Demutualization of stock exchanges

Business, Company

DEMUTUALIZATION OF STOCK EXCHANGES PROBLEMS, SOLUTIONS AND CASE STUDIES Edited by SHAMSHAD AKHTAR Director, Governance, Financeand Trade Division, East and Central Asia Department, Asian Development Bank The views expressed in this book are those of the authors and do not necessarily reflect the views and policies of the Asian Development Bank, or its Board of Governors or the governments they represent. The Asian Development Bank does not guarantee the accuracy of the data included in this publication and accepts noresponsibilityfor any consequences for their use.

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mutual organization is transformed into a forprofit shareholder corporation. Exchanges around the world have been demutualizing because of international competition and technological challenges to traditional modes of trading securities. The change of a stock exchange from a member-owned organization to a for-profit shareholder corporation triggers a number of questions about regulatory oversight.

When a demutualized exchange is listed on its own board, some regulatory oversight needs to be transferred to a government regulator. In many countries, demutualization of the major national stock exchange has been accompanied by general securities regulatory reform. This book grew out of a conference on Demutualization of Stock Exchanges held in Manila on 13-14 August 2001 organized under the APEC Financial Regulators Training Initiative sponsored by the Asian Development Bank.

The conference focused on developing greater understanding of demutualization by discussing the general problems it engenders and how these might be solved, developing common themes and lessons from case studies and also seeing how different countries have evolved different approaches to demutualization. This book is divided into three parts. Part I, consisting of Chapters 1-11, discuss various dimensions and issues involved in the process of stock exchange demutualization.

Chapters 1-3 give a broad overview of the reasons for demutualization, the critical issues and challenges, the decision-making process relating to demutualization and the possible models stock exchanges may choose, including that of a privately owned for-profit corporation and that of a publicly held company listed on the exchange’s own board. Chapter 4 sets forth the critical issues an exchange and its regulator must confront in connection with the demutualization process from the vantage point of a particular jurisdiction—Australia.

Chapters 5-7 discuss the conflicts of interest raised by an exchange's demutualization and then Chapters 8-11 set forth how regulators in Canada, Singapore, the United States and Australia attempted to deal with some of these conflicts through regulation. Part II of this book is a series of case studies. Chapters 12-17 discuss the demutualization experience in Australia, Hong Kong, Singapore, xiii Demutualization of Stock Exchanges—Problems, Solutions and Case Studies Toronto and the Philippines.

Part III of this book provides information about jurisdictions that have not demutualized their exchanges. Chapters 18-22 discuss the Colombo, Kuala Lumpur, Shanghai and Shenzen, Taiwan and Thailand exchanges. Chapters 1-16 were submitted as papers by professionals who presented papers at the conference. Chapters 17-22 were submitted by participants in the conference who were not presenters. This conference was coordinated by the Finance and Industry Division (East) of ADB under the overall guidance and supervision of Ms.

Shamshad Akhtar, Director, Governance, Finance and Trade, East and Central Asia Department. Special thanks are due to the various contributors as well as the organizers. The book has been edited by Ms. Akhtar. Ms. Roberta Karmel, Professor of Law at Brooklyn Law School, was engaged to integrate the conference materials and provide editorial advice. R. Jane Lee, a student at Brooklyn Law School supported the compilation of this book. Mr.

Lyle Raquipiso coordinated the publication of this book and Ms. Nancy Bustamante provided administrative support. Geert H.

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Amex APEC Archipelago Archipelago Exchange ASIC ASTC ASX ATS BOT CATS CBA CBI CBOT CCASS CDNX CDS CFE CFTC CGE CME CMP CNS CSE CSRC DTF EBOT ECM ECN Australian Securities and Investments Commission Australian Settlement and Transfer Corporation Pty Ltd Australian Stock Exchange alternative trading system Bank of Thailand computer assisted trading system Colombo Brokers Association Canadian-based interlisted issuer Chicago Board of Trade Central Clearing and Settlement System Canadian Venture Exchange Central Depository Systemcommunicationfront-end system Commodity Futures Trading Commission Committee on the Governance of the Exchanges Chicago Mercantile Exchange Capital Market Masterplan Continuous Net Settlement Colombo Stock Exchange China Securities Regulatory Commission derivatives transaction execution facility exempt board of trade exempt commercial market electronic communications network American Stock Exchange Asia Pacific Economic Cooperation Archipelago Holdings, LLC Archipelago Exchange, LLC xxi Demutualization of Stock Exchanges—Problems, Solutions and Case Studies ETF ETP FCM FIBV GEM HIBOR HKCC HKEC HKEx HKFE HKFECC HKSCC IDA

IISL IMM IOM IOSCO IPO KLSE KULBER LFX LSE MAS MCD MDEX ME MESDAQ MkSE MMCD MOF MOU MSE xchange traded fund equity trading permit futures commission merchant International Federation of Stock Exchanges Growth and Emerging Market Hong Kong Interbank Offered Rate HKFE Clearing Company Hong Kong Exchanges and Clearing Hong Kong Exchanges and Clearing Limited Hong Kong Futures Exchange Limited HKFE Clearing Corporation Limited Hong Kong Securities Clearing Company Investment Dealers Association India Index Services & Products Limited International Monetary Market Index and Option Market International Organization of Securities Commissions Initial Public Offer Kuala Lumpur Stock Exchange KLSE-Bernama Real-Time Information Services Labuan International Financial Exchange London Stock Exchange Plc Monetary Authority of Singapore Malaysian Central Depository Malaysia Derivatives Exchange Montreal Exchange Malaysian Exchange of Securities Dealing and Automated Quotation Bhd Makati Stock Exchange Mark to Market Collateral Deposit Ministry of Finance memorandum of understanding Manila Stock Exchange xxii Abbreviations MSRS NASD NASDAQ NASDR NSE NYSE OECD OM OSC OTC PCX PCX PCX Holdings PCXE PSE REC RIIAM SAFE SC SCA SCANS SCCP SCORE SCH SEA SEC SEHK SEL SEOCH SES SET Malaysian Share Registration Services National Association of Securities Dealers, Inc. NASDAQ Stock Market, Inc. NASD Regulation, Inc. National Stock Exchange of India New York Stock Exchange Organisation for Economic Co-operation and Development OM Gruppen AB Ontario Securities Commission over-the-counter Pacific Exchange PCX Equities, Inc. PCX Holdings, Inc.

PCX Equities, Inc. Philippine Stock Exchange, Inc. recognized exchange controller Research Institute of Investment Analysts Malaysia South Asian Federation of Exchanges Securities Commission Securities Commission Act 1993 Securities Clearing Automated Network Services Sdn Bhd Securities Clearing Corporation of the Philippines System on Computerised Order Routing and Execution Securities Clearing House Securities and Exchange Act of 1992 Securities and Exchange Commission The Stock Exchange of Hong Kong Limited Taiwanese Securities and Exchange Law SEHK Options Clearing House Limited Stock Exchange of Singapore Stock Exchange of Thailand xxiii

Demutualization of Stock Exchanges—Problems, Solutions and Case Studies SFA SFC SFE SGX SGX-ST SIA SIIS SIMEX SIPF SME SRC SRO STAMP TBDC TSD TSE TSE RS TSE TSEC TSI Securities and Futures Act Securities and Future Commission SFE Corporation Limited (formally known as Sydney Futures Exchange Limited) Singapore Exchange Limited Singapore Exchange Securities Trading Ltd Securities Industry Act 1983 Special Isolated Immediate Settlement Singapore International Monetary Exchange Limited Securities Investors Protection Fund Small Medium Enterprise Board Securities Regulation Code Self-regulatory organization standard message protocol Thai Bond Dealing Center Thailand Securities Depository Co. , Ltd.

The Toronto Stock Exchange TSE regulatory services Tokyo Stock Exchange Taiwan Stock Exchange Corporation Thailand Securities Institute xxiv PART I Issues Involved in Stock Exchange Demutualization Demutualization of Asian Stock Exchanges—Critical Issues and Challenges 1 Demutualization of Asian Stock Exchanges— Critical Issues and Challenges Shamshad Akhtar 1 1. 1

Introduction Stock exchanges offer a host of services to listing companies. These include: (i) liquidity, (ii) execution of services, (iii) signaling function for listed companies, (iv) monitoring of trading to prevent manipulation and insider trading, (v) standard rules to reduce transaction costs, and (vi) clearing of buy and order transactions.

Traditionally, stock exchanges operating as a " club of brokers" offered these services as monopoly operators serving largely under a mutual governance structure. The members of the club enjoyed rights of ownership, decision-making (one member, one vote), and trading. Value enhancement of the exchange was achieved by restricting access. Stock exchanges are now increasingly changing their business model and restructuring themselves across the world due to the simultaneous convergence of a number of powerful developments. The most notable of these has been the: (i) rapid advancement and innovation 1 Director, Governance, Finance and Trade, East and Central Asia Department, Asian Development Bank. 3 Part I: Issues Involved in Stock Exchange Demutualization ntechnologythat has facilitated alternative trading systems (ATS) including electronic communication networks (ECNs); and (ii) growing market competition and integration as well as globalization induced partly by cross-border listing and portfolio flows, etc. Together these developments have eroded the significance of physical national stock exchanges and their trading floors. Consequently, across the globe stock exchanges are now rethinking their business strategy and model in order to find ways of how best to survive. In the process, exchanges have evolved towards new corporate, legal and business models to strengthen governance and face the competition.

This process of transformation from members' associations into for-profit corporations is referred to as demutualization. There is a great need to distill lessons from the rapidly evolving experience with demutualization and synthesize both the normative and positive aspects of this exciting and relatively new structure so that developing countries can take advantage of it. This paper, therefore, aims to provide basic perspectives and dimensions of demutualization based on a review of literature and experience. In the process it explains: (i) What is demutualization and how significant has it been? (ii) What factors have been driving the demutualization of exchanges? iii) What ownership, legal and strategic approaches are being adopted in the process of demutualization? (iv) What are the principal benefits of demutualization? (v) What regulatory challenges and responses does a demutualized exchange face? (vi) Have the demutualized exchanges been financially viable? 1. 2 Demutualization: Its Definition, Size and Significance Demutualization, in the strictest sense, refers to the change in legal status of the exchange from a mutual association with one vote per member (and possibly consensus-based decision making), into a company limited by shares, with one vote per share (with majority-based decision making).

Demutualization makes sense if it induces a change in the exchange’s objective from managing the interests of a closed 4 Demutualization of Asian Stock Exchanges—Critical Issues and Challenges member-based organization with a central focus on providing services for the benefit primarily of the members/brokers and keeping costs and investments limited to financing agreed by members, into a company set up with the objective of maximizing the value of the equity shares by focusing on generating profits from servicing the demands of their customers (brokers and investors) in a competitive manner. The number of exchanges that have privatized or listed has been increasing since the Stockholm Stock Exchange demutualized in 1993.

In 1999, 11 stock exchanges had been privatized or listed and this number rose to 21 by early 2002, with several other exchanges either considering demutualization or already having stated their intent to do so. Of the World Federation of Stock Exchanges-formerly the International Federation of Stock Exchanges (FIBV)-member exchanges, around 52% of stock market capitalization is accounted for by demutualized exchanges. In Asia, demutualized stock exchanges including the Tokyo Stock Exchange now account for 76 % of the region's market capitalization (Figures 1. 1 and 1. 2). Figure 1. 1. Market Capitalization FIBV Stock Exchanges (2001) Figure 1. 2. Market Capitalization Stock Exchanges in Asia (2001) Demutualized 52%

Not demutualized 48% Demutualized 76% Not demutualized 24% Source: International Federation of Stock Exchanges (FIBV) Source: International Federation of Stock Exchanges (FIBV) 1. 3 Motivation and Driving Factors for Demutualization Today, exchanges are no longer the soleprimary and secondarymarket makers or the sole service providers of trade execution, signaling or other activities. This is largely because of the widespread proliferation of ATS and ECNs that have been supported by technological revolution and introduction of high capacity hardware, software packages and Internet facilities. ATS/ECNs have allowed efficient and effective matching 5

Part I: Issues Involved in Stock Exchange Demutualization of the buy and sell orders of customers at lower transaction costs, while offering price transparency, trader anonymity and extended trading hours. Large global brokers are able to price-match within their own order-stock and only report the net position as a trade to the exchange (thus avoiding transaction costs). Given the competitive edge, the market share of the ECNs has grown. In 2002, ECNs have accounted for 45% of NASDAQ shares traded (compared to 25. 5% in 1999) - although they only accounted for about 5% of the listed shares traded. Of the several ECNs, Island ECN alone accounted for 32% of the ECN's market share.

Instinet makes up another 29%, ArcaEx 27. 2% (formed through the merger of Archipelago and REDIBook), Bloomberg Tradebook 6. 3% and Brut ECN 5. 3%. The rest is accounted by other networks. 2 Having attracted substantial trading, ECNs are also entering into strategic alliances or tie ups with other exchanges or are offering services such as quotes and listing shares to further raise revenues. The growing competitive pressure has also triggered a wave of restructuring and mergers and alliances among securities markets to maximize economies of scale, accessibility and market reach, while providing global trade facilities through around the clock trading.

For instance: (i) Euronext was established by the merger of former national exchanges in France, the Netherlands, Belgium and Portugal and the integrated equity trading markets of the northern-European countries of Sweden, Finland, Denmark and Norway; (ii) in the derivatives markets, a/c/e, the trading platform of Eurex and Chicago Board of Trade (CBOT), and Globex (Chicago Mercantile Exchange, Liffe, Singapore and others), have already formed global alliances with participants from all time zones, thus creating 24 hour trading markets; and (iii) NASDAQ has developed global alliances/interconnections to attract more liquidity for the United States and regional securities markets. NASDAQ has structured agreements with Europe, Japan, Hong Kong and Canada and is positioned for similar arrangements with China, Latin America and Middle East. In Asia, several exchanges have trading links and dual-listing agreements with the United States-based NASDAQ. 2 Global Finance Staff Research. 2002. National Association of Securities Dealers (NASD). JP Morgan, H. 6 Demutualization of Asian Stock Exchanges—Critical Issues and Challenges The market integration has encouraged a process of disintermediation.

With the emergence of new structures, there is no need for formal floors of stock exchanges or financial market intermediaries and participants, as they do not add value (to match the cost) to trading of securities. Exchanges with low market capitalization and weak trading volumes have had to particularly re-examine their operations and organizations with the view to increasing their competitive offering and price mix to minimize further diversion of trading volumes. Summarizing the emerging issues, a recent World Bank study3 concluded that: " Powerful trends of internationalization and migration of order flow are putting pressures on stock exchanges around the world. For some exchanges, already more than half of trading and listing has migrated offshore… Migration makes it difficult for countries to sustain a full-fledged local stock exchange.

As trading volumes further decrease, financing the fixed overhead of maintaining market oversight, clearing and settlement systems, … and generating enough business for local investment banks, accounting firms, and other support services will become even harder, especially for smaller emerging markets. The trend towards increased migration will thus make it more difficult for small exchanges to survive. " [page 18] In order to survive in this environment, exchanges need to diversify and move towards commercially oriented business practices with greater focus on improving efficiency, accessibility and ease of use of their systems. Since exchanges have higher overhead costs (as compared to

ECNs) due to (among other things) cost of building and facilities, they need to strive harder to achieve profitability and economies of scale, while offering competitive services and fees compatible to those being provided by the ECNs. These considerations have driven exchanges to consider alliances and consolidation. By merging two exchanges, the exchange can multiply the volume at the same overhead cost (provided cost cutting synergies are fully explored). It can thus offer to the investors and brokers more listed securities for trading on the same platform. There are forecasts available that indicate that by 2010, there will be fewer than five major stock exchanges; and, perhaps two or three of these will be entirely electronic markets—which have not yet been established. 4 3 4 Claessens, Stijn, et. l. 2002. Explaining the Migration of Stocks from Exchanges in Emerging Economies to International Centers. World Bank Working Paper No. 2816. Young, Patrick. 1999. Capital Market Revolution: The Future of Markets in an Online World. Harlow: Financial Times. 7 Part I: Issues Involved in Stock Exchange Demutualization 1. 4 From Mutuality to Demutualization of Exchange The transformation of exchanges from mutual to demutualized structure involves two key features:

(i) a change in the ownership structure, and (ii) a change in legal as well as organizational form. Both need to be accompanied by adequate safeguards to ensure appropriate governance.

Depending on the nature of ownership and legal forms adopted, the demutualized exchange—given their corporate model and facing growing competitive pressures—lends itself to focusing on evolving strategic positioning which, depending on a number of conditions, could involve greater market consolidation, vertical integration and product diversification. 1. 4. 1 Ownership Structure The transformation from the mutual member-based to demutualized exchange involves issues of transferability of ownership from members to nonmembers. There are various ways that dilution of membership can be achieved. Sequentially, it involves conversion of existing member seats by monetizing these and assigning a certain value per seat.

Once the valuation is done, the members can opt to convert their membership to share ownership or to sell off their interest to nonmembers. In most cases of demutualization of exchange, members have opted to retain their share ownership. A listing of equity shares in the exchange facilitates the unlocking of the members' equity and buy out of the interest of the traders, while leading to the monetization of the value of the members' seats. An entity with freely transferable shares, rather than membership rights, can form equity-swap-based strategic alliances or mergers with other exchanges, domestically or in other countries or time zones. Such alliances are stronger and offer greater credibility than pure cooperation agreements.

To avoid stock exchanges operating in special or limited interests, securities regulators often place restriction on ownership by one holder or a group of holders to non-controlling stakes of 5-10%. Limits on ownership stakes could affect potential take-over by other exchanges. Such take-overs could have merit in terms of efficiency and economies of scale of the market especially where more efficient participants acquire inefficient ones. Recognizing the synergies of take-overs, most demutualized exchanges have provisions in place to allow other 8 Demutualization of Asian Stock Exchanges—Critical Issues and Challenges exchanges, or technology partners, the possibility of acquiring or swapping strategic stakes.

The reluctance to relinquish control to strategic partners or owners remains however one reason why non-equity, swapbased cooperative alliances have been more prolific in the exchange industry. 5 Indeed, several hostile take-over attempts (including OM Gruppen's moves to acquire the London Stock Exchange in 2000, and the bidding war for Sydney Futures Exchange by Australian Stock Exchange and Computershare in 1999) have failed due to the voting strength still exerted by the brokers (Table 1. 1). 1. 4. 2 Legal and Company Structure Most stock exchanges are registered as private limited companies with a paid-up capital base, while others operate as member associations or cooperative arrangements.

At the end of 2000, FIBV statistics indicates that 90% of its member exchanges, accounting for 60% of market capitalization, were private limited companies. Almost 46% of these were legal company exchanges with inside ownership. Around 25% (accounting for 21% of market capitalization) of the exchanges had been privatized, 13% (accounting for 8% of market capitalization) were registered as listed companies6 and the remaining 17% had other types of status—with some being state-owned or semi-public entities (such as the Shenzhen and Shanghai Stock Exchanges (SZSE and SHSE). As evident in Table 1. 2, in Asia, with the exception of SZSE and SHSE, most of the exchanges are legal entities registered as private limited companies.

So far, five exchanges in Asia have been fully demutualized, with three of these listed on their own exchange, and another two have announced plans to demutualize in 2003. The legal structure for the demutualized exchange is based on considerations similar to that for any profit-making company including decisions on number of shareholders (partnership vs. corporation), voting procedures, limitation of liability (liability limited to equity invested vs. joint and several liability for all debts), accounting and reporting requirements (based on taxation laws and on partners/shareholders' access to information of the company) and distribution of dividends (re-investment 5 6

Interestingly, this is similar to another rapidly globalizing industry with national quasimonopolistic companies—the airline industry—in which global cooperation alliances have proven very important for customer retention. Notably half (of six) of the exchanges that have listed themselves are in Asia. 9 Part I: Issues Involved in Stock Exchange Demutualization Table 1. 1. Asian Stock Exchanges: Shareholding Structure SHAREHOLDING LIMIT Australian Stock Exchange (ASX) Initially maximum shareholding limit was 5%, but the Financial Services Reform Act raised this to 15% in March 2002. Higher shareholding can be allowed if it is in national interest subject to approval of the Minister for Financial Services and Regulation.

Singapore Exchange Limited (SGX) Maximum shareholding limit is 5% and can be higher if approved by the Monetary Authority of Singapore (MAS). In 2001, MAS announced that, with its approval, strategic investors and fund managers who invest pools of consumer funds could acquire up to 10% of share-holding. SHAREHOLDING STRUCTURE As of June 2001, issued and paid-up capital of ASX amounted to A$106, 282, 000. After listing, ASX's shareholders rose from 606 to 16, 313. Besides individual investors, the large domestic and international fund managers subscribed to ASX equity including Chase Manhattan Nominees Ltd. whose holding is 6. 9%, National Nominees Ltd. 3. 5%, followed by AMP Life Ltd. (2. %), Westpac Custodian Nominees Pty. Ltd. (2. 11%) and Citicorp Nominees Pty. Ltd. (2. 07%). The top 20 shareholders account for 27. 3% of issued capital. SGX has authorized share capital of S$1, 000, 000, 00. As of August 2001, its issued and paid-up capital stood at S$10, 000, 000. The top shareholders include SEL Holdings Pte. Ltd with 25% of total shares (but owing to the restrictions in the exercise of votes attached to shares, SEL is not regarded as a substantial shareholder), Raffles Nominee Pte. Ltd. (12. 9%), followed by DBS Nominees Pte. Ltd. (9. 9%), Overseas-Chinese Bank Nominees Ltd. (5. 3%) and HSBC Singapore Ltd. and Citibank Singapore (each over 4. %), and others with significant stake in the range of 0. 60-2%. The top 20 shareholders account for 77. 8% of total shares. Out of the shares issued to SEL, the Company made an Initial Public Offer (IPO) and a private placement. The IPO raised S$470 million. Consequently, the issued and fully paid share capital of SGX increased from S$61, 670 as at 30 June 2000 to S$10 million as at 16 November 2000. HKEx has authorized share capital of HK$2, 000, 000, 000. As of December 2001, issued and fully paid capital amount to HK$1, 040, 664, 846. As of March 2002, the two Central Clearing and Settlement System (CCASS) Participants held 28. 8%, and 12. 1% of HKEx's issued share capital.

SFC granted approval to these two entities as minority controllers of HKEx on the basis that the shares are held in custody for their clients. Hong Kong Exchanges and Clearing Limited (HKEx) Maximum shareholding limit is 5%. The Securities and Futures Commission (SFC), in consultation with the Finance Secretary, may give approval to a person to hold more than 5% where it can be demonstrated to be in the interest of the public or the investing public. Philippine Stock Exchange (PSE) The Securities Regulation Code imposes a 5% maximum shareholding limit for individuals and individual companies and 20% for industry or business groups. The demutualized PSE has an authorized capital stock of P36. million, with subscribed and fully paid-up capital base of P9. 2 million representing a portion of the members' total contribution of P286. 6 million as of 31 December 2000. Each of the 184 member-brokers was granted 50, 000 common shares of the new PSE at a par value of P1. 00 per share. The remaining members' contribution of P277. 4 million will be booked under additional paid-in surplus. Prior to demutualization, TSE had a capital of Y11, 500 million. After demutualization, TSE raised it to Y22, 874 million by issuing 2, 300, 000 shares for equal allotment to its members. The total number of authorized shares after demutualization is 9, 200, 000. TSE now has 114 shareholders.

Tokyo Stock Exchange (TSE) Under the Securities and Exchange Law, there is a 5% maximum shareholding limit. Source: Stock Exchanges. Latest Annual Reports 10 Demutualization of Asian Stock Exchanges—Critical Issues and Challenges Table 1. 2. Asian Stock Exchanges: Legal and Corporate Structure STOCK EXCHANGE TSE LEGAL FORM TSE was demutualized on 1 November 2001 Legal Status: Company SGX was demutualized in December 1999 Legal Status: Company (for profit). Singapore Exchange Securities Trading Limited (SGX-ST), the stock exchange, is a wholly-owned subsidiary of SGX. HKEx was demutualized in March 2000 Legal Status: Company (for profit) with the Stock Exchange of Hong Kong Limited (SEHK) set up as a wholly- owned subsidiary of HKEx.

ASX was demutualized on 13 October 1998 Legal Status: Company (for profit) LISTING STATUS Not listed (plans to list in FY2005) SGX On 23 November 2000, the Company was admitted for listing of SGX-ST. SGX became a public-listed company with 1, 000, 000, 000 ordinary shares outstanding. HKEx Listed ASX ASX was listed on its own exchange on 14 October 1998. When ASX shares were quoted on 14 October 1998, they closed at A$4. 25; sub-sequently they rose as high as A$16 by 16 March 1999. By the end of 1999, they traded at a range of A$10 to A$11, valuing the company at between A$1 billion and A$1. 1 billion. Not Listed PSE PSE was demutualized in August 2001 Legal Status: Company

Source: Stock Exchanges. Latest Annual Reports needs vs. distribution to partners, taxation). In most jurisdictions, a limited liability company has been observed to be the traditional and preferred option for profit-making ventures involving more than a close group of partners. The methods for transforming an association into a limited liability company varies between jurisdictions, but in principle, the existing members agree to transfer the assets and operations of their association to a newly formed company, in exchange for shares in that new company. 11 Part I: Issues Involved in Stock Exchange Demutualization 1. 5 Benefits of Demutualization of Exchanges 1. 5. Improvements in Corporate Governance Exchanges, when run as mutual associations, clubs and cooperatives of traders and brokers allow members exclusive rights of access to trading systems and platforms. Operating under this mutual structure, exchanges enjoyed quasi or full monopoly on trading and they derived profits from the intermediation of nonmember transactions. Since members under the mutual structure were owners of the exchange, they imposed rights to trading and disallowed direct access to the trading floor to any outsiders. Brokers inadvertently resisted changes if these entailed additional costs, loss of revenue or competitive threat.

This resistance eventually impeded the ability of the company to react quickly to a rapidly changing market environment. Also, in some developing countries if the exchanges enjoyed a legal or decreed national monopoly, government-appointed officials and stakeholder representatives were often represented on the board. While in the short-run such appointments may have proved conducive to mitigating entrenched vested interests, in the long-run these can prove counter productive leading to unhealthy government interference. With the changing economics of automated auction trading and its easy access electronically, the economics of member-cum-trading floor based exchanges has lost its merit.

As a result, it has generated pressures to replace the age-old reliance on one member, one vote and the committee-based decision structure where control is vested with the interest groups that have exclusive rights of intermediation at exchange. Under demutualization, there is increased acceptance to separation of ownership from membership that automatically provides trading rights. This segregation helps introduce effective corporate governance if: (i) there are accompanying improvements in the incentive structure, 7 which allow the exchanges to sell their equity stakes to nonmembers and outsiders, (ii) decision making is based on this new ownership structure (not on rights of intermediation), and (iii) when there is an effective oversight of a governing board and a company structure. 7 Steill Ben 2002.

Changes in the Ownership and Governance of Securities Exchanges: Causes and Consequence. In Brookings-Wharton Papers on Financial Services. Washington D. C. : Brooking Institution Press. 12 Demutualization of Asian Stock Exchanges—Critical Issues and Challenges Since under demutualization the economic ownership of the exchange is separated from trading membership, it is not appropriate that interest groups (such as the trading members) have exclusive authority over the decisions of exchange. After demutualization, some exchanges have granted less than 50% of the voting rights to the broker members on the board of the exchange (see Table 1. 3).

To gradually decrease broker influence on the board, the exchanges have appointed independent directors or directors that are nontrading owners. After demutualization, the appointment of government appointed officials (a common feature of exchanges in developing economies) has by and large been viewed as controversial given that the demutualized exchange is a private sector company operating in a competitive environment. In environments where broker influences are often daunting, the continued role of the representative(s) of the securities regulator can support the transition of exchange till such time as the regulation is changed to allow the exchanges to operate in a fully competitive manner.

Besides appropriate board representation, it is important that the management of the exchange is fully qualified and motivated to act not only in the best interests of the shareholders, but also to conduct the business in a prudent manner so as not to disrupt the orderly and fair trading in the capital markets. To ensure that this public interest is satisfied, " fit-and-proper" screening of the board and management, similar to tests put in place in the banking regulations of many jurisdictions, could be undertaken. The management should be accountable to the board, which would determine management's appointment and remuneration, supervise the strategic direction and audit the financial and operational results, including risk management, and if needed, effect the removal of management.

To ensure the effective supervision and auditing of management, it would seem prudent to ensure that a majority of board members are truly independent directors. To remain competitive, a stock exchange must follow international best practices in ethics and procedures. This is necessary in order to ensure that institutional investors do not shift their investments to other alternatives perceived to be more fair or secure. Therefore, it is in the profit-motivated exchange's best interest to ensure fair and transparent practices; and, as such, good corporate governance needs to be an integral part of the exchange once it is driven by the profit motive. 13

Part I: Issues Involved in Stock Exchange Demutualization Table 1. 3. Asian Stock Exchanges: Board Representation STOCK EXCHANGE ASX BOARD REPRESENTATION/COMPOSITION 9 member board of directors. Of ASX's 9 directors, 4 are ASX Members/ Affiliates. 11 member board of directors. Of SGX 11 directors, 4 represent broker interests. SGX plans to broaden membership base by attracting new international members both global and regional securities houses. In addition, SGX will be introducing a new membership structure that allows new and existing members to choose between trading-only membership or clearing-only membership or both trading and clearing membership. Central Depository Pte. CDP) clearing rules have been revised to incorporate the admission requirements and expect to launch the new membership structure in the third quarter of 2002. The board comprises 8 Public Interest Directors appointed by the Financial Secretary to represent public and market interests, 6 Directors elected by shareholders, and the Chief Executive of HKEx who is an ex-officio board member. Pursuant to the Exchanges and Clearing Houses (Merger) Ordinance, the number of Public Interest Directors will be reduced to no more than the number of elected Directors immediately following the annual general meeting of HKEx in 2003. 51% of the board (8 of 15 directors) should be independent. 11 member board of directors, of whom 6 are outside directors. SGX HKEx PSE TSE

Source: Stock Exchanges. Latest Annual Reports 1. 5. 2 Opening Up of Trading Rights of Exchanges Consistent with the for-profit motive, the demutualized exchanges in Asia have included provisions to admit new trading partners (Table 1. 4) and permitted eligible applicants (new customers) unrestricted commercial access to the services of exchange. Some exchanges, however, adopted a moratarium period on the issuance of new trading rights. If share ownership were a requirement for trading membership, it would be relatively easy for existing members to protect their market share by refusing to sell existing or issue any new shares, thus barring new entrants.

If new shares can only be issued to the active trading members, then the public, financial institutions, institutional investors and others would generally not be able to invest. The question of a broader ownership 14 Demutualization of Asian Stock Exchanges—Critical Issues and Challenges Table 1. 4. Asian Stock Exchanges: Trading Rights and Dividend for Profit-Seeking STOCK EXCHANGE ASX TRADING RIGHTS Trading rights may be acquired through application with ASX or from an existing Participant. Trading rights have to be acquired through application with SGX, as these cannot be secured through transfer from an existing member. In July 2000, SGX opened the securities market to new members, and five new member firms joined in 2000.

SGX also changed its rules to allow a single legal entity to be a member firm in each of the securities and derivatives markets thereby furthering their members' opportunities to trade in both markets. Access to the markets may be obtained through acquisition of trading rights from existing members of the exchanges and from HKEx after the expiry of a two-year moratorium on March 2002. Trading rights issued by HKEx (other than those automatically conferred to the exchange shareholders on the effective date) will not be transferable. For a further period of 2 years thereafter, no new trading rights will be issued for less than HK$3. 0 million per Stock Exchange Trading Right or for less than HK$1. 5 million per Futures Exchange Trading Right.

An entity may acquire trading right from an existing trading participant (with approval of TSE), or through application with TSE. Trading right can be acquired through purchase from an existing trading participant. PSE temporarily imposed a moratorium on the issuance of new trading rights and limits it to its present number of 184, transferable for an unlimited period of time. PAYOUT RATIO 70% of net profit after tax. 85% SGX HKEx 46% TSE n. a. PSE n. a. Source: Stock Exchanges. Latest Annual Reports base of the exchange (as a public listed company) is critical in situations where exchanges need to raise funds for future investments. Broader ownership would help avoid potentially large swings in the value based on the trading of a limited number of shares only.

With share ownership separated from the right to trade, the question of the compensation of existing trading members arises especially since trading rights are granted freely to new members when the existing 15 Part I: Issues Involved in Stock Exchange Demutualization members had to acquire their trading memberships. If existing shareholders continue to retain their shares, then they would enjoy the trading rights granted to the shareholders and there would be no need to compensate them for trading rights. This is argued largely because for both the old and new shareholders, the economic value that the shares now represent would always be inclusive of the right to trade provided such rights have been granted.

In order for shares to have economic value, there must be an expectation of dividends, at some point in the future. The introduction of a dividend policy (which does not exist in mutual exchanges), coupled with a listing of the shares, thus transfers the value of stock exchange share ownership from the right to trade, to the right to receive dividends and trade the shares (see Table 1. 4). These factors should in theory minimize the resistance to the demutualization of exchanges by the brokers. However, a moratorium (limited in time) on the granting of new trading rights has often been introduced to lessen the competitive impact on smaller brokers. 1. 5. Restructuring and Alliances of Exchanges After being demutualized, most exchanges have revisited their commercial strategy to improve viability and enhance business prospects. Exchanges have opted to: (i) consolidate, merge and/or integrate their domestic markets; (ii) build alliances by establishing cross-border linkages with other exchanges within or outside the region; and (iii) merge with other exchanges—a phenomena more predominant thus far in Europe. In Asia, the exchanges have by and large opted thus far for (i) and (ii). Emphasis has been largely to re-group businesses to broaden the markets, offer issuers and investors better distribution networks and improved liquidity.

Predominant in-country mergers or restructuring have taken place in Singapore, Hong Kong, Australia and Japan, and in early 2002, the Kuala Lumpur Stock Exchange (KLSE) merged with MESDAQ (Table 1. 5). In-country restructuring of exchanges has involved: (i) Merger of two or more exchanges into a single viable nationallevel company, which would be of sufficient scale to be an interesting partner for other (foreign) exchanges, and as a listed company for investors to consider. While these mergers lead to 16 Demutualization of Asian Stock Exchanges—Critical Issues and Challenges Table 1. 5. Asian Exchanges: Mergers and Alliances STOCK EXCHANGE TSE MERGERS PRIOR TO DEMUTUALIZATION Hiroshima and Niigata Stock Exchanges merged with the TSE in March 2000. ALLIANCES W