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Demutualization of Asian Stock Exchanges—Critical Issues and Challenges

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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

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in technology that 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

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).

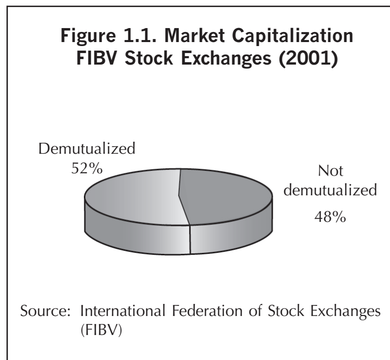

Figure 1.1. Market Capitalization FIBV Stock Exchanges (2001)

Source: International Federation of Stock Exchanges (FIBV)

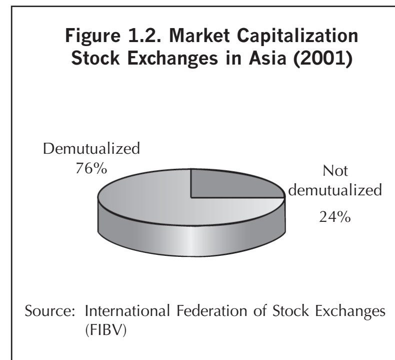

Figure 1.2. Market Capitalization Stock Exchanges in Asia (2001)

Source: International Federation of Stock Exchanges (FIBV)

1.3 Motivation and Driving Factors for Demutualization

Today, exchanges are no longer the sole primary and secondary market 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

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.

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[2] Global Finance Staff Research. 2002. National Association of Securities Dealers (NASD). JP Morgan, H&Q.

The market integration has encouraged a process of dis-intermediation. 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 study[3] 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]

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3 Claessens, Stijn, et. al. 2002. Explaining the Migration of Stocks from Exchanges in Emerging Economies to International Centers. World Bank Working Paper No. 2816.

4 Young, Patrick. 1999. *Capital Market Revolution: The Future of Markets in an Online World.* Harlow: Financial Times.

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

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, swap-based 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 companies[6] 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 Interestingly, this is similar to another rapidly globalizing industry with national quasi-monopolistic companies—the airline industry—in which global cooperation alliances have proven very important for customer retention.

6 Notably half (of six) of the exchanges that have listed themselves are in Asia.

Table 1.1. Asian Stock Exchanges: Shareholding Structure

SHAREHOLDING LIMIT	SHAREHOLDING STRUCTURE
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.	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. (2.6%), 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.
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.	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 4.0%), 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.
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.	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.
Philippine Stock Exchange (PSE) The Securities Regulation Code imposes a 5% maximum share-holding limit for individuals and individual companies and 20% for industry or business groups.	The demutualized PSE has an authorized capital stock of P36.8 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.
Tokyo Stock Exchange (TSE) Under the Securities and Exchange Law, there is a 5% maximum shareholding limit.	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.

Source: Stock Exchanges. Latest Annual Reports

Table 1.2. Asian Stock Exchanges: Legal and Corporate Structure

STOCK EXCHANGE	LEGAL FORM	LISTING STATUS
TSE	TSE was demutualized on 1 November 2001 Legal Status: Company	Not listed (plans to list in FY2005)
SGX	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.	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	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.	Listed
ASX	ASX was demutualized on 13 October 1998 Legal Status: Company (for profit)	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.
PSE	PSE was demutualized in August 2001 Legal Status: Company	Not Listed

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.

1.5 Benefits of Demutualization of Exchanges

1.5.1 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.

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[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.

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.

Table 1.3. Asian Stock Exchanges: Board Representation

STOCK EXCHANGE	BOARD REPRESENTATION/COMPOSITION
ASX	9 member board of directors. Of ASX's 9 directors, 4 are ASX Members/ Affiliates.
SGX	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.
HKEx	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.
PSE	51% of the board (8 of 15 directors) should be independent.
TSE	11 member board of directors, of whom 6 are outside directors.

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

Table 1.4. Asian Stock Exchanges: Trading Rights and Dividend for Profit-Seeking

STOCK EXCHANGE	TRADING RIGHTS	PAYOUT RATIO
ASX	Trading rights may be acquired through application with ASX or from an existing Participant.	70% of net profit after tax.
SGX	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.	85%
HKEx	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.	46%
TSE	An entity may acquire trading right from an existing trading participant (with approval of TSE), or through application with TSE.	n.a.
PSE	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.	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

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.

1.5.3 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 national-level 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

Table 1.5. Asian Exchanges: Mergers and Alliances

STOCK EXCHANGE	MERGERS PRIOR TO DEMUTUALIZATION	ALLIANCES WITH OTHER EXCHANGES
TSE	Hiroshima and Niigata Stock Exchanges merged with the TSE in March 2000.	NYSE, CME, American Stock Exchange (Amex), Korea Stock Exchange, Stock Exchange of Thailand (SET), ASX, PSE, SGX, KLSE, HKEx, Taiwan Stock Exchange (TSEC)
SGX	Stock Exchange of Singapore and SIMEX merged under a holding company, SGX.	ASX, TSE, Amex, CME/ Globex, National Stock Exchanges of India
HKEx	Consolidation of the Hong Kong Stock Exchange, Hong Kong Futures Exchange and Hong Kong Securities Clearing to form a holding company structure.	NASDAQ, Sydney Futures Exchange, MOU with ASX, SET, KLSE, Luxembourg Stock Exchange
ASX	ASX has evolved from amalgamation of six regional stock exchanges.	NASDAQ, MOU with HKEx, JSX, Korea Stock Exchange, KLSE, PSE, TSEC, TSE, SET and SGX
PSE	PSE was established by the merger of Manila Stock Exchange and Makati Stock Exchange in 1992.	MOU with TSE and ASX
TSEC	"Transferred" 55 listed companies of ROC over-the-counter Securities Exchange (ROSE) to TSEC in 2001.	MOU with ASX, SET, Korea Stock Exchange and TSE
SHSE	Plans exist to merge the Shanghai Stock Exchange and Shenzhen Stock Exchange.	Talks with Euronext started
SZSE	Plans exist to merge Shanghai Stock Exchange and Shenzhen Stock Exchange.	
KLSE	MESDAQ merged with KLSE in early 2002. Subsidiaries: Malaysian Derivatives Exchange (KL Options and Financial Futures Exchange merged with Commodity and Monetary Exchange of Malaysia) Labuan International Financial Exchange	No alliances outside of Malaysia—terminated agreement with Singapore allowing trading in Malaysian securities (CLOB) in 1998.
SET	—	MOU with ASX, TSE, TSEC, HKEx
CSE	Amalgamation of the Colombo Brokers Association and the Stock Brokers Association trading floors to constitute the Colombo Securities Exchange Limited in 1985, later renamed Colombo Stock Exchange (CSE) in 1990.	Stock Exchange of Mauritius, Stock Exchange of Mumbai

Source: Stock Exchanges. Latest Annual Reports

synergy effects on the cost side, they tend to reduce possible competition in the domestic market. Thus, the effect of the merger can in some cases nurture monopolistic behavior, at least until new entrants appear or until domestic companies can be traded on exchanges domiciled in other jurisdictions.

(ii) Consolidation of same-market exchanges, whether domestic or regional, is part of a global trend where the minimum economic scale of the exchange increases as trading fees decrease with competition. The lower the fees an exchange can charge, the higher the necessary trading volume to stay profitable.

(iii) Vertical integration of the clearing, settlement and depository institutions with the exchanges helps to guarantee the availability of those functions in-house and provides for alternate source of revenues, while supporting cost reductions that lower the overall transaction cost to investors. This vertical integration could, however, potentially reduce the competitive threat by attempting to restrict access to the clearing functions in the country to any potential new entrants.

(iv) Merger of different types of markets such as the derivatives and cash markets or equity, bond, derivatives, and commodities markets have led to economies of scale. Mergers of this nature have been driven by a combination of factors including, economies of scale, cost cutting in administrative functions, "one-stop-shopping" for investors and brokers, as well as product development potential.

After demutualization, some regional exchanges such as the SGX and HKEx have taken a wide range of initiatives. For instance, SGX has developed cross linkages with Japan, NASDAQ and Australia, and SGX has provided global access to Singapore Exchange Derivatives Trading Ltd. (SGX-DT) electronic trading system to provide on-line access for both trading of domestic and international securities, offered Exchange Trade Funds and effectively integrated the settlement infrastructure to the central depository to facilitate straight through processing. On 1 July 2002, SGX offered a new real-time multi-level data system that allows investors to access full order book information on the SGX securities market, on a subscription basis. The greater transparency and the enhanced price discovery process offered by the system will enable investors to make better-informed decisions.

In order to remain competitive, exchanges need to continually restructure and upgrade themselves based on the latest technological advancements in trading and information dissemination technology. Members of mutual exchanges have been unable or unwilling to commit to such investments. A profit-making exchange with transferable (and listed) shares would be able to access a broader investor base for such funds.

1.6 Regulatory Oversight: Challenges and Responses for Demutualized Exchange

1.6.1 Regulatory Framework for Exchanges

The securities market regulation is critical to ensure efficiency, integrity and fairness of the markets that together lend credibility to markets and safeguard investor interest and confidence. To achieve this, the regulators have to perform adequate oversight of exchanges in order to deal with: (i) the conflict of interest between owners of exchange and the business they offer, (ii) rules governing primary and secondary market trading, (iii) qualification, operative and ethical practices of market participants in particular brokers and dealers, (iv) investor protection, and (v) transparency of market transactions, etc.

For ensuring confidence, the regulation for securities markets has to be effective and enforced properly. However, regulation should not stifle the economic activity (within firms and across market) or process of resource allocation and/or market and product innovation. Ideally, regulation should be harmonized internationally to avoid migration of trading to weakly regulated jurisdictions and it should nurture competition, be responsive to the new structures and products, and offer better alternatives to firms to mobilize funding and reduce transactions costs, etc.

The role and significance of the regulatory framework and its requirements remain relevant irrespective of whether there is a mutual or a demutualized exchange or whether there is a single or multiple exchanges. Under all circumstances, exchanges ought to operate on established criteria as defined in the securities law, and the regulators to retain the authority to license an exchange or to revoke it if it fails to comply with the requirements. Irrespective of the structure of the exchange, national exchanges need to keep in consideration their own

reputational and financial risks associated with a weakly regulated exchange that would ultimately affect own business prospects.

In view of the market challenges, regulators ought to be responsive and supportive of the restructuring of exchanges within the national jurisdiction or formation of their alliances with overseas exchanges that are critical to improve competitiveness and innovation. In the Philippines and some other developing countries, regulators have been instrumental in encouraging a transformation of the existing exchanges given the issues with their governance structure. For instance, the Securities Law issued in 2000, mandated the PSE to demutualize itself by August 2001 and induct non-broker members to its board.

1.6.2 Conflicts of Interest Under Demutualized Exchange

In general, the degree of conflicts at the exchange level exists whether an exchange has a mutual or a demutualized structure, though the nature of the conflicts and responses to addressing these conflicts may differ depending on the type of exchange and the range of businesses it ventures in. In the mutual exchange, the key challenge is how to balance the members (who are owners) interest with that of the public interest of investors and issuers; meanwhile the demutualized exchange has to balance its commercial objectives with those of protecting public interest. In theory, the establishment of a privately for-profit exchange changes incentive structure and operating environment. In some sense, demutualization is perceived as a way to resolution of conflict of interest observed in mutual exchange particularly if the ownership is segregated from the membership and trading rights, and the company structure is set up to subscribe to sound corporate governance principles and to allow proper running of the day-to-day management of exchange. However, demutualization brings with it some new sources of conflict of interests. These are:

First, the exchange's drive for profit is argued by some to carry the risk of increasing the scope and intensity of conflict. For instance, a company aiming to maximize profits and dividends for its shareholders is argued to have:

(i) Less incentive to commit resources for self-enforcement or to take enforcement action against its customers or users who are a source of income.

(ii) Temptation to commercialize services and charge fees for selling of data and trade information that traditionally has been offered free in interest of continuous disclosure that is central to market integrity. ASX came under severe criticism in its inquiry over selling of the range of all ordinaries index that tracked market movements. Standard and Poor's (S&P) has sought license to use this information. While demutualized exchange sees market information as an asset to generate return, the investors perceive it as critical for public interest.

(iii) Resulted in some exchanges undergoing transformation to suspend trading in the liquid products listed on its market that would impact the transaction fees such trading would generate.

However, proponents of demutualization argue that such exchanges have greater competitive advantage and resources to devote to regulation than the member-based exchanges given the latter's predominant emphasis on protecting the self-interest of members. Viable competitors—domestic and international exchanges—who have to manage business effectively in order to be competitive will end up upholding the reputation of the exchange and implicitly serving public interest. In addition, the market pressures in a demutualized exchange would ensure that the company strives to be competitive by upholding principles of market integrity and transparency and by maintaining cost effectiveness and efficiency in the primary and secondary market regulation.

Second, the self-listing of the public issue on its own exchange can pose issues of conflict of interest if listing standards and its oversight are compromised by the exchange concerned. Recognizing this, most of the Asian exchanges have developed specific arrangements and memoranda of understanding for regulating and oversight of self-listing (for examples, see Box 1). The common approach has been to lay down a credible approach and proper regulatory standards to avoid conflict of interest at exchange level in relation to its own prospective listing. Generally, the securities regulator have all the powers and functions that an exchange has in relation to listed issuers except for an exchange's power to make listing rule. The listing standards for exchanges have to be the same as for other listed companies and the listing fee for the exchange has to be determined and collected by the securities regulator. Although the stock exchanges serve as the front line regulators, they are obligated to take

Box 1: Self-Listing Arrangement for Demutualized Exchange

In November 2000, the Monetary Authority of Singapore (MAS), Singapore Exchange (SGX)—the holding company—and the Singapore Exchange Securities Trading (SGX-ST) signed a Deed of Undertaking to develop a cooperative working relationship between these three entities for oversight of self-listing keeping in place adequate oversight. Under this, SGX-ST is the front line regulator for firms listed on the exchange and SGX is subject to same listing rules and regulations as applicable for other listed companies. MAS enjoys full powers in relation to listing of the SGX and it retains the option to approve or reject (in case of noncompliance with SGX-ST regulations) the application of listing.

The Australian Stock Exchange (ASX) applied to the Australian Securities and Investments Commission (ASIC) for self-listing. Both have entered into a number of MOUs over the 1990s that define ASX's obligation to the: (i) listing rules and enforcement of the business rules in relation to ASX's securities, (ii) need for ASX to conform to the Corporations Law as a listed entity, and (iii) be supervised by ASIC to ensure ASX's compliance with the listing rules as a listed entity. To facilitate implementation of various MOUs, a set of administrative letters have been signed between ASX and ASIC, and the Australian Settlement and Transfer Corporation (ASTC) and ASIC, defining decision making steps involved in the process application and associated action.

ASX is obligated to pay listing fees to ASIC. ASC provides its licensed software to ASIC for surveillance of the quoted securities of ASX as self-listing exchange. ASTC is obligated to supervise and provide an audit report to ASIC on the conformity of ASX with the SCH Business Rules.

action as required by the securities regulators for admission, suspension or removal of listing on stock exchange, put in place procedures to deal with the conflicts of interests that may arise, and ensure complete disclosure of listing.

Finally, demutualization triggered extensive debate on the merits of self-regulation. Questions have been raised on inherent conflicts of interest that self-regulatory organizations (SROs)—which in some cases could be stock exchanges—face in their dual roles as market operators and regulators. On the part of exchanges, there have been concerns

regarding the direct costs to the exchange of implementing the supervisory framework and indirect costs associated with a perceived lack of flexibility and management of authorization and approval process. Critics outside exchanges raise doubts regarding the ability of SROs to regulate members with which they compete and there are perceptions that SROs might abuse its regulatory authority, e.g. through rule making processes, disciplinary actions, use of in proprietary information and unfair practices vis-à-vis competitors it regulates. In the United States, market participants have also complained of regulatory inefficiencies that have emerged because the broker-dealers are subject to the multiple SROs that have different rules and examination standards.

Despite inquiries on these fronts, self-regulation—though riddled with issues of perception—continues to be a preferred mode of oversight as the exchanges or its specialized subsidiaries have the advantage of: (i) proximity to market participants and understanding of supervision of complex nature of industry, products and market; (ii) developing rules and supervisory arrangements that reflect market needs, adopting flexible and effective enforcement and monitoring; (iii) keeping costs of regulation manageable given that exchanges may loose competitive edge; and (iv) having experienced, well funded, independent experts who regulate better than the regulators with little or no experience. Self-policing is critical as the exchange's key business asset is its reputation for integrity and efficiency and not one that it could compromise without threatening the value of its own business.

1.6.3 Regulatory Oversight of Demutualized Exchange

Experience gained thus far has shown that demutualized exchanges have developed different regulatory arrangements and controls. Most exchanges recognize that a publicly traded exchange cannot afford to risk its reputation and market integrity given its implication for business and revenue stream/profits. To address issues and challenges they face, demutualized exchanges have evolved governance structure to lessen the emerging conflict(s) and are adopting a set of regulatory responses. The demutualized exchanges have been observed to pursue different options. For instance, in Australia, stock market regulation is based on a co-sharing regulatory model that involves a combination of statutory oversight provided by the ASIC and by the ASX Supervisory Review Pty Limited (ASX-SR) to oversee the operations of ASX and its group (Box 2).

Box 2: Role and Functions of ASX Supervisory Review Pty Limited

The Australian Stock Exchange (ASX) established the ASX Supervisory Review Pty Limited (ASX-SR) which initiated operations in March 2001. ASX-SR, is a wholly owned subsidiary of ASX that has been set up to provide oversight of the ASX and its Group. ASX-SR is responsible for the: (i) integrity, efficiency and transparency of ASX's Group and supervision of its markets; (ii) assessment of its obligations as a market operator and clearing house operator; (iii) conducting its supervisory activities ethically and responsibly; (iv) instituting appropriate controls to avoid conflict of interest; and (v) serving as an internal auditor.

In fulfilling this function, ASX-SR is required to review the policies and procedures of the ASX Group, oversee supervision of listed issuers with special identified conflicts with the ASX Group, and provide reports on ASX compliance and conduct. To facilitate the role and function of ASX-SR, ASX is required to furnish all required information and the ASX-SR board can consult with an independent professional adviser to assist with its role. ASX-SR has entered into a formal agreement with ASX and its operating subsidiaries. Under the agreed arrangements, the board of ASX-SR comprises a majority of non-executive independent directors (chosen by ASX) and ASX adequately provides for resources to ASX-SR and imparts its flexibility and independence to perform its oversight function. ASX-SR is dependent on its funding from ASX.

The ASX-SR does not strictly separate market and regulatory roles (as such it varies from the National Association of Securities Dealers (NASD) Regulatory model). ASX-SR is not independent of ASX, although it operates at arms length and serves as an agency that conducts an internal review and audit of ASX. The ASX-SR's role and the supervisory framework as a whole will need to be kept continually under review if ASX continues to enter into cross-border alliances or global linkages. While the legislature envisages that the usual method for addressing conflicts would be through independent supervision arranged by the market operator, it was considered desirable to provide an avenue whereby the Australian Securities and Investments Commission (ASIC) could undertake this function. To achieve this, a new Corporations Regulation has now been introduced. In essence, the regulation allows ASIC to intervene, at the request of a commercial competitor of ASX, and to take a supervisory role where there is a specific and significant conflict, or potential conflict, between the commercial interests of ASX (or a subsidiary of ASX) and its market supervision obligations in dealing with a listed entity that is a competitor.

The regulation provides that a competitor may lodge with ASIC an application asking ASIC, instead of ASX, to make decisions and take action (or require ASX to take action on ASIC's behalf) in relation to the competitor's listing application, or the compliance by the competitor (if already listed) with the applicable listing rules.

ASIC's role and function and its oversight of ASX is defined in an MOU signed between ASIC and ASX. ASIC monitors ASX's compliance with its role and functions and is mandated to audit supervisory arrangements of market operators. ASX supervises the exchange on a day-to-day basis through contractual arrangements with market participants whereby they agree to comply with the rules for admission to and continued participation in trading activity. Besides these rules, ASX and its market participants are subject to legislative requirements of the Corporation Law, Contract Law and the Trade Practices Act that prevent the abuse of market power.

Regulatory working relationship between the Hong Kong and Singapore demutualized exchanges and respective securities regulators are defined to be cooperative. In these cases, the securities regulator closely oversees the prudential and conducts regulation of market participants. Under the regulations, the securities regulators obligates companies to report continuous disclosure and monitors compliance with liquid capital requirements and conducts surveillance on selective basis to ensure that exchange users have in place proper systems of management and control.

Depending on regulatory response of demutualized exchange, the regulators need to position themselves to deal with the new structure of exchange and must keep up with the new market structure and market technology. Generally, regulators need to ensure that stock exchanges operating as limited liability companies in a particular jurisdiction are regulated at par (in terms of conformity of laws and regulations) with the limited liability company operating in other jurisdictions and should not provide privileges to one exchange that its potential competitors may not enjoy. Enforcement cases will become more complicated as market manipulation and other misconduct are now also conducted on the Internet, making it more difficult to be detected.

1.7 Financial Viability of Demutualized Exchange

The principal sources of revenues for exchanges have been membership subscription fees, listing fees, trading charges, services fees including clearing and settlement, depository fees, etc. and charges for other activities such as company news, quote and trade data.

Over the last five years, given the exchanges' move towards for-profit structures there has been a steady rise in revenues of FIBV member

exchanges (growing at a rate of 12.3% per annum) that outpaced their costs (growing at a rate of 10% per annum). In 2000, FIBV member exchanges reported aggregate revenue of US$6.7 billion: of which US$2.9 billion was from trading fees, US$2 billion from services, and US$1 billion from listing fees with the bulk coming from annual fees (see Table 1.6).

In relative terms, the ratio of income from these sources varies somewhat depending on the legal structure of the exchanges. For instance, the legal company exchange derived about 45.5% of revenues from trading charges, while the privatized and limited companies accrued 39-42% of income from it. These exchanges being more service oriented have generated greater revenues from service fees.

In general, mutual associations often charged fees to cover expenses but kept the charges low to serve the interests of member brokers; and expenses were not managed effectively given issues with governance and management. The Cost and Revenue Survey 2000, undertaken by the FIBV (Table 1.6) confirmed that the mutual exchanges and associations were relatively less cost competitive and profitable. Demutualized exchanges, with a new strategic mandate, were the most profitable bourses and earned an average return of 41%.[8]

This is largely because a for-profit exchange strives to keep its cost within manageable level, charges fees to recover its operational costs, and earn a profit margin on top of the costs to replenish reserves, pay for new investments to improve services, and provide dividends to investors. As such the business and financial profile of the demutualized exchange revolves around need to generate profits, while still keeping the fees and charges competitive so as not to impede the flow of business. In any case, a dividend-paying (or at least profitable) exchange, with listed shares, should be able to raise additional funds, if needed, through equity offerings to the general public.

A comparison of trend of operating profit and net income of a few Asian exchanges confirms that the demutualization of exchanges in its initial years have improved the financial viability of the exchange (see Table 1.7). However, these exchanges need to continue to strive to ensure the financial viability is sustainable.

Despite steady growth of the revenues of demutualized exchanges, in recent years the financial viability of exchanges has been of some concern. This is largely because of a combination of factors including

[8] However, if demutualized exchanges function as monopolies, the increase in profitability could arise from their ability to impose high transaction fees.

Table 1.6. FIBV Member Stock Exchanges Analysis of Costs and Revenues, 2000

LEGAL STATUS OF EXCHANGE	TOTAL COSTS		TOTAL REVENUES		RETURN ON SHAREHOLDERS' EQUITY
	(US$M)	%	(US$M)	%	
Legal companies	2,492	36.9	3,220	47.7	13%
Others	649	9.6	950	14.1	13%
Sub-total for non-demutualized	3,141	46.5	4,170	61.8	13% (average)
Privatized exchanges	1,413	20.9	1,951	28.9	26%
Listed exchanges	300	4.4	632	9.4	56%
Sub-total for demutualized exchanges	1,713	25.4	2,583	38.2	41% (average)
Total	4,854	100	6,753	100	

Source: International Federation of Stock Exchanges (FIBV)

Table 1.7. Demutualized Asian Exchanges: Financial Highlights (in millions of local currency)

EXCHANGE/ DEMUTUALIZATION	OPERATING PROFIT		NET INCOME	
	BEFORE DEMUTUALIZATION	AFTER DEMUTUALIZATION	BEFORE DEMUTUALIZATION	AFTER DEMUTUALIZATION
ASX (13 Oct 1998)	A$26.4 (1998)	A$77.9 (2002)	A$16.7 (1998)	A$59.1 (2002)
SGX (1 Dec 1999)	S$37.0 (1999)	S$64.0 (2002)	S$28.0 (1999)	S$60.9 (2002)
HKEx (6 Mar 2000)	HK$557 (1999)	HK$822 (2001)	HK$521 (1999)	HK$740 (2001)
TSE (1 Nov 2001)	Y3,250 (2001)	Y1,308 (2002)	Y2,152 (2001)	Y2,826 (2002)
PSE (8 Aug 2001)	P72.9 (2000)	P17.3 (2001)	P70.1 (2000)	P18.3 (2001)

Note: For the years ending 30 Jun for ASX and SGX, 31 Dec for HKEx and PSE, 31 Mar for TSE.
Source: Stock Exchanges.

growing competition and technology that drives charges and fees lower, and loss of some sources of income because of ongoing exchanges transformation and migration of businesses.

In the presence of ATS/ECNs and virtual exchanges, a for-profit demutualized structure does not guarantee a profitable existence, since the business will soon drift to competitive areas. The ATS/ECNs have indeed driven down the transaction fee on trading—the largest source of revenue for the exchanges. Investors look at transacting at the lowest cost and since the marginal cost of trade on automated trading systems is zero most investors expect that the exchanges pass on this benefit to users. In case of demutualization, exchanges lose membership fees as a source of income and/or the service revenues of exchanges may be lower if the clearing and depository functions are handled by other entities. There is also intense competition for the listing of companies and pressures that exchanges should not perform listing function.

To offset this revenue loss, exchanges are increasingly resorting to retailing price and quote data arising from their securities trading systems. This will serve as a more resilient source of revenue as the dominant exchanges are unlikely to loose their position as the main source of price discovery for the securities they trade.

At the same time, exchanges' costs might rise as pressure increases to supply existing and additional services at international quality levels. If competition takes the trading away from the exchange and if brokers and investors obtain better service at lower prices elsewhere, there may no longer be any economic basis for the exchange. In these situations, the exchange may cease operations, or be taken over by a better operating exchange. Furthermore, exchanges may end up spending more on regulatory oversight, particularly if they retail these services out to independent subsidiaries such as in the case of ASX-SR that is completely dependent on ASX funding.

1.8 Conclusion

There is now a widespread recognition that exchanges are handling commodity business of buying and selling securities.[9] As such, exchanges are increasingly opting to operate as a “firm” that seeks business for profit and gears its business strategy to respond to different competitive forces from the automated proprietary systems including ATS and ECNs, and other international operators. The survival of exchanges is contingent on their ability to generate trading volumes and offer efficient and cost effective execution services.

These factors have required a re-examination globally of the role of stock exchanges and their business relations, model and governance structure. A number of exchanges are transforming from members' associations into for-profit corporations (demutualization); and, in some cases this has involved consolidation and merger with other exchanges and/or with clearing, settlement and depository institutions. The approaches and modalities for restructuring of exchanges have in part differed from case to case depending on prevailing conditions and the degree of success of exchange transformation and alliances whose trends and structure have varied across the globe and region.

In general, the demutualization of the exchanges has been observed to offer a wide range of advantages. It allows exchanges to abolish the members/traders' monopoly over intermediation and be responsive to the needs of its issuers and investors by allowing them direct and cost effective access to exchange. For-profit motive of exchanges allows it to generate the desired levels of investments, while offering appropriate returns to owners. Provided the incentive structure of demutualized exchange is developed effectively, demutualization lends itself to improved governance. This can be achieved through: (i) a shift in the ownership of the exchange from member brokers and dealers to a wider group of investors with adequate safeguards to prevent excessive concentration of ownership and power; (ii) appointment of a professional board and management; and (iii) appropriate investments in automated trading to offer competitive services.

The for-profit exchanges have futher been observed to have adopted strategies and incentives to enhance competitiveness through cost effective measures and broadening and diversification of the revenue

[9] O' Hara, Maureen. 1999. Designing a Financial System for the Millennium. Capital Market Research Center.

base. The corporate culture of demutualized exchanges have been observed to lend themselves better to deploying profits into investments for the modernization of exchanges and improving the SRO functions and performance.

However, there are concerns that demutualized exchanges may have an inherent degree of conflict of interest, given that stricter enforcement of regulations can be costly and may result in loss of business. The loss of investor confidence because of weak regulation may itself lead the exchange to loose its competitive edge. In some instances, exchanges have opted to segregate the market and regulatory roles within their organizational setup or have established a separate but subsidiary corporate entity to handle SRO functions or outsourced this function to an independent entity. Independent of these arrangements, the structure of an exchange can only make a difference if the outfit is well governed and managed efficiently and fairly, while ensuring high standard market surveillance and trade practices monitoring, and effective checks and balances on market participants.

The technicalities and merits of demutualization will evolve as further experience is gained. However, the creation of commercial, for-profit trading exchanges with appropriate incentive structures is of high priority in developing Asian countries where the entrenched vested interests have undermined the opportunities for financial diversification and penalized investors.

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