities and issues arising in relation to the use of demutualization to unlock value, to restructure market institutions and also explores issues which are now beginning to emerge in relation to the listing of the demutualized entity.

2.1 The extent of demutualization in emerging market jurisdictions

The pace of exchange demutualization in developed market jurisdictions has been quite rapid. In the fifteen years since the first exchange demutualization took place in 1993, 21 exchanges in developed market jurisdictions have demutualized – representing almost 40% of the membership of the World Federation of Exchanges⁵.

In contrast, the pace of demutualization in emerging market jurisdictions has been relatively slower. As at the point of report, exchange demutualization have been completed in only 5 jurisdictions out of a total of 76 emerging market jurisdictions⁶.

The survey, based on a sample of 15 emerging market jurisdictions, indicated that the option of demutualization was considered by the majority of respondents while 4 were in the process of undergoing demutualization. It is quite likely that the proportion of positive responses would decrease substantially if the survey sample was broadened as the survey was mainly targeted at the relatively larger and more mature market jurisdictions.

⁵ Source: World Federation of Exchanges Annual Report and Statistics 2003.

⁶ Source: IOSCO EMC WG2 surveys.

Table 1
Survey results: Demutualization status of exchanges in selected emerging markets

Jurisdictions	Considered	Status
Brazil	No	Not demutualized
China	No	Not demutualized
Poland	No	Not demutualized
South Africa	Yes	Not demutualized
Sri Lanka	Yes	Not demutualized
Thailand	Yes	Not demutualized
India ⁷	Yes	In the process
Indonesia	Yes	In the process
Pakistan	Yes	In the process
Turkey	Yes	In the process
Chile	Yes	Demutualized
Hungary	Yes	Demutualized
Malaysia	Yes	Demutualized
Philippines	Yes	Demutualized
Chinese Taipei	Yes	Demutualized

Source: IOSCO EMC WG2 Surveys

On reflection, the varying experience between developed and emerging market jurisdictions in relation to demutualization is not really a surprising result. It is however certainly one worthy of deeper analysis and possible insights it may offer on the varying perspectives regulators may have in different jurisdictions, and how this may impact the implementation of policies in relation to demutualization.

Broadly, several questions emerge from this difference in perspective – some of which are dealt with in this survey – as follows:

- (a) Is it differences in policies or conditions that affect the pace of demutualization in emerging markets?
- (b) Do these different perspectives imply that the benefits accruing from demutualization in emerging markets are considerably less than that for a developed market or is it a case that the costs are considerably higher?
- (c) Is it because the state of economic and capital market environment in emerging markets are not yet at a level where demutualization is relevant and that there are other more effective alternatives to achieving the goals associated with demutualization?

2.2 Drivers of demutualization in emerging markets

Responses from the survey show that one of the main drivers cited for demutualization in emerging markets that have chosen this path is the increasing competition for global order-flow. More specifically, concerns were expressed by survey respondents about the lack of liquidity and on the growing threat of marginalization of their domestic markets.

⁷ The National Stock Exchange of India Limited has been operating as a demutualized for-profit company since its inception since 1993, while the other exchanges are undergoing demutualization.

Some respondents were of the view that domestic markets would be forced into more direct competition regionally and internationally. It was noted that domestic issuers were increasingly being provided access to multiple markets and, in tandem with this, order flow and liquidity could easily migrate quickly to major markets with sometimes adverse consequences for smaller markets. Clearly this posed a problem for emerging markets which in 2003 accounted for only 11.1% of global market capitalization and 9.8% share of global trading value.⁸

From the survey responses, demutualization was therefore seen as a catalyst to set in motion a transformation of the exchange's business model to facilitate a more effective response to forces re-shaping the exchange business; including the intensifying competition for global capital order-flows.

In addition, some emerging market regulators viewed demutualization as a means of collaborating with strategic shareholders with specialized technical know-how with the objective of importing international skills, knowledge and technical efficiencies into the domestic market. One of the reasons for demutualization cited in the emerging market survey was that demutualization was a means of accelerating the development of technology-related infrastructure and capabilities.

To place matters in perspective in relation to emerging markets, the threat of competition from Alternative Trading Systems (ATs) and Electronic Communication Networks (ECNs) was not a pre-dominant driver for demutualization. The rare exception was Pakistan, where it was noted that members of stock exchanges showed considerable interest in demutualization after the Securities and Exchange Commission of Pakistan granted a license to PEX Limited to operate as an ECN⁹.

⁸ Source: Standard & Poor's World Stock Markets Factbook.

⁹ See Report of the Expert Committee on Demutualization and Integration/Transformations, 2 September 2004.

Table 2
Commonly cited reasons among demutualized jurisdictions

Exchange	Competitive-ness	Ownership Reform	Facilitating Alliances	Broadening Access	Unlocking Value
Budapest Stock Exchange	✓	✓	✓		
Bursa Malaysia	✓	✓	✓	✓	✓
Philippine Stock Exchange	✓	✓			
Taiwan Stock Exchange Corp.	n/a – TSEC has been a company-type exchange since it was founded				

Only one survey respondent (which has not yet demutualized) cited access to funds as a reason to demutualize citing that the exchange’s income was currently too dependent on trading and listing fees.

In parallel with this, views were also cited on using demutualization as a means of reforming the exchange’s governance structure. Some survey respondents cited conflicts between broker interests with interests of other stakeholders as being one of the key reasons they were contemplating demutualization.

In some jurisdictions, the issue of reforming the governance structure was considered paramount and after making the necessary reforms to the governance structure, it was decided that there was no pressing need to demutualize the exchange.

2.3 Decision-making and initiation

One interesting feature of demutualization efforts in many of the emerging markets is that they are typically led by either the government or the regulator. This contrasts with the experience in many developed markets where the process was generally led by the exchange or industry.

Within this context, it should be noted that in most emerging markets, there is only one¹⁰ exchange or, in cases where there are a few, only one dominant exchange¹¹. Therefore, these exchanges are seldom subject to competition domestically and, in many cases, are also relatively insulated from external and electronic competition¹². In such circumstances, although the laws in these markets do not necessarily prohibit the establishment of another exchange, many emerging market exchanges effectively have

¹⁰ Thailand, India, Malaysia, Sri Lanka, Philippines and Turkey have only one stock exchange.

¹¹ There are three stock exchanges in Pakistan. The Karachi Stock Exchange is the dominant exchange, with the highest number of listed companies and the largest share turnover. There are twenty-three stock exchanges in India, with the Mumbai Stock Exchange and the National Stock Exchange being the dominant exchanges. Even in jurisdictions where there are multiple exchanges, competition among exchanges is limited, and the most actively traded companies in both markets tend to be listed and traded on more than one exchange.

¹² Note: PEX Limited was licensed as an ECN (with the status of an exchange) by the Securities and Exchange Commission of Pakistan in 2003. PEX limited is not yet operational.

monopoly status in their domestic markets.

In some emerging markets, the exchange is a state-owned institution and is regarded as a “national exchange”¹³. In these cases, the board of directors, including the Chairman, may be government appointees. The government may also grant significant tax incentives to the exchange and provide subsidies or grants.

The development of exchanges in many emerging markets is seen as part and parcel of national policy given the strategic importance of the exchange in promoting economic development. Another factor that should be taken into consideration is the relatively nascent development of market institutions or the capital market industry – requiring governments and regulators in emerging markets to typically provide considerable support and implement initiatives that are usually the purview of the private sector in developed markets. This probably explains the significant role played by the government or regulator in initiating reform efforts in emerging market jurisdictions.¹⁴ Many regulators in emerging markets, in fact, have statutory obligations placed on them for both regulation and development.

Following discussions with emerging market regulators, concerns were expressed that this prescriptive approach could force a pre-mature solution in an environment where the necessary pre-conditions for demutualized exchanges to thrive successfully may not be present.

For instance, if there is still a tightly regulated and insufficiently liberalized capital market environment, then creating a for-profit exchange where business strategies were constrained might undermine the viability of the exchange. In one jurisdiction, this issue was seen to be a sufficiently important consideration such that efforts to demutualize the exchange were ultimately abandoned.

But undoubtedly, in many of these markets, the support of the government is critical irrespective of who drives the efforts to demutualize. This political support helps at many levels, including managing the often conflicting demands of the various stakeholders in the process, or ensuring that an appropriate framework for managing commercial and regulatory considerations can be in place.

This experience was overwhelmingly re-affirmed in the survey where eight jurisdictions – comprising those that have already completed demutualization of the exchange or were in the process - stating that the demutualization process was initiated by the government or the statutory regulator.

For example, in India the government announced the proposal to demutualize the stock exchanges and followed up by establishing a group chaired by a former Chief Justice of India to advise on the issue¹⁵. This Group subsequently recommended that exchanges which did not demutualize after a specified date would have its recognition withdrawn under the Securities Contract (Regulation) Act 1956, thus leading to its eventual winding up.

¹³ For instance, the Istanbul Stock Exchange is a state owned institution. The Capital Markets Law of Turkey provides that all exchanges, where capital market instruments are traded, are public institutions. In Thailand, the Stock Exchange of Thailand is a half-mutual organization established on the government’s initiative under a specific law.

¹⁴ In some countries exchanges are owned by the government and therefore the demutualization exercise is in effect a privatization of a state owned entity.

¹⁵ Group on Corporatization and Demutualization of Stock Exchanges in India

In the Philippines, legislation was specifically enacted mandating the exchange's demutualization within a specified timeframe¹⁶. In Pakistan, the Expert Committee on Demutualization and Integration/Transformation of Stock Exchanges¹⁷ (Expert Committee) recommended that the decision for demutualization and integration of Pakistan's 3 stock exchanges should be made by the Securities and Exchange Commission of Pakistan given the impact of integration and demutualization on public interest. The Expert Committee further recommended that if sufficient progress was not made towards the integration and demutualization of the existing exchanges within 1 year, a new stock exchange would be established to become the national exchange.

In Malaysia, consolidation and demutualization of the exchange was identified as key initiatives under the Capital Market Masterplan (CMP) – the country's 10-year strategic blueprint for the development of its capital market. The CMP recommended a sequential path of first consolidating the 5 exchanges in the country to be followed by the consolidation and listing of the exchange with a view to enhancing the competitive position of the country's market institutions.

Even in instances where exchanges chose not to demutualize, policy-makers often have a lead role in the decision-making process. In Thailand, the Minister of Finance appointed a steering committee comprising of representatives from the Securities and Exchange Commission, the Stock Exchange of Thailand (SET), the Ministry of Finance and the brokerage and fund management industries.

The steering committee recommended that the demutualization of the SET should be put on hold because it viewed that the SET could best meet its objectives under its current structure as a national exchange. This allowed the government to rely on the SET to implement capital market development policies¹⁸, which may not have been possible if the SET transformed into a for-profit entity.

The steering committee also expressed the view that the SET was sufficiently well-capitalized and had no immediate need to raise new funds. In addition, domestic controls on capital flows also reduced the prospects of strategic alliances or other cross-border exchange arrangements – taking into account the perspective that cross-border exchange arrangements were perceived as most likely to occur between demutualized exchanges.

However, it was viewed that the SET could achieve a stakeholder-based governance structure by having both the SET and the broker members voluntarily agreeing to appoint or elect other stakeholders to sit on the Board¹⁹.

Follow-up discussions with emerging market regulators in relation to the relatively prescriptive approach revealed that many emerging market regulators believed that they were not in a position to adopt a laissez-faire approach to demutualization as they considered that the costs and risks involved in the failure of a demutualized exchange could have a far-reaching impact on national economic development.

This view was based on the observation and experience that economic development

¹⁶ Section 33.2(a) of the Securities and Regulation Code (SRC) required the Philippine Stock Exchange, Inc. to incorporate within one year from the date of coming into effect of the SRC.

¹⁷ Report of the Expert Committee on Demutualization and Integration/Transformation, 2 September 2004.

¹⁸ For example, the special tax privilege granted to companies listed on the Market for Alternative Investment board for SMEs, and SET's role in sponsoring the establishment of a futures exchange.

¹⁹ SET members have reduced their broker representatives to only 3 seats (out of the previous 5) and elected the other 2 members from other stakeholders. The members also appointed a steering committee.

was generally led by the public sector in emerging markets and that the private sector was not sufficiently mature nor were the market mechanisms sufficiently developed to be fully self-dependent and self-sustaining. The survey responses reflected concerns of emerging market regulators that, in some cases, the economic and capital market environment and relevant pre-conditions may not exist or be sufficiently developed in order to ensure the success of a demutualized exchange in emerging market jurisdictions.

As mentioned earlier, an insufficiently liberalized capital account was cited by one regulator as creating conditions that may not be conducive for the creation of a for-profit exchange as these controls could inhibit the ability of a commercialized exchange to implement business strategies, including the implementation of cross-border alliances. However, other jurisdictions such as India, Malaysia and Pakistan have proceeded with their demutualization process despite similar constraints.

2.4 Demutualization and stakeholder issues

While in emerging market jurisdictions, the decision to demutualize is largely made by policy-makers, it is based on a process that is achieved through substantial engagements, i.e. a consultative and consensus-seeking process, reflecting the value placed on social cohesiveness in these societies. This process recognizes that various commercial stakeholders have substantial lobbying powers and that without sufficient “buy-in” from the significantly varied interests and convergence of expectations, the lack of support from a broad stakeholder base could pose a major hurdle in the process of demutualization.

In this regard, the tensions arising from a demutualization exercise could actually be more pronounced when the government and the regulator are the prime movers in the demutualization process. Survey respondents cite the fact that, in some cases, demutualization was opposed by member brokers and that this created some complications in implementation.

Typically, the obvious and direct stakeholders are the stockbrokers who are members of the exchange in a mutual structure. Apart from the government and the regulator, other stakeholders include the exchange management, exchange directors, investors and listed companies.

Drawing on the Malaysian demutualization experience, the interests and expectations of stakeholders can be carefully managed to ensure consensus and support for the demutualization process. This can be summarized as follows:

- **Stockbrokers.** The decoupling of broker membership from management of the exchange was not a major issue since the implementation of oversight rules in the mid-1980s. There was general support from the stock broking community as they saw benefits arising from the unlocking of value in the exchange through the demutualization process.
- **Exchange management.** Exchange management perceived demutualization as opening up new opportunities and were major proponents of the demutualization process. Indeed, considerable efforts were made early on, about 2 years prior to the actual demutualization, to design and implement plans to restructure and streamline the organization to capture operational efficiencies.

- **The government and regulator.** Extensive consultation was undertaken with the major stakeholder groups prior to making a decision to demutualize the exchange. Given the broad support from the major stakeholders, the role of the regulator and the government focused almost exclusively on public interest issues such as re-designing the regulatory role of the exchange as well as ensuring that effective governance mechanisms were put in place to prevent potential conflict of interest situations.
- **Investors and issuers.** While major institutional investors and issuers were not central to the process, nonetheless their opinions were sought as part of the process to ensure that decisions took into account a wide spectrum of views. This can prove to be a useful process in providing a mediating influence where there are divergent views between the different stakeholder groups.

Given that substantial policy and exchange re-organizational changes are needed, it is critical to develop a robust strategic framework, outline a well-planned transformation process and have strong support from policy-makers for its implementation. Regardless of whether the decision-making process is driven by the public or private sector, it should be recognized that government or regulatory involvement can help in many aspects, including expediting the process for regulatory changes and approval.

In most cases, exchanges either appointed an external consultancy firm²⁰ to provide consultancy services or established an expert committee to advise on the demutualization design and model of the exchange²¹. The recommendations were then evaluated by the government and or the regulator in question, with approval being given by either of these bodies.

The Philippine Stock Exchange, through a Demutualization Committee, met with different regulatory agencies to seek advice on how specific issues relating to demutualization could be resolved. In Malaysia, there was considerable engagement with domestic and international parties, and a working group chaired by the regulator, comprising of members of the exchange, the association of stockbrokers and the Capital Market Advisory Council²² was established to facilitate the demutualization process.

²⁰ In Turkey, Malaysia and Thailand, the services of a consultancy firm was procured by the exchange. The Philippine Stock Exchange, Inc secured the technical assistance of demutualization experts and consultants connected with the Australian Stock Exchange to provide an appropriate framework for the demutualization of the exchange.

²¹ In India and Pakistan, a committee appointed by the regulator was established to formulate a comprehensive plan for demutualization.

²² The Capital Market Advisory Council (CMAC) was appointed in 2001 by the Securities Commission, Malaysia to advise the Commission on issues relating to the implementation of the Capital Market Masterplan and developments occurring in global and domestic capital markets, and the potential implications for Malaysia. CMAC members comprised of members from the capital market industry, including senior domestic and foreign capital market participants and specialists providing representation over a spectrum of capital market activities.

2.5 Unlocking value through demutualization

As indicated earlier, demutualization also provides an opportunity to unlock the value of the exchange – though the realization of value is largely dependent upon the eventual listing of the exchange. Issues in relation to listing are discussed in a later section. The process of allocating value needs to be adroitly managed as this can be a fractious process. Some of the difficult issues requiring resolution include determining the eligibility and entitlement of parties.

The potential additional complication is that in some exchanges, ownership of the exchange may not be clearly defined. An exchange which is limited by guarantee prior to demutualization may have difficulty in arguing ownership of the exchange belongs to its members²³. Additionally, the nature of the interest of members would also be very much dependent on the rights enshrined in the memorandum and articles of association of the exchange. For instance, the distribution of the surplus assets of the exchange may be indicative of where ownership rights lie²⁴.

Various approaches adopted in determining value allocation include those based on legal ownership rights of the exchange and the historical economic contributions to the development of the exchange. In the majority of jurisdictions, the value of the exchange is usually distributed to member brokers. Hungary, Philippines and Chinese Taipei distributed value to its members based on direct conversion of members to current owners²⁵. Therefore, following the completion of the demutualization exercise, the exchange was fully owned by its former member-brokers in those jurisdictions.

One point worth noting is that this approach would not be consistent if the objective set for the demutualization exercise was to de-couple exchange ownership from the stock broking community and to broaden its shareholder base with a view to strengthening the governance structure and business decision-making process as was the case in some jurisdictions.

In emerging market jurisdictions such as Malaysia, Pakistan and India, the demutualization resulted in a de-coupling of ownership and membership.

- In Malaysia, 40% of the total value of the exchange was allocated to the stock broking industry, of which 30% was allocated to stock broking companies and 10% to their agents (known as remisiers). A further 30% was allotted for the setting up of a Capital Market Development Fund, and the remaining 30% was allocated to the Minister of Finance Incorporated. This allocation was determined based on the historical contribution of the different stakeholder groups where it was deemed that the success and development of the exchange was essentially an outcome of “public” efforts and that therefore the allocation of value should be distributed in a manner so as to benefit a broad spectrum of stakeholders, including the government, agents of stock broking companies (remisiers), issuers and investors, from the unlocking of value from an exchange.

²³This was recognized in Pakistan by the Expert Committee on Demutualization and Integration/Transformation.

²⁴In Pakistan and the Philippines, the Memorandum and Articles of Association of the exchanges provide that income and property can only be distributed to the members in case of winding up. In Malaysia the Memorandum and Articles of Association of the exchange prohibited the distribution of income and property to its members upon the winding up of the exchange.

²⁵The Philippine Stock Exchange, Inc allocated 50,000 shares in the exchange at par value of P1.00 per share to 184 member-brokers. The shares were subscribed and fully paid for by the member brokers.

- In Pakistan, the recommended approach was that 60% shares of the exchange were to be issued to financial institutions for cash consideration while 40% were to be allocated to the members of the existing 3 exchanges, issued for consideration other than cash.
- In India, the Report of the Group on Corporatization and Demutualization recommended to the regulator that the voting rights of the shares held by the members be determined by the Securities and Exchange Board of India in consultation with the Government of India.

It is worth mentioning that the allocation of a portion of the value for the creation of a capital market development fund²⁶ to fund projects with a high “public” value can be used to ensure the benefits of demutualization are shared with a broad spectrum of capital market stakeholders. As noted earlier, Malaysia among the emerging markets established such a fund, and Singapore similarly had earlier established a Financial Sector Development Fund. Similar structures have also been proposed in emerging market exchanges contemplating demutualization.

2.6 Demutualization and exchange restructuring

Often within developed market jurisdictions, demutualization is discussed within the context of competitive pressures necessitating a restructuring of exchange operations. Commentators typically cite examples in Europe, where under competitive pressure from the London Stock Exchange and Deutsche Borse, domestic exchanges have consolidated and entered into alliances across geographical borders, for instance, the merger of the Swiss Option and Financial Futures Exchange with the Deutsche Terminborse in 1998 to form Eurex and the formation of the pan-European exchange Euronext following the merger of the Amsterdam, Paris, Brussels and Lisbon exchanges in 2000.

To some extent, these views are shared by emerging market regulators. As reflected by the survey responses, emerging market regulators are highly concerned with global competition for order-flows. Demutualization therefore provides an opportunity to re-organize exchange operations within the country with the objective of consolidating liquidity in one market-place.

Some emerging market regulators recognize that their relatively small markets may not have sufficient depth and liquidity to support the existence of separate exchanges. While the existence of multiple exchanges can create a competitive landscape, it has the disadvantage of fragmenting liquidity as well as resulting in economic inefficiencies with different sets of intermediaries, front-end trading systems, information channels and compliance requirements for the various exchanges.

Some suggest that a consolidated exchange offers economies of scale and scope by reducing duplication of resources and that the consolidation of order-flow from a combined distribution network would enhance the micro-structure efficiency with the consolidation of market liquidity enhancing the price discovery process. Other benefits of consolidation cited include enhancing investor interest in the demutualized exchange in

²⁶ In Malaysia, a Capital Market Development Fund was established to build capacity in skills, knowledge, research and education in the capital market, and to assist in enhancing the standards of expertise and professionalism in the market. In Thailand, the steering committee discussed the possibility of creating market development fund which would be allocated value from the Stock Exchange of Thailand.

the event it was listed and strengthening the exchange's bargaining position in respect of negotiations to establish trading alliances with other exchanges.

It should be noted that consolidation between futures and equity bourses in developed Asian-Pacific markets included integration of existing corporate structures and product lines prior to demutualization²⁷.

In emerging markets, the issues in relation to exchange restructuring are typically a matter of public policy. In Malaysia, the Capital Market Masterplan recommended that demutualization be preceded by a consolidation of the 5 exchanges in the country as well as the creation of a single clearing and settlement institution for all exchange-traded products through the acquisition of the derivatives clearing house by the equities clearing house. The consolidation of exchanges was completed approximately 2 years prior to the demutualization of the exchange.

In Pakistan, the Expert Committee recommended that the process of demutualization and integration occur simultaneously, and that the 3 existing exchanges should form a fully integrated demutualized exchange. The Committee proposed to the regulator that if insufficient progress is not made towards demutualization and integration within 1 year, a new demutualized exchange, sponsored by financial institutions should be established.

In India, the consultative group appointed by the Securities and Exchange Board of India felt it was unlikely that the existence of 23 stock exchanges in the country would serve an economical purpose but concluded that the decision to merge was a commercial decision that should be left to the respective exchanges. The consultative group felt however that corporatization and demutualization would facilitate the process of consolidation of the exchanges.

One notable difference that is beginning to emerge in relation to exchange restructuring in emerging and developed market jurisdictions relates to the emphasis placed on competition issues. For example, the attempt by the Australian Stock Exchange (6 months after it demutualized) to acquire the Sydney Futures Exchange was rejected by the Australian Competition and Consumer Commission (ACCC) on the basis that the existence of 2 exchanges is likely to facilitate competition, especially in light of impending regulatory changes to the Corporations Law²⁸.

However, it is difficult to infer generalisations in approaches as there are wide ranging variations in capital market and regulatory structures such that the choices in individual jurisdictions are likely to be a reflection of circumstances and individual preferences unique to that country.

In Pakistan, the Expert Committee highlighted possible inefficiencies resulting from a lack of inter-exchange competition as well as the risks to the capital market in the event an integrated exchange experienced financial distress. Despite the Committee's concerns that the size of the market in Pakistan was too small to justify multiple exchanges, it nonetheless came to the conclusion that favoured minimising monopolistic

²⁷ For instance, a new demutualized integrated exchange, the Hong Kong Exchanges and Clearing Ltd, was established in March 2000 with the merger of the Stock Exchange of Hong Kong Ltd, Hong Kong Futures Exchange Ltd and three clearing houses. In Singapore, the Singapore Exchange Ltd. (SGX) was formed in December 1999 by the merger of the Stock Exchange of Singapore, which traded securities, and the Singapore International Monetary Exchange Ltd, which traded futures. SGX also holds the clearing, settlement the Central Depository Pte Ltd and the Singapore Exchange Derivatives Clearing Limited (SGX-DC) provide clearing services to the respective exchanges. In Australia, six stock exchanges merged to form the Australian Stock Exchange in 1988.

²⁸ Press release by ACCC, 17 June 1999.

practices and encouraged the establishment of ECNs and even contemplated the possibility of licensing another stock exchange in the future.

Consolidation through cross-border mergers and acquisitions – commonplace in developed markets - may be difficult for emerging market exchanges to pursue at this juncture given the sensitivity of issues related to national sovereignty. Emerging market exchanges are exploring alternatives, including facilitating closer integration within the region and, more specifically, establishing trading links with neighbouring bourses²⁹. To some extent, this approach offers benefits similar to a cross-border merger while allowing domestic retention of control over the exchange.

2.7 Listing of the demutualized exchange

For demutualized exchanges in developed market jurisdictions, the listing of the demutualized entity typically appears to be a natural consequence of market forces³⁰. Table 3 provides a list of demutualized exchanges which have listed. There also appears to be a considerable variation in relation to how quickly an exchange lists after the completion of demutualization. For example, the Australian Stock Exchange listed the day after it demutualized, whereas for some exchanges there was a lapse of several years after demutualization before the exchange was listed. There appears to be a stronger tendency to pursue a listing among emerging markets with Bursa Malaysia and the Philippine Stock Exchange, Inc listing on its own exchange.

Table 3
Listed exchanges

Exchange	Date of demutualization	Date of listing
Athens Stock Exchange	1999	2000
Australian Stock Exchange	1998	1998
Bursa Malaysia Bhd.	2004	2005
Deutsche Borse AG	2001	2001
Euronext	2000	2001
Hong Kong Exchanges and Clearing	2000	2000
London Stock Exchange	2000	2001
Philippine Stock Exchange	2001	2003
Singapore Exchange	1999	2000
TSX Toronto Stock Exchange	2000	2002

Source: WFE Annual Report 2003, IOSCO EMC WG2 surveys

The Philippine Stock Exchange, Inc was listed two years after it demutualized.³¹ Given that upon demutualization, the Philippine Stock Exchange, Inc. had allocated 100% of its shares to member-brokers, the listing exercise had the effect of significantly reducing the

²⁹ For instance, ASX and SGX developed a co-trading link in December 2001 which enables investors in Australia and Singapore to trade selected securities in each other's markets. Bursa Malaysia and SGX are currently in discussions on developing a similar cross border trading link.

³⁰ It is noted that the New York Stock Exchange is not a demutualized or listed exchange.

³¹ The Philippine Stock Exchange, Inc demutualized in August 2001, and listed in December 2003.

ownership of the exchange by brokers³². Bursa Malaysia was listed slightly more than a year after it demutualized.

One rather surprising feedback from emerging market regulators has been in relation to the merits of pursuing a listing too soon after completion of the demutualization exercise. In expressing concerns in relation to the need to prepare exchange management and market constituents to cope with the challenges of a demutualized environment, this is perhaps an issue that is likely to be of concern to emerging market jurisdictions where the decision to demutualize is policy rather than market-initiated.

Before examining these concerns, it might be useful to review the perceived benefits arising from the listing of a demutualized exchange which have been commonly cited. They are:

- (a) Listing provides the necessary public scrutiny and motivation (in the form of share options and share price performance) for exchange management to hasten the implementation of commercially-motivated strategies and to raise their business performance. Listing also raises the profile and brand of the exchange which would help to attract more investors and issuers.
- (b) Listing provides an exit mechanism for former broker members to sell down equity – thereby facilitating objectives in relation to a broadening of the shareholder base and the decoupling of broker interests from that of the exchange. In addition, realizing the value of the exchange is largely facilitated through a listing exercise.
- (c) Listing provides an avenue whereby an exchange can easily tap the capital market to fund its expansion or to upgrade its infrastructure if it so chooses, as well as facilitates mergers with other exchanges.

These reasons appear to still be largely valid with the exception of the need to raise capital. In the survey, several emerging market regulators cited that the need for funding was not a major driver for demutualization³³.

In recent international regulatory forums, emerging market regulators have begun to express concerns in relation to whether the challenges in relation to managing the post-demutualization exercise may have been under-estimated while the benefits may have been over-stated.

In this context, listing appears to intensify the pressure to achieve success within too short a time frame. In managing the transition to a post-demutualization environment, it may be too much to expect exchange management, having previously operated mostly in a regulatory mode to easily assimilate a commercial mindset or develop the necessary capacity to execute business strategies. Most critically, there are concerns that the pressures from meeting investor expectations may result in a dilution in focus on regulatory duties or even a reduction in regulatory resources.

The challenges that may arise include designing and managing the post-demutualization

³² The listing of the Philippine Stock Exchange, Inc. involved a private placement to 5 institutional investors which subscribed to an equivalent of 36.4% of the PSE's current total issued and outstanding shares.

³³ Capital raising has not been observed to be a key driver of demutualization in developed jurisdictions. See J. Elliot – Demutualization of Securities Exchanges: A Regulatory Perspective, 2002 and B. Steil, Changes in the Ownership and Governance of Securities Exchanges: Causes and Consequences, 2002.

regulatory arrangements (covered in greater detail in the next chapter) and organizational restructuring at the exchange (which may include voluntary separation schemes).

Chapter 3: Regulatory Issues

From the perspective of regulators in both emerging and developed market jurisdictions, much of the debate on the merits of demutualization has centered substantially on the conflict of interest issues that naturally arise when an exchange transforms from a member-owned into a “for-profit” exchange and are more profound when the exchange is listed.

While this is an issue of critical importance, the experiences of emerging markets suggest that there are other areas of regulation that equally require substantial attention and that the changing structures of the exchange industry, of which demutualization is only a sub-set, are placing pressure on existing regulatory frameworks and arrangements.

This chapter provides a broad review of three broad areas of regulation. First, it reviews the varying regulatory approaches used in emerging markets to facilitate or effect the demutualization process.

Second, it addresses the “conflict-of-interest” issues from the broader perspective of addressing public interest concerns through an extensive review of the various mechanisms and approaches adopted by various emerging market jurisdictions – including for the purpose of managing conflicts.

Third, it identifies an emerging area of concern among regulators in relation to the regulatory arrangements and relationship between the regulator and the demutualized exchange as well as outlines the regulatory challenges arising from a changing exchange landscape.

3.1 Approaches to effecting demutualization

The process of converting from a mutual entity to a demutualised entity is unique to individual jurisdictions. Due to the dissimilar membership structures of exchanges, varying legal and regulatory frameworks and the differing objectives of demutualization, the process of converting an exchange from a member-owned entity into a for-profit corporation has taken many forms.

In certain jurisdictions, the exchange is a company limited by guarantee, where the liability of its members is limited to the respective amounts that the members undertake to contribute to the company if it is wound up. In this situation, the demutualization process entails converting membership into shares.

In other jurisdictions, the exchange could be a mutual entity limited by shares, where the liability of members is limited to any amount which is unpaid on the shares in the company. In other instances, the exchange could be a state-owned corporation requiring privatization rather than demutualization.

Survey respondents cited that legal amendments were required to facilitate the process of corporatization and demutualization of the existing exchanges. Typically, this involved

amendments to existing legislation³⁴ or the enactment of a separate legislation to support or enable the conversion³⁵ of the company structure, for example, from a company limited by guarantee to a company limited by shares, and to provide for a regulatory framework to cater for the new structure of the exchange.

Aside from amendments to legislation, there were instances where amendments were required to legislation other than securities laws³⁶. In this regard, demutualization may involve the transfer of assets from the exchange to a new company and legal exemptions from stamp duty and sales tax to may be required.

Where the regulator licenses the exchange under securities legislation, consideration may also need to be given as to whether the new license was required to be issued to reflect changes in the exchange's structure and other licensing terms and conditions, or whether the existing licenses should be preserved by operation of law. Legislative changes may involve a fairly lengthy process and has been cited by survey respondents as one of the major challenges in the demutualization processes.

Some exchanges considered a non-legislative route in converting the exchange company. It is worth noting the case of the Stock Exchange of Hong Kong (SEHK) and the Hong Kong Futures Exchange (HKFE) which were both companies limited by shares. The demutualization and merger was implemented by two parallel schemes of arrangement, one applying to SEHK and one to HKFE. Each scheme of arrangement was conditional on the other proceeding. Following approval by members on the relevant schemes of arrangements, an application was made to the Court to sanction the schemes. The process required valuation of the businesses of the exchanges to fix the ratio for the relative interests which the current members of each of the existing exchanges collectively would have in the Hong Kong Exchanges³⁷.

Generally, emerging market exchanges made amendments to their legislation to facilitate demutualization. Many emerging market exchanges have drafted their legislative frameworks based on the approaches adopted by developed market exchanges, albeit with modifications to take into account the different national characteristics and considerations.

For example, in Malaysia, demutualization was effected under a specific legislation, the Demutualization (Kuala Lumpur Stock Exchange Act) Act while relevant amendments were made to the existing legislation governing the securities and futures industries. In South Africa, new legislation is expected to be promulgated to provide for the ability of the domestic exchanges to demutualize. In Indonesia, amendments to the Capital Market Law are currently ongoing, while in Pakistan, the Expert Committee on Demutualization and Integration/Transformation, recommended that special legislation be effected to facilitate the process of demutualization and integration and that all aspects relating to this exercise be covered by the proposed special law.

³⁴ In Australia, the Corporations Law (the governing legislation for corporations, and securities and futures markets) had to be amended to enable ASX to become a for profit company and contemporaneously list on its own exchange.

³⁵ In Singapore, to effect the demutualization and merger of SES, Simex and SCCS, the Exchanges (Demutualization and Merger) Act 1999 was passed. In Toronto, the Ontario Legislative Assembly passed a specific legislation to facilitate demutualization.

³⁶ In India, amendments were required to the Securities Contract (Regulations) Act 1961, the Income Tax Act 1961 and the Indian Stamps Act 1989 to facilitate corporatization and demutualization of the stock exchanges and to grant fiscal exemptions to encourage this process.

³⁷ Legislation (Exchanges and Clearing Houses (Merger) Ordinance) was also enacted in March 2000 which provided for the conversion of the Hong Kong Securities and Clearing Corporation from a company limited by guarantee to a company limited by shares, as well as the introduction of new regulatory checks and balances and consequential amendments flowing from changes made to the then existing regulatory framework.

3.2 Addressing public interest concerns

IOSCO has reiterated that public interest in a fair and efficient exchange continues in a demutualized environment³⁸. Typically, public interest concerns arise in relation to the capacity and willingness of exchanges to continue to perform their regulatory responsibilities in a satisfactory manner even when they are in conflict with profit objectives.

This debate is often framed within the context of “conflict of interests” which recognizes that there is a natural tension between the competing objectives of a “for-profit” entity with responsibilities towards shareholders and the regulatory duties associated with the ownership of an exchange which essentially provides a public good.

The conflict of interest generally relates to the willingness of “for-profit” exchanges to commit sufficient resources to regulatory functions and the perceived lack of a natural incentive to regulate customers – leading possibly to ineffective enforcement of rules or a reduction in standards for listing. The conflict of interest issues are often broadened to cover either competitive issues and, in the circumstances where the exchange is a monopoly, an abuse of its monopoly position.

From the perspective of regulators, this is clearly an important debate that has been extensively covered in related literature. This section focuses on the practice in emerging market jurisdictions to address public interest concerns. This includes requirements such as those relating to the exchange’s governance structure, shareholding limits and procedures for dealing with conflicts of interest. However, it is likely that the approach towards governance may be dependent on degree of regulatory oversight that the regulator chooses to exercise over the exchange.

Governance Structure

Reform of the governance structure has been cited by many emerging market exchanges as one of the reasons for demutualization. However, as highlighted earlier in the paper, the Stock Exchange of Thailand was able to implement reforms to its governance structure without undergoing demutualization, for example, by appointing non-member directors on the board of the exchange – which makes the point that change in governance structures can be achieved through means other than demutualization.

In relation to the governance structure, much of the focus has been on the composition of the board of directors and the selection process for directors. Within this context, it is worth noting that in a traditional mutual structure, exchange boards were structured to prevent capture of the decision-making process – leading awkwardly to the result that exchange boards were sometimes dominated by the small stockbrokers, when a one-firm one-vote approach resulted in the bigger firms being excluded from the decision-making process.

In this regard, even from a traditional standpoint, the implicit suggestion seems to be that exchanges should be subject to higher governance standards than is the norm because

³⁸ Report of the Technical Committee of the IOSCO – Issues Paper on Exchange Demutualization, June 2001

of the responsibilities that come attached with operating a market – with particular emphasis on standards in relation to fairness, independence and transparency.

In this regard, “public interest directors” have been appointed to the boards of demutualized exchanges, for example in Hong Kong, as a means of ensuring that the interests of a broad spectrum of the capital market are represented. The appointment of public directors on the exchange’s board to represent the interests of the community was discussed in the IOSCO Technical Committee ‘Issues Paper on Exchange Demutualization’³⁹.

Complications may arise with this approach, though it should be said that in practice the subject has hardly attracted any controversy – demonstrating that this is a principle that is generally accepted. One such complication is the difficulty in legally defining a public interest director and public interest. At best, it appears that these definitions need to be kept fairly broad.

The other complication is in differentiating between a public interest director from an independent director. This distinction is critical as it reflects the different underlying duties and typically, the belief has been that public interest directors have a duty beyond that of independent directors whose obligations are limited to representing the interests of minority shareholders.

In Malaysia, there was substantial discussion on how best to design a board structure that would ensure an appropriate balance between the interests of the major shareholders, minority shareholders and that of public interest. It was eventually decided that an exchange board should comprise one-third public interest directors⁴⁰ (including the non-executive Chairman), one-third independent directors with the remainder would be shareholder directors. This outcome provided compliance with the governance standards contained in the Malaysian Code of Corporate Governance and avoided complications that could arise if public interest directors were not deemed independent directors. In relation to the latter, the view was taken that it might be difficult for public interest directors to look after both public interest as well as represent minority shareholders’ interests.

Creating a board structure with balanced representation also meant that majority shareholders could not effectively control the board. However, this would be consistent with the principle that exchanges should be subject to higher governance standards and with the traditional practice of preventing capture of the decision-making process at exchange boards.

Another issue relates to the appointment of public interest directors. In Malaysia, public interest directors are appointed by the Minister of Finance in consultation with the Securities Commission⁴¹. In India, it was proposed that this category of directors be nominated by the Securities and Exchange Board of India from among a panel comprising of academics, professionals, industry representatives, public figures and investors’ association, none of whom should have any interest in a stock broking company.

³⁹ See Report of the Technical Committee of the International Organization of Securities Commission, Issues Paper on Exchange Demutualization, June 2001

⁴⁰ The requirement for one-third public interest directors is contained in the law.

⁴¹ In the case of all other directors, concurrence of the Securities Commission would be required prior to their accepting the appointment or election as a director. The Securities Commission’s concurrence is guided by a transparent list of criteria.

Additional safeguards can include imposing requirements for “fit and proper” tests for directors of a demutualized exchange. In Malaysia, the SC may refuse to concur with the appointment of a director of the exchange where the SC is not satisfied that the proposed director is a person of integrity and is fit and proper to be a director.

The composition of the board and key committees are also areas that require careful consideration. For instance, a Nominating Committee may recommend appointments to the board and key management positions, an Executive Committee to make swift decisions on behalf of the board, an Appeals Committee to deliberate on appeals by market participants against the exchange’s regulatory enforcement decisions, an Investment Advisory Committee to review and recommend investment decisions, and a Risk Management Committee to review risk management policies and compliance, manage group risk exposure and safeguard public interest.

Mechanisms to deal with potential conflicts of interest

As suggested earlier, potential areas for conflicts of interest include the possibility that the demutualized exchange may not devote sufficient priority and resources to the conduct of its regulatory functions, abuse its monopoly power to increase prices or offer lower quality of services or products or act in a bias manner by treating its competitors unfairly or giving preferential treatment towards its associates or partners. This could cover areas relating to acceptance of participants to the exchange or in relation to enforcement and listing functions.

Regulatory measures that have been adopted in emerging markets to address these concerns include strengthening regulatory oversight for a demutualized exchange. This includes requiring the exchange to submit an annual regulatory report, conducting an annual regulatory audit over the exchange’s discharge of its functions, establishing a Conflicts Committee at the exchange for the purpose of referring all situations of conflict to the regulator, imposing obligations on the exchange to act in the public interest and having broad powers of direction by the regulator over the exchange in the event of a conflict of interest.

It should be noted that sensitivities may arise in several areas especially in terms of the regulator exercising its oversight. One potential area of dispute that may give rise to sensitivities includes the conduct of regulatory functions by the exchange, and whether the exchange is viewed by the regulator as adequately discharging its regulatory functions. In addition, a demutualized exchange may require regulatory approval in specific instances - for example, entering into mergers and strategic alliances, changes affecting the exchange’s fees and charges – and these are potential areas of disputes between the regulator and the exchange. The imposition of ownership limits also features for some demutualized exchanges with thresholds ranging from between 5% to 15% for a single party⁴². Many demutualized exchanges also allow these ownership restrictions to be waived where approval has been granted by the Minister of Finance or the statutory regulator as the case may be – as it is envisaged that there may be circumstances requiring a strategic shareholder. It is worth noting that Australia increased the permitted voting powers in ASX from 5% to 15% of issued shares⁴³ to allow ASX greater flexibility in pursuing commercial relationships.

⁴² Includes single persons or persons acting in concert.

⁴³ The discretion of the Federal Minister is required to exceed this limit.

Ownership limits may also be imposed on “industry groups”. For instance, the Securities and Regulation Code prohibits any industry group from holding 20% of the shares of the Philippine Stock Exchange, Inc.

Typically, demutualization is accompanied by a change in the organizational structure of the exchange with a view to resolving potential conflicts of interest. In Malaysia, the exchange was re-organized to separate regulatory functions from the business roles. It is worth noting the approach in the Toronto Stock Exchange (TSE) hived its regulatory operations into a separate entity, TSE Regulatory Services.

3.3 Regulatory arrangements and relationships

This section examines how recent developments in the exchange industry, including demutualization, are having a significant impact on the regulation of the exchange business. In fact, many of the areas of contention in the various market jurisdictions, both emerging and developed, revolve around the regulatory role of a demutualized entity and its relationship with the regulator.

Therefore, in reviewing regulatory arrangements and relationships between the regulator and the exchange post-demutualization, it is necessary to form a perspective on the broad themes affecting the exchange industry and how some of them are inter-linked with demutualization.

Broad Overview

The boundaries of an exchange business are continually being re-defined arising from advances in technology, globalization and convergence. In developed markets, many exchanges are in the process of re-configuring their corporate structures through mergers and strategic alliances and vertical or horizontal integration. There has been outsourcing of certain exchange functions to global specialists and even efforts at divesting regulatory units with a view to evolving them as a specialist supplier of regulatory services for exchanges.

These recent developments contrast with the past where exchanges operated in a generally stable environment focusing on conducting self-regulatory functions with a view to sustaining a fair market for their members. Despite the absence of commercial objectives, the traditional exchange business model was viable and reliable.

The changing landscape dynamics are undermining the viability of the traditional exchange business model and these tensions are accentuated, rather than caused, by demutualization which sharpens the focus on the difficult task of balancing commercial and regulatory objectives.

Therefore, as the exchange business model experiences tremendous change, it is only a logical consequence that the traditional regulatory model for exchanges, anchored to the legacy of the traditional Self-Regulatory Organization (SRO), may require substantial review. It may be that a broader perspective, from outside of the narrow perspective of demutualization, may be required to obtain greater clarity as to the regulatory obligations of a demutualized exchange.

For example, exchanges are increasingly expanding their range of services while non-regulated entities are increasingly offering exchange-related services. The solutions offered by segmentation through licensing requirements have diminishing relevance and operational effectiveness.

The impact of pressures emanating from a more competitive exchange industry and, the implications of demutualization on the regulatory role and arrangements for demutualized exchanges, are still not fully understood and is clearly an area that requires further study.

Several solutions have been offered which emerging market regulators in developing the regulatory arrangements may wish to consider. One approach is to allow the exchange to focus on functions that are directly connected to its business activities, and thus concentrate on building its business and maximizing its value. This would imply that the regulatory obligations of the exchange are minimized, either through the direct transfer of the regulatory functions conducted by the exchange over to the regulator, to create independent entities to which these regulatory functions are subsequently transferred to or to create an industry SRO and to gradually migrate the relevant regulatory duties from the exchange to the industry.

Some emerging markets have favored the creation of industry SROs. However, this may not be possible if an industry association SRO either does not exist or it is still in too nascent a stage such that it has not yet developed the attributes that allows it to evolve into an industry SRO.

Another approach would be to focus on functional regulation of the exchange's services or products where the exchange is not regulated as an institution, but to regulate the exchange's specific services or products, where public interest demands it. Functional regulation may be an appropriate approach given the increasing number of non-licensed entities offering electronic markets for a wide range of products, if the regulatory philosophy eventually extends to the regulation of all types of market-places.

The challenge for regulators is to define future regulatory obligations and scope is in fast-changing landscape. This suggests that whatever solutions being adopted now are likely to be interim solutions en route to a more comprehensive approach over the longer term.

Demarcation of regulatory roles and responsibilities

One of the most critical tasks during the demutualization exercise is to delineate the regulatory roles and responsibilities of the regulator and the exchange. To streamline and clarify regulatory responsibilities, exchanges typically enter into non-legally binding agreements such as Memorandum of Understanding (MoU), Deed of Undertaking or Guidance to clarify the regulatory relationship between the exchange and the regulator⁴⁴.

The formalisation of the regulatory functions and processes into a document provides clarity and accountability to the public on the post-demutualization regulatory functions being undertaken by the respective entities including the separation of decision-making processes, as well as guides the working relationship between the regulator and the

⁴⁴ The Securities Commission, Malaysia, aside from entering into a broad MoU to guide the working relationship between SC and Bursa Malaysia Bhd, has also issued Guidance to Bursa Malaysia Bhd. in relation to Bursa Malaysia Bhd's regulatory role and the self-listing of Bursa Malaysia Bhd. on its own exchange.

exchange. It is important that parties work seamlessly towards the efficient operation, regulation and development of the market to avoid risks posed by potential negative public perceptions. Clarifying the arrangements in an explicit manner could assist operational staff both at the exchange and the regulator as well as assist communication to potential investors in the listed exchange and mitigate uncertainties.

Given that demutualization is a substantial exercise involving a significant amount of legislative and restructuring work, some emerging market jurisdictions adopted a practical and gradual approach to defining regulatory arrangements by refining status quo arrangements through the streamlining of regulatory responsibilities. This was the approach generally undertaken in Malaysia where there was no significant re-definition of the exchange's regulatory obligations, with the Securities Commission retaining the listings approval function while broker compliance functions remained with the exchange⁴⁵.

Individual jurisdictions can also choose to transfer significant regulatory duties from the exchange to the regulator. As a matter of comparison, in the United Kingdom, the Financial Services Authority took over a large number of regulatory functions from the London Stock Exchange (LSE), including the exchange's role as the listing authority after the LSE demutualized. In Hong Kong post-demutualization, the exchange no longer regulates brokers, while listed company regulation is shared with the statutory regulator.

In this regard, numerous approaches have been adopted post-demutualization ranging from the transfer of listings approvals and broker supervision from the exchange to the regulator to the maintenance of status quo. Given the variety of approaches, it would appear that at this point, there does not appear to be a definitive blueprint that can be adopted by all jurisdictions. There does appear to be general acceptance that exchanges should continue to conduct market surveillance functions, but there seems to be some vacillation over whether exchanges should conduct regulation over listed companies or supervise trading participants (inspections, prudential controls, functional regulation of employees). It is likely that the choices in individual jurisdictions will evolve through negotiations as well as circumstances.

In the event an exchange decides to pursue a listing, MoUs on self-listing are also entered into which would allow the regulator to regulate the compliance of the exchange with its own listing rules⁴⁶ which ensures that any unusual market activity involving the exchange's securities is monitored by an independent party.⁴⁷

It should be noted that concerns have been expressed as to whether regulators should enter into MoUs with regulatees and whether the MoUs should, in any way, bind the powers of the regulators. Differences may also arise between the regulator's and the exchange's expectations on the intended impact or effect of these arrangements.

⁴⁵ Post demutualization, the Securities Commission, Malaysia has taken over from Bursa Malaysia Bhd. the approval of listings and corporate proposals on the MESDAQ Market. MESDAQ is the market for high-growth technology companies within the Bursa Malaysia Bhd. group.

⁴⁶ The Securities and Exchange Commission (SEC) and the Philippine Stock Exchange, Inc. (PSE) entered into a Memorandum of Understanding which provides that the SEC will take all actions and make all decisions in relation to PSE's application for listing and continued listing on the PSE Trading Board. Upon listing, the SEC has, in relation to the PSE, all the powers and functions that the PSE has in relation to a listed company.

⁴⁷ The Philippine Stock Exchange, Inc is required to immediately inform the SEC if, in the course of its surveillance of Trading Participants (in relation to trading and clearing matters) and listed companies or as a result of complaints or market intelligence, it detects unusual market activity (whether of Trading Participants, their representatives or clients) involving PSE's securities, which reveals a possible breach of the Securities and Regulation Code and the related rules, the PSA shall take such necessary action as may be requested by the SEC for the purpose of ensuring the integrity of trading on the shares of PSE.

Exchanges may use MoUs to limit their regulatory duties and obligations to the regulators with a view to reducing their regulatory costs. There are also risks that these MoUs could also be used to impose constraints or obligations on regulators. Such developments need to be carefully managed as it should be recognized that further refinements to regulatory arrangements may be needed arising from the future changes in the exchange business model.

While it is conceptually easy to demarcate regulatory duties, the reality is that there are many functions that either involve 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 are designed based on principles and not allowed to become too operational in nature and scope.

Chapter 4: Summary

This report sets out to survey the experiences and views of emerging market regulators in relation to the demutualization of their domestic exchanges. As part of the WG2 mandate, this report attempts to identify whether there are different perspectives on and implications arising from demutualization in emerging market jurisdictions relative to developed market jurisdictions.

While the approach to demutualization tends to generally be jurisdiction-specific in keeping with the regulatory framework and economic circumstances of individual countries, this report attempts to find common themes and identify emerging issues which are important to put forward for consideration by regulators, particularly in emerging markets. Indeed, many of the views and issues identified by the survey appear to require further extensive debate and analysis

The conclusions and implications that can be drawn from the findings of the IOSCO WG2 survey on demutualization in emerging markets can briefly be summarized as follows:

- The driving factors for demutualization in emerging market exchanges do not differ significantly from those affecting developed markets. However, differences in market conditions and private sector market structures and mechanisms can heavily influence the philosophy and practices of market regulators – leading to different strategic perspectives within emerging market jurisdictions.
- Constraints in domestic markets reduce policy choices available and regulators in emerging markets are required to take a more pro-active approach to development. A policy-led approach on demutualization results in challenges and issues which are different from those arising from a market-led approach.
- Some jurisdictions considered that demutualization was not an appropriate approach to pursue for their exchanges and that reforms to the exchange need not necessarily be achieved through demutualization.
- There are some suggestions that exchanges should be listed only after a sufficient amount of time has lapsed after the completion of the demutualization exercise. This will allow a transition period for the exchange management and other market participants to operate in a post-demutualized environment with the appropriate regulatory arrangements in place.
- The impact of demutualization on the regulatory role and arrangements for demutualized exchanges is quite substantial. Possible approaches that may be adopted include minimizing the regulatory obligations of the exchange by transferring the regulatory functions to the regulator, an independent entity, or an industry SRO.
- The transition phase for post-demutualization regulatory arrangements and relationships between the exchange and regulators needs careful management. Challenges that need to be managed during this phase include designing and managing post-demutualization regulatory arrangements and organizational restructuring of the exchange.

It is too early to gauge the benefits of demutualization given that too short a period of time has lapsed since demutualization has occurred in emerging markets and that, at the point of writing, only a handful of exchanges in emerging markets have completed their demutualization exercise. It is also quite likely that the views on demutualization are likely to evolve as events continue to unfold quickly in a fast-moving landscape

Regardless of whether demutualization is considered an important enabler or a necessity; the success of demutualization is dependent on changes in mindset and capacity such that the “for-profit” exchange can raise its level of competitiveness, operate in an efficient manner and fulfill its regulatory obligations to ensure a fair market.

Demutualization is also likely to bring a host of new regulatory issues and it is critical that regulators and exchange management alike ensure that they are well-positioned and prepared to evaluate new risks and deal with them in an effective manner.

Annex 1

Respondents to the IOSCO EMC Working Group on the Regulation of Secondary Market Regulation Survey

No.	Respondent
1.	Comissao de Valores Mobiliarios, Brazil
2.	China Securities Regulatory Commission
3.	Hungarian Financial Supervisory Authority
4.	Securities and Exchange Board of India
5.	Capital Market Supervisory Agency, Indonesia
6.	Securities Commission, Malaysia
7.	Securities and Exchange Commission of Pakistan
8.	Securities and Exchange Commission, Philippines
9.	Stock Exchange of Philippines
10.	Polish Securities and Exchange Commission
11.	Financial Services Board, South Africa
12.	Securities and Exchange Commission, Sri Lanka
13.	Securities and Futures Bureau, Chinese Taipei
14.	Securities and Exchange Commission, Thailand
15.	Capital Markets Board, Turkey

Annex 2

Key developments in selected emerging market exchanges which have not demutualized

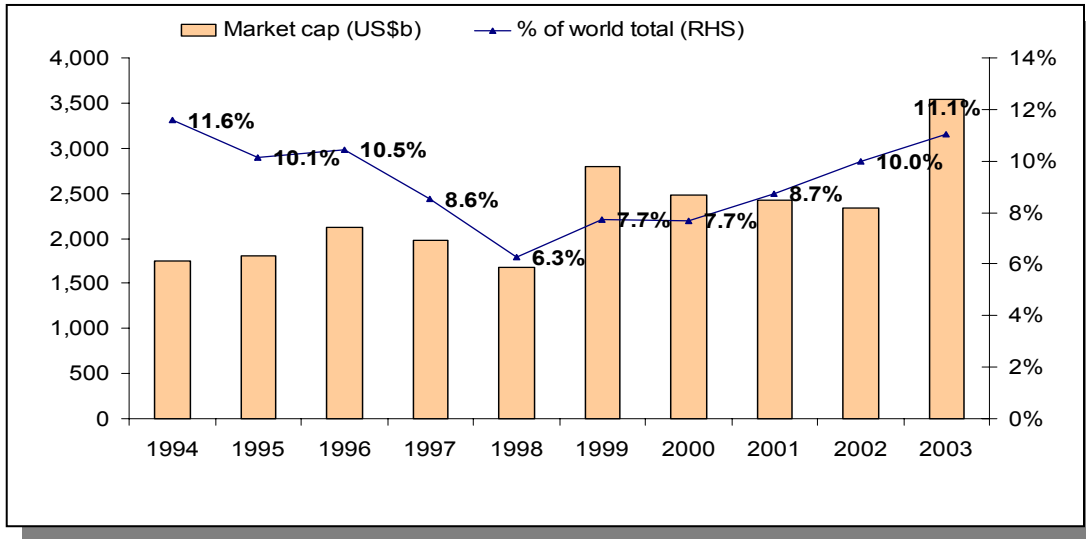
Exchange	Changes in governance structure	Changes in products/services/client base
Johannesburg Stock Exchange	<p>Restructuring of composition of main committees to comply with best practices in corporate governance.</p> <p>Establishment of advisory committees to advise the exchange's Executive Committee.</p>	<p>Introduction of electronic trading.</p> <p>Amendment of the exchange's rules to include foreign members.</p> <p>Introduction of exchange traded funds and warrants.</p>
Warsaw Stock Exchange	<p>No major changes in the exchange's governance structure.</p>	<p>Introduction of new products.</p> <p>Introduction of platform for shortselling of selected securities.</p>
Brazilian Mercantile and Futures Exchange	<p>Range of members expanded to include banks</p>	<p>Introduction of new products and services.</p> <p>Acquisition of clearing house and securities exchange.</p> <p>Opening of overseas representative office.</p>
Sao Paulo Stock Exchange	<p>No major changes in the exchange's governance structure</p>	<p>Introduction of new products.</p> <p>Acquisition of a domestic organized OTC market.</p>
Stock Exchange of Thailand	<p>Changes to governance structure, including the appointment or election of non-members onto the exchange's board.</p>	<p>Establishment of a bond exchange for retail investors</p> <p>Upgrading of post-trade infrastructure of the Thailand Securities Depository, a subsidiary of the Stock Exchange of Thailand.</p>

Annex 3

I. Market size

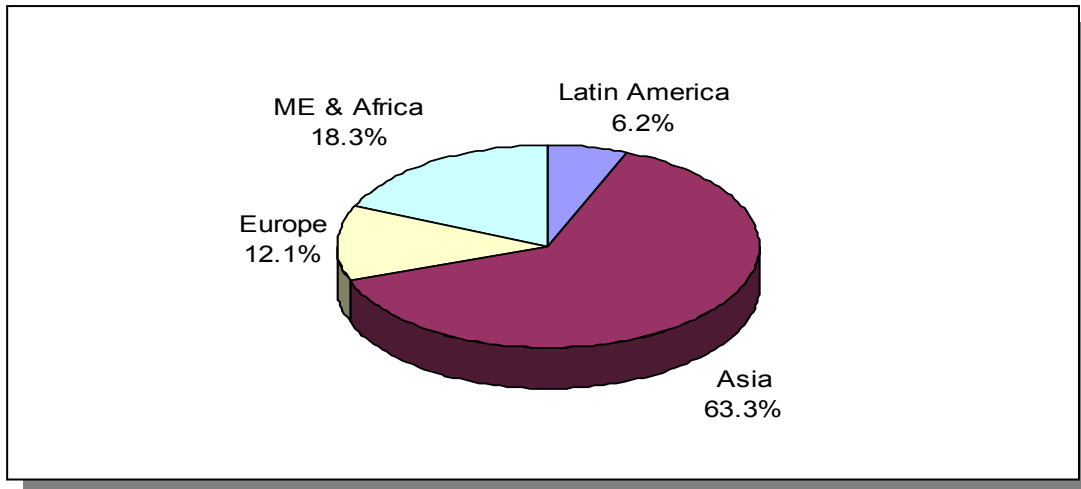
In 2003 emerging markets accounted for 11.1% of global market capitalization and held a 9.8% share of global trading value.⁴⁸ Asia accounts for more than half (63.3%) of total emerging market capitalization. The number of listed companies in emerging markets amounted to 25,282 in 2003, exceeding the number in developed countries of 24,573.

Table 1: Emerging markets' share of world market capitalization, 1994-2003



Source: Standard & Poor's Global Stock Markets Factbook.

Table 2: Share of emerging market capitalisation, end-2003



Source: Standard & Poor's Global Stock Markets Factbook

⁴⁸ Source: Standard & Poor's World Stock Markets Factbook. Emerging markets here are defined as, among others things, those located in a low- or middle-income economy, as defined by the World Bank.

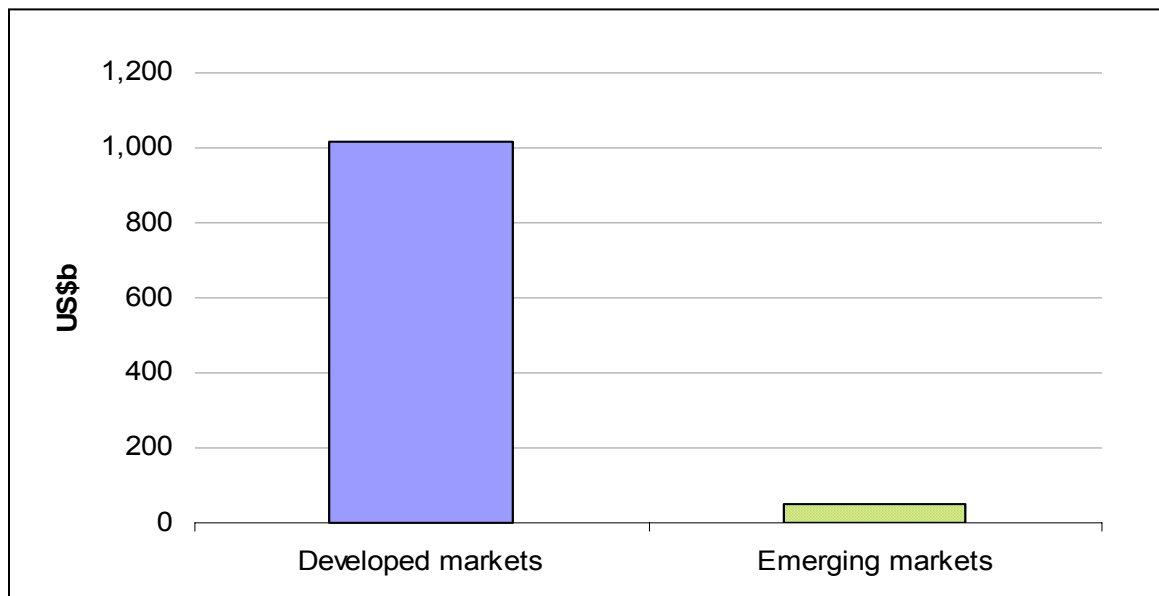
II. Diversity of emerging markets

Emerging markets are an economically diverse group as they vary tremendously in size, liquidity, and sophistication. Some emerging capital markets include some of the largest and most liquid markets in the world with advanced trading, clearing and settlement infrastructure together with a well-developed regulatory framework, while others have come into existence only in the last few years.

In addition to the issue of data availability, the different stages of development of emerging markets, as well as the different ways in which they have evolved, mean that in many cases it is possible only to achieve a selected coverage of areas, depending on their relevance to a particular jurisdiction. Although it may be difficult to generalize, some clear trends about the progress of emerging market exchanges can be inferred.

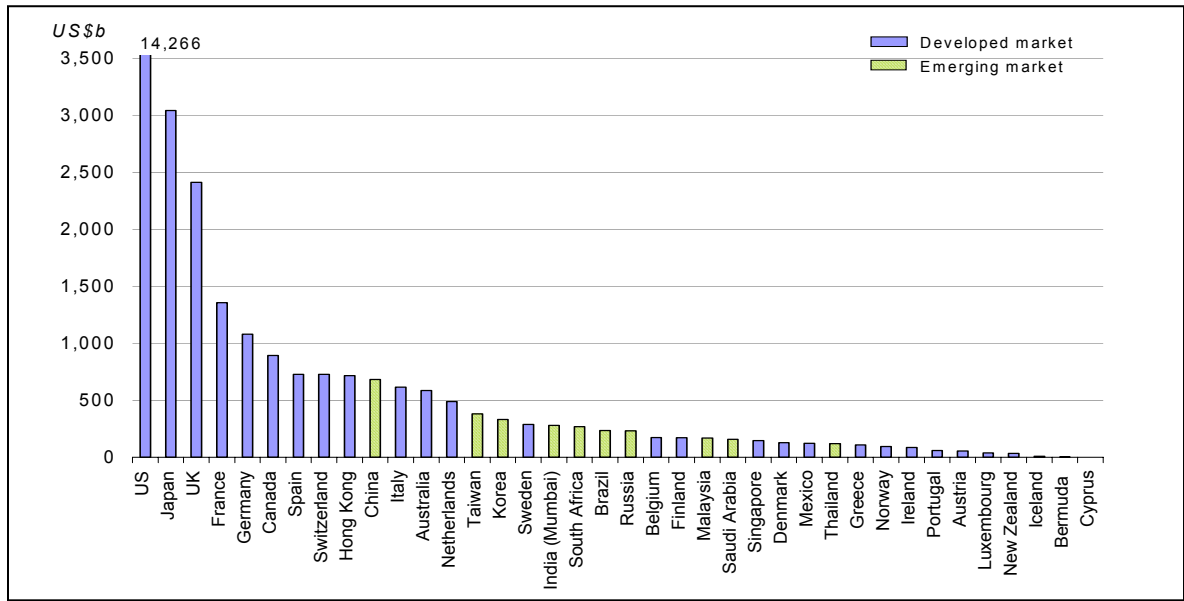
Most emerging markets are only a fraction the size of their developed counterparts. There is considerable diversity in the size of emerging markets: the smaller half of emerging markets have a combined market capitalization of less than US\$70m at end-2003, while 10 of the largest emerging markets have a market capitalization of more than US\$100m each. These larger emerging markets are comparable in size with the mid-sized developed markets.

Table 3: Average market capitalization of emerging vs developed markets, end-2003



Source: Calculations based on data from Standard & Poor's Global Stock Markets Factbook

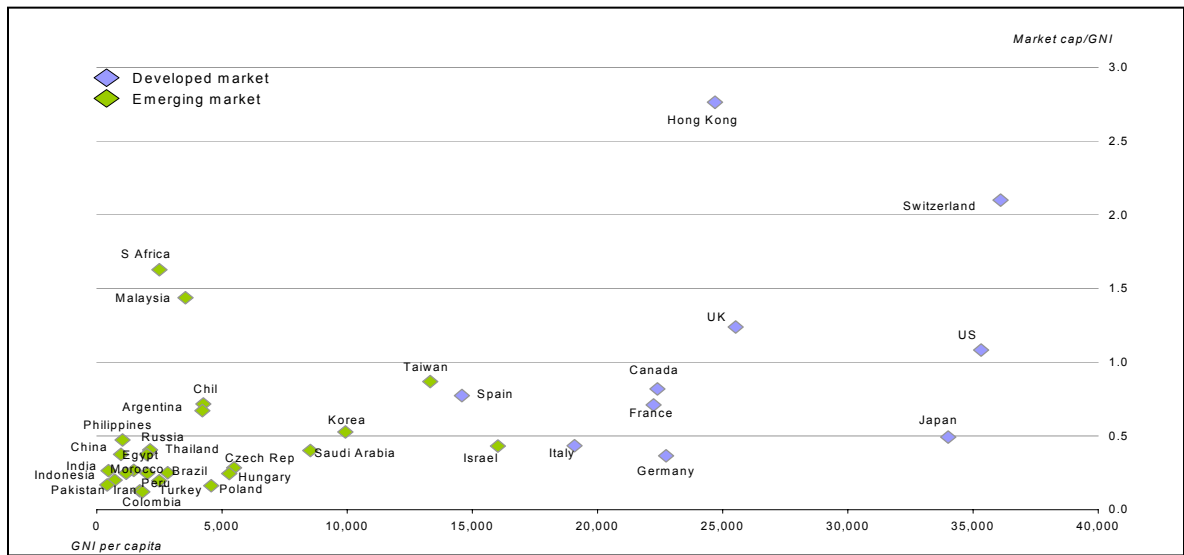
Table 4: Market capitalization of the 10 largest emerging markets vs developed markets, end-2003



Source: Standard & Poor's Global Stock Markets Factbook

The ratio of market capitalization to gross national income is typically used as a proxy of the level of sophistication of the capital market. Table 5 includes the 25 largest emerging markets and the 10 largest developed markets by market capitalization, and shows that, relative to the size of their domestic economies, many emerging markets have stock markets as large as those in developed economies. The table also shows that relative stock market development is not necessarily related to per capita income levels.

Table 5: Market capitalization as a % of GNI vs GNI per capita (US\$), 2002

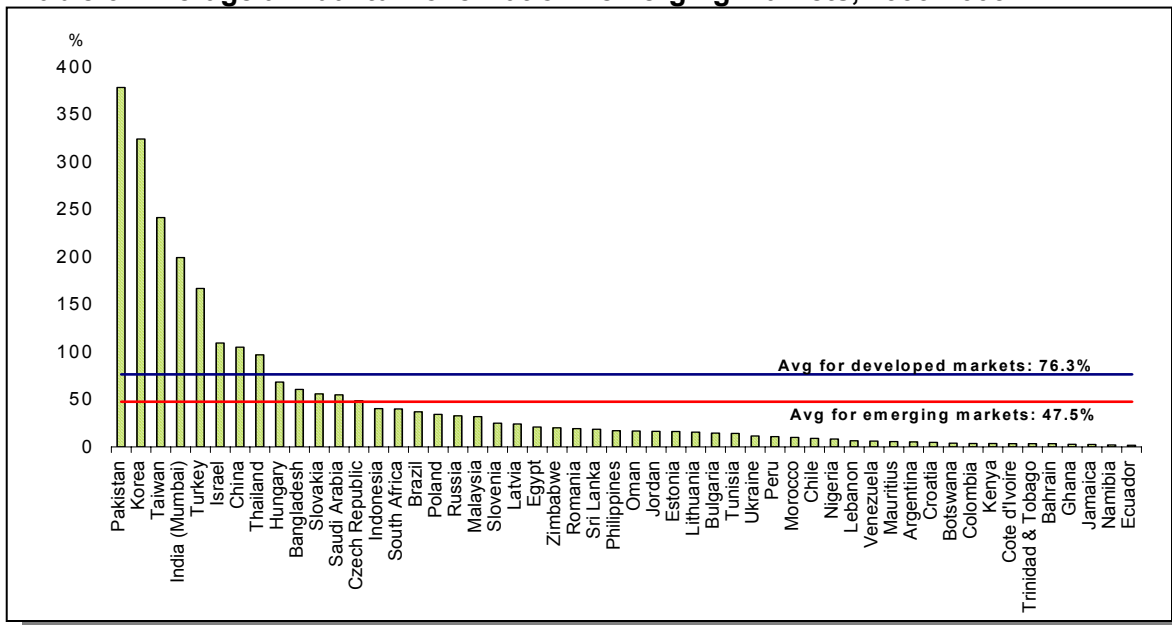


Source: Calculations based on data from S&P's Global Stock Markets Factbook

III. Competition for order flow and listings

Survey findings suggest that increasing competition for global order-flows, particularly amid concerns about the lack of liquidity of domestic markets, is one of the main drivers for demutualization in emerging markets. As Table 6 shows turnover velocity, an indicator of market liquidity, is extremely low in many emerging market exchanges. At the other end of the spectrum, a small number of emerging markets exhibit very high turnover ratios.

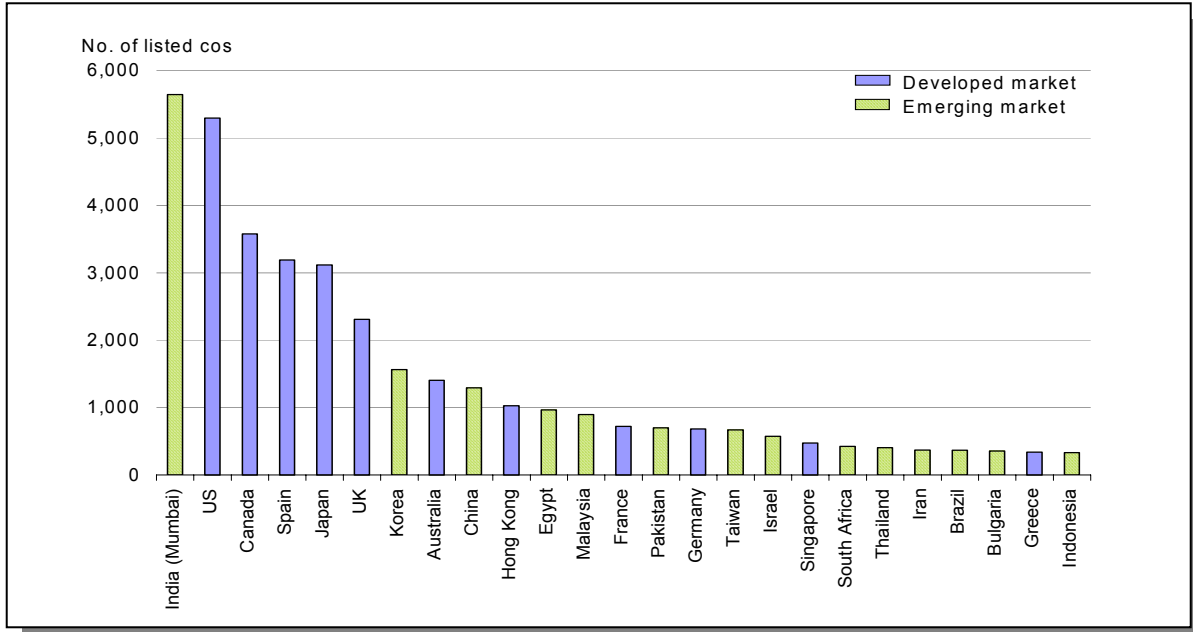
Table 6: Average annual turnover ratio in emerging markets, 1999-2003



Source: Standard & Poor's Global Stock Markets Factbook. Annual turnover ratio = Annual turnover value divided by average market capitalization for the year and the previous year.

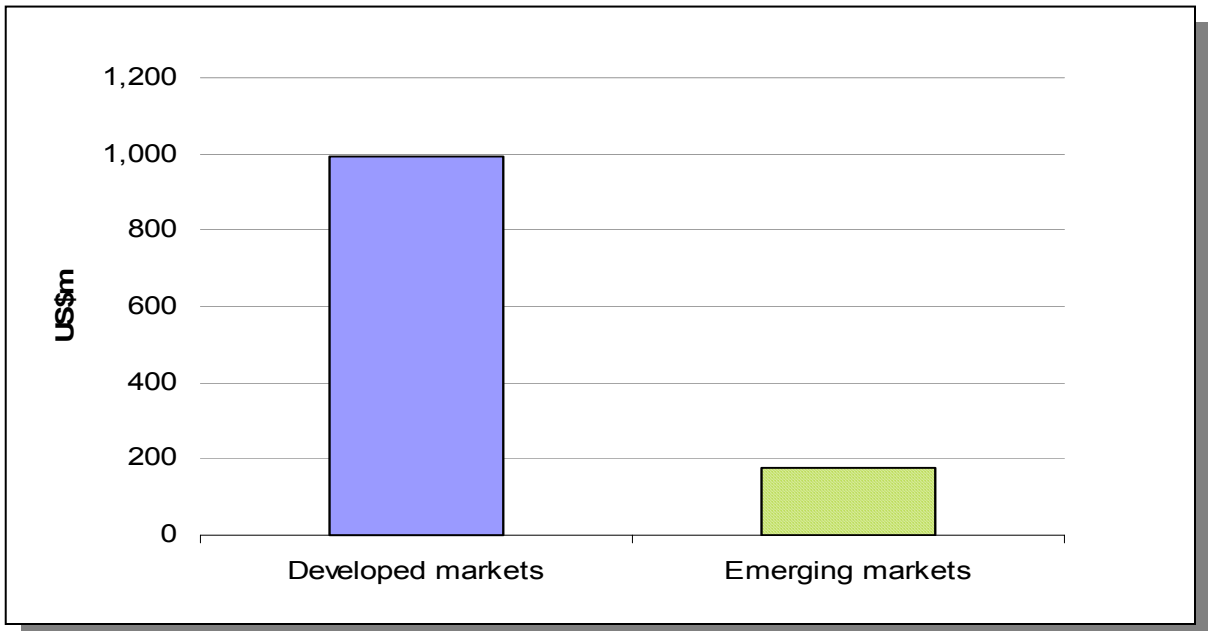
There are a few common factors behind the low liquidity of many emerging markets: 1) there is often a scarcity of large and quality listed companies – even when there are substantial numbers of new listings, these are typically of small-capped companies. Tables 7 and 8 show that while some emerging markets have large numbers of listed companies, the average size per company is usually only a fraction of their developed market counterparts; 2) the free float of shares in many companies is often quite low, as Table 9 shows; and 3) in some emerging markets, foreign participation is extremely low, due in part to foreign investment restrictions and an insufficient supply of investable companies i.e. companies with secondary market characteristics that make them appealing to global institutional investors.

Table 7: Markets globally with the highest numbers of listed companies, end-2003



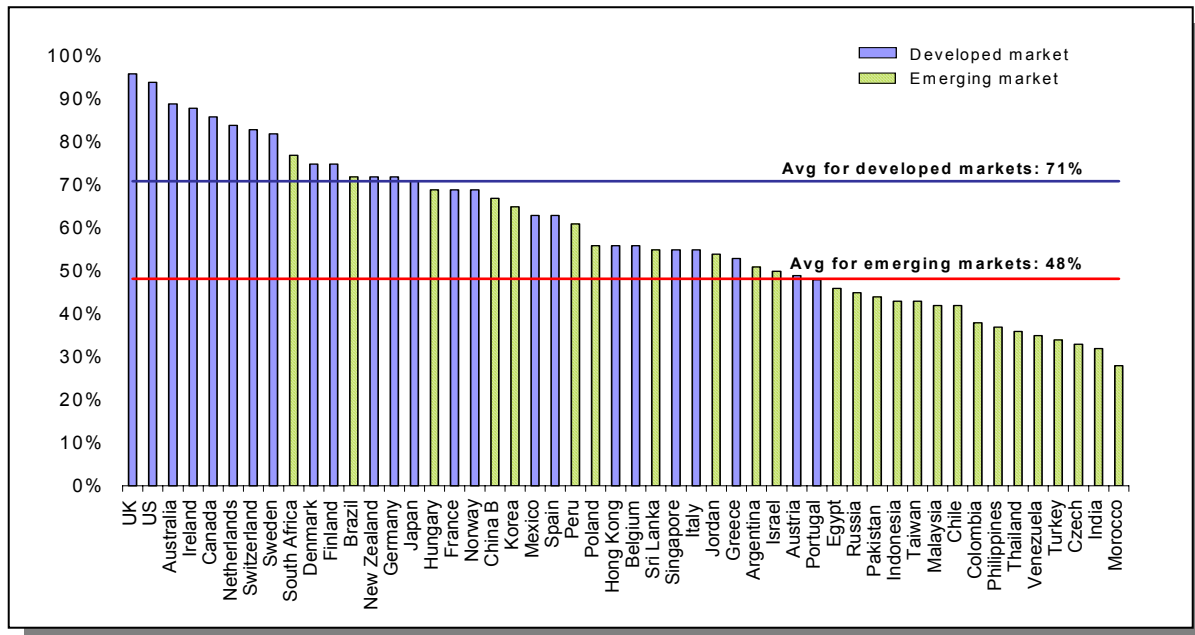
Source: Standard & Poor's Global Stock Markets Factbook

Table 8: Average market capitalization per listed company in emerging vs developed markets



Source: Calculations based on data from Standard & Poor's Global Stock Markets Factbook

Table 9: Average free float of shares in global markets included in MSCI indices



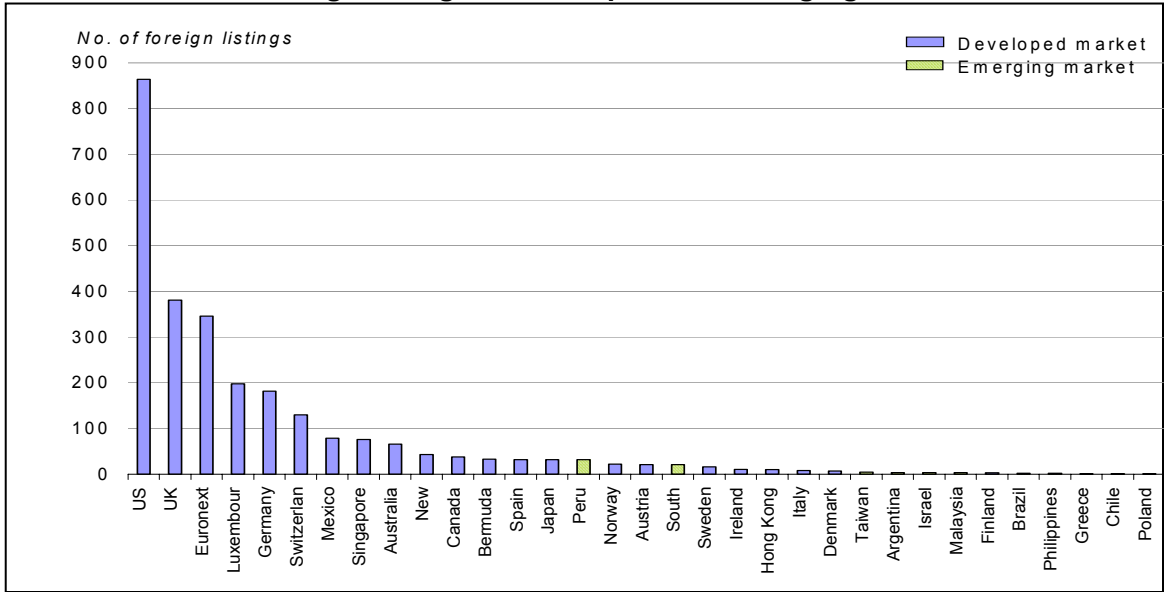
Source: MSCI. Data is as of May 2002, the latest available.

Liquidity and order flow has been commonly observed to exhibit a tendency to migrate to markets which are already liquid, thus putting further pressure on emerging market exchanges to retain and enhance their liquidity.

The threat of companies and issuers migrating to larger international exchanges either through dual-listing, the use of depository receipt programs or a single listing on a foreign exchange is also a widespread concern for emerging market exchanges. Larger and more attractive companies in emerging markets may prefer to list on an international exchange rather than on its domestic exchange given that such a listing would raise its international profile and potentially increase its investor base. Tables 10 and 11 show that developed markets have attracted substantial foreign listings, and increasing numbers of these foreign listings come from emerging markets. On the New York Stock Exchange and Nasdaq, for example, companies from emerging markets now account for 27% and 26% respectively of total foreign listings on these exchanges.⁴⁹

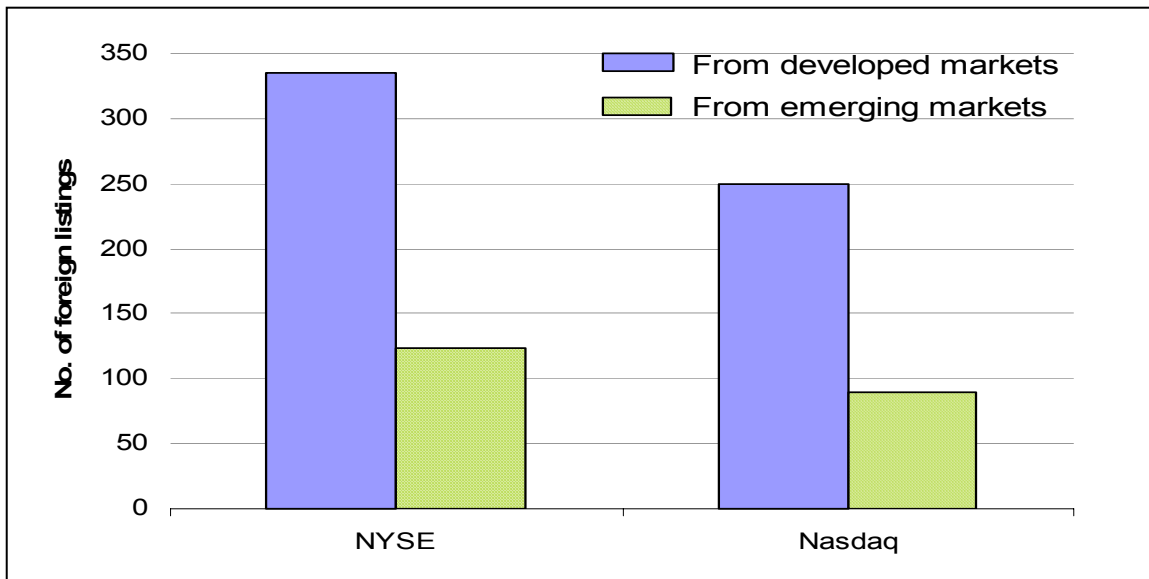
⁴⁹ As of mid-2004. Source: Estimates based on information from NYSE and Nasdaq.

Table 10: No. of foreign listings in developed and emerging markets, end-2003



Source: World Federation of Exchanges

Table 11: No. of foreign listings on NYSE and Nasdaq, from emerging vs developed countries, 2004



Source: Estimates based on information from NYSE and Nasdaq

IV. Regulatory and market infrastructure

The rulebooks and infrastructure for capital markets are being rapidly developed to conform with international best practices and standards. Emerging markets regulators have made substantial progress in strengthening practices and infrastructure in areas such as operational efficiency, quality of market regulation, supervision and enforcement, corporate governance practices, minority shareholder rights, transparency and level of accounting standards.

Table 12
Market information of selected emerging market exchanges

Exchange	Trading systems	Settlement cycle
Bolsa de Comercio de Buenos Aires	Open outcry and electronic matching system	T+3
Budapest Stock Exchange	Order driven, screen-based, remote electronic trading system	T+3
Colombo Stock Exchange	Fully Automated Trading System	T+5 for Buyers T+6 for Sellers
Istanbul Stock Exchange	Fully Computerized	T+2
Jakarta Stock Exchange	Automated Trading System	T+3
JSE Securities Exchange, South Africa	JSE SETS	T+5 rolling settlement
Korea Stock Exchange	Fully Computerized	T+2
Bolsa de Valores de Lima	Electronic trading system	T up to T+3
Bursa Malaysia	Screen based trading system	T+3 (rolling settlement system)
National Stock Exchange of India	Fully Automated Screen based trading	T+2
Philippine Stock Exchange	Screen based	T+3
Shanghai Stock Exchange	Screen based	T+1
Bolsa de Valores de Sao Paulo	Open outcry and electronic trading system	T+3
Taiwan Stock Exchange Corp.	Fully Automated Securities Trading System	T+2

Source: World Federation of Exchanges

In the area of operational efficiency, there have been substantial improvements in many emerging markets in the past two decades. Many emerging markets now adopt international best practices in the areas of securities trading, clearing and settlement, and have upgraded their market infrastructure.

Annex 4

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